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2012 ECBC EUROPEAN COVERED BOND **FACT BOOK**

ECBC
European Covered Bond Council
The Covered Bond Voice of the European Mortgage Federation

EUROPEAN MORTGAGE FEDERATION

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Contact Details

Luca Bertalot
Head of European Covered Bond Council
lbertalot@hypo.org

Benjamin Burlat
Economic Advisor
bburlat@hypo.org

Paloma Repullo Conde
Economic Advisor
prepullo@hypo.org

Sophie Blave
Administrative Assistant
sblave@hypo.org

EUROPEAN MORTGAGE FEDERATION/EUROPEAN COVERED BOND COUNCIL
Avenue de Cortenbergh 71
B - 1000 Brussels
Tel: + 32 2 285 40 30

LIST OF EDITORS

Chairman: Wolfgang Kälberer
Head of Brussels Office
Association of German Pfandbrief Banks – vdp
kaelberer@pfandbrief.de

Luca Bertalot
Head of European Covered Bond Council
EUROPEAN COVERED BOND COUNCIL
lbertalot@hypo.org

Benjamin Burlat
Economic Advisor
EUROPEAN COVERED BOND COUNCIL
bburlat@hypo.org

Paloma Repullo Conde
Economic Advisor
EUROPEAN COVERED BOND COUNCIL
prepullo@hypo.org

LIST OF CONTRIBUTORS

We are most grateful for the time, effort and expertise which the following contributors have lent to the production of this study.

FOREWORD

Paul O'Connor
Chairman
EUROPEAN COVERED BOND COUNCIL
paul.oconnor@acsireland.ie

Annik Lambert
Secretary General
EUROPEAN MORTAGE FEDERATION
alambert@hypo.org

Luca Bertalot
Head of European Covered Bond Council
EUROPEAN COVERED BOND COUNCIL
lbertalot@hypo.org

CHAPTER 1
KEY THEMES OF THE YEAR

Alexandra Hauser
Head of Covered Bonds and Financials Credit Research
LANDESBANK BADEN-WÜRTTEMBERG – LBBW
alexandra.hauser@lbbw.de

Uwe Burkert
Head of Credit Research - Managing Director
LANDESBANK BADEN-WÜRTTEMBERG – LBBW
uwe.burkert@lbbw.de

Alessandro Sciamarelli
Head of Statistics
EUROPEAN MORTGAGE FEDERATION - EMF
emfinfo@hypo.org

Leef H. Dierks
Head of Covered Bond Strategy
MORGAN STANLEY (UK)
leef.dierks@morganstanley.com

Jason Somerville
Covered bond analyst
MORGAN STANLEY (UK)
jason.somerville@morganstanley.com

José Sarafana
Credit Sales
Aurel BGC
jsarafana@aureletcp.com

Florian Eichert
Senior Covered Bond Analyst – Credit Research
CREDIT AGRICOLE CIB
florian.eichert@ca-cib.com

Fritz Engelhard
Covered Bond Strategist
BARCLAYS CAPITAL
fritz.engelhard@barcap.com

Jan King
Covered Bond & Supra/Agency Strategist
ROYAL BANK OF SCOTLAND
jan.king@rbs.com

Florian Hillenbrand
Senior Covered Bond Analyst
Director - UniCredit Research - MRE3FI
UNICREDIT
florian.hillenbrand@unicreditgroup.de

Michael Schulz
Senior Director - Head of Fixed Income Research
NORDDEUTSCHE LANDESBANK / NORDLB - GERMANY
michael.schulz@nordlb.de

Ralf Berninger
Head of Origination - Public Sector & Financial Institutions
DEXIA CREDIT LOCAL
ralf.berninger@dexia.com

Sabine Winkler
Covered Bond Analyst
CREDIT SUISSE
sabine.winkler.2@credit-suisse.com

Anne Caris
Director-Covered Bond Analyst
BANK OF AMERICA MERRILL LYNCH (UK)
anne.caris@baml.com

Rondeep Barua
Analyst
BANK OF AMERICA MERRILL LYNCH (UK)
rondeep.barua@baml.com

Heiko Langer
Senior Covered Bond Analyst
BNP PARIBAS - UK
heiko.langer@uk.bnpparibas.com

Franz Rudolf
Managing Director
Head of Financials Credit Research - UniCredit Research
UNICREDIT
franz.rudolf@unicreditgroup.de

Ralf Burmeister
Senior Portfolio Manager
DB Advisors

Nathalie Aubry-Stacey
Director - Market Practice and Regulatory Policy
International Capital Market Association – ICMA
nathalie.aubry-stacey@icmagroup.org

CHAPTER 2
GENERIC SECTION

Ralf Grossmann
Head of Covered Bond - Origination
SOCIETE GENERALE
ralf.grossmann@sgcib.com

Otmar Stöcker
Managing Director
Association of German Pfandbrief banks - vdp
stoecker@pfandbrief.de

Richard Kemmish
Chairman of the Market Related Issues Working Group
EUROPEAN COVERED BOND COUNCIL
richard.kemmish@credit-suisse.com

Florian Eichert
Senior Covered Bond Analyst – Credit Research
CREDIT AGRICOLE CIB
florian.eichert@ca-cib.com

Fritz Engelhard
Covered Bond Strategist
BARCLAYS CAPITAL
fritz.engelhard@barcap.com

Frank Will
Head of Covered Bond & Supra/Agency Research
ROYAL BANK OF SCOTLAND
frank.will@rbs.com

Jan King
Covered Bond & Supra/Agency Strategist
ROYAL BANK OF SCOTLAND
jan.king@rbs.com

Bernd Volk
Director, Head of European Covered Bond & Agency Research
DEUTSCHE BANK
bernd.volk@db.com

CHAPTER 3
THE ISSUER'S PERPECTIVE

AUSTRALIA
Alex Sell
Chief Operating Officer
THE AUSTRALIAN SECURITISATION FORUM - ASF
asell@securitisation.com.au

AUSTRIA
Alexa Mezei
Structurer, Adviser
ERSTE GROUP BANK / AUSTRIAN PFANDBRIEF AND COVERED BOND FORUM
alexa.mezei@erstegroup.com

Friedrich Jergitsch
Lawyer
FRESHFIELDS BRUCKHAUS DERINGER
friedrich.jergitsch@freshfields.com

BELGIUM
Carol Wandels
Senior Advisor
BELFIUS BANK
carol.wandels@belfius.be

BULGARIA
Yolanda Hristova
Manager Capital Markets
UNICREDIT BULBANK

Franz Rudolf
Managing Director
Head of Financials Credit Research - UniCredit Research
UNICREDIT
franz.rudolf@unicreditgroup.de

CANADA
Anne Caris
Director-Covered Bond Analyst
BANK OF AMERICA MERRILL LYNCH (UK)
anne.caris@baml.com

CYPRUS
Doros Theodorou
Deputy Director
Treasury and Capital Markets
CYPRUS POPULAR BANK – GREEK BRANCH
dtheodorou@marfinbank.gr

Dimitris Spathakis
Head of Wholesale Funding
CYPRUS POPULAR BANK – GREEK BRANCH
dspathakis@marfinbank.gr

CZECH REPUBLIC
Pavel Kühn
ČESKÁ BANKOVNÍ ASOCIACE - CZECH BANKING ASSOCIATION
cba@czech-ba.cz

DENMARK
Svend Frost Bondorf
Chief Analyst
NYKREDIT GROUP TREASURY
sbo@nykredit.dk

Mette Saaby Pedersen
Department Manager
ASSOCIATION OF DANISH MORTGAGE BANKS
msp@rkr.dk

FINLAND
Timo Ruotsalainen
Managing Director
AKTIA REAL ESTATE MORTGAGE BANK P.L.C
timo.ruotsalainen@aktia.fi

Bernd Volk
Director, Head of European Covered Bond & Agency Research
DEUTSCHE BANK
bernd.volk@db.com

FRANCE
Cristina Costa
Senior Analyst
NATIXIS
cristina.costa@natixis.com

Boudewijn Dierick
Head of structured covered bonds
BNP PARIBAS
boudewijn.dierick@uk.bnpparibas.com

Francis Gleyze
Chief Executive Officer of CIF Euromortgage
CREDIT IMMOBILIER DE FRANCE GROUP
francis.gleyze@3cif.fr

Henry Raymond
Chief Executive Officer
CAISSE DE REFINANCEMENT DE L’HABITAT
henry.raymond@crh-bonds.com

GERMANY
Wolfgang Kälberer
Head of Brussels Office
Association of German Pfandbrief banks - vdp
kaelberer@pfandbrief.de

Otmar Stöcker
Managing Director
Association of German Pfandbrief banks - vdp
stoecker@pfandbrief.de

GREECE
Alexander Metallinos
Partner
KARATZAS & PARTNERS LAW FIRM

HUNGARY
András Gábor Botos
Secretary General
ASSOCIATION OF HUNGARIAN MORTGAGE BANKS
botos.andras@jelzbank.hu

IRELAND
Nick Pheifer
Head of Legal
DEPFA BANK plcs
nick.pheifer@depfa.com

Sinéad Gormley
Legal Adviser
Group Legal Services
BANK OF IRELAND
sinead_j.gormley@boi.com

ITALY
Alfredo Varrati
Senior Analyst - Credit Office
ITALIAN BANKERS ASSOCIATION
a.varrati@abi.it

LATVIA
Kaspars Gibeiko
Head of the Mortgage Deals Administration
MORTGAGE AND LAND BANK OF LATVIA
kasparsg@hipo.lv

LUXEMBOURG
Reinolf Dibus
Member of the Board of Directors & Managing Director
EUROHYPO Europäische Hypothekenbank S.A.
reinolf.dibus@eurohypo.com

Frank Will
Head of Covered Bond & Supra/Agency Research
ROYAL BANK OF SCOTLAND
frank.will@rbs.com

THE NETHERLANDS
Daniëlle Boerendans
Head, Covered Bonds
ABN AMRO BANK N.V.
danielle.boerendans@nl.abnamro.com

Rezah Stegeman
Advocaat
CLIFFORD CHANCE LLP
Rezah.stegeman@cliffordchance.com

Kees Westermann
Advocaat
LINKLATERS LLP
kees.westermann@linklaters.com

NEW ZEALAND
Frank Will
Head of Covered Bond & Supra/Agency Research
ROYAL BANK OF SCOTLAND
frank.will@rbs.com

Neville Wood
Head of Capital Management & Debt Origination
ASB BANK LIMITED
neville.wood@asb.co.nz

NORWAY
Stein Sjølie
Director
FINANCE NORWAY – FNO
stein.sjolie@fno.no

POLAND
Piotr Cyburt
CEO
BRE BANK HIPOTECZNY
piotr.cyburt@brehipoteczny.pl

Agnieszka Drewicz-Tułodziecka
President
MORTGAGE CREDIT FOUNDATION
a.tulodziecka@ehipoteka.pl

PORTUGAL
Alda Pereira
Capital Markets Funding
CAIXA GERAL DE DEPOSITOS
alda.pereira@cgd.pt

ROMANIA
Irina Neacsu
Head of DCM Department
BANCA COMERCIALA ROMANA SA
irina.neacsu@bcr.ro

Adrian Sacalschi
Deputy Head Frankfurt Branch
FHB BANK
adrian.sacalschi@fhb.hu

Martin Schweitzer
Head of Group Balance Sheet Structuring
ERSTE GROUP / AUSTRIAN PFANDBRIEF AND COVERED BOND FORUM
martin.schweitzer@erstegroup.com

RUSSIA
Tim Lassen
Corporate Banking Continental Europe
Corporate Banking Russia
EUROHYPO AG
tim.lassen@eurohypo.com

SLOVAK REPUBLIC
Viktória Múčková
Mortgage Trustee
CSOB
muckovaviktoria@gmail.com

Jaroslav Sobolič
Investment Banking
CSOB
jsobolic@csob.sk

SLOVENIA
Sonja Anadolli
Deputy Director
BANK ASSOCIATION OF SLOVENIA
sonja.anadolli@zbs-giz.si

SPAIN
Gregorio Arranz
Secretary General
SPANISH MORTGAGE ASSOCIATION - AHE
garranz@ahe.es

SWEDEN
Jonny Sylvén
Head of ASCB secretariat/Senior Adviser
ASSOCIATION OF SWEDISH COVERED BOND ISSUERS (ASCB)
jonny.sylven@swedishbankers.se

SWITZERLAND
Jörg Schmid
Corporate Executive Officer
PFANDBRIEFBANK SCHWEIZERISCHER HYPOTHEKARINSTITUTE
joerg.schmid@pfandbriefbank.ch

Richard Kemmish
Head of Covered Bond Origination
CREDIT SUISSE
richard.kemmish@credit-suisse.com

Ulrike Hock
Director, Covered Bonds, Desk Analyst
UBS DEUTSCHLAND AG
ulrike.hock@ubs.com

TURKEY
Fritz Engelhard
Covered Bond Strategist
BARCLAYS CAPITAL
fritz.engelhard@barcap.com

Batuhan Tufan
Senior Vice President / Financial Institutions
GARANTI BANK
batuhant@garanti.com.tr

Ozlem Gokceimam
Supervisor / Structured Finance
GARANTI BANK
ozlemgokc@garanti.com.tr

UKRAINE
Anton Sergeev
Executive Director
UKRAINIAN NATIONAL MORTGAGE ASSOCIATION
sergeev@unia.com.ua

Arsen Nizelsky
Senior Legal Advisor
UKRAINIAN NATIONAL MORTGAGE ASSOCIATION
nizelsky@mortgage.in.ua

Konstantin Kuczerenko
Legal Advisor
UKRAINIAN NATIONAL MORTGAGE ASSOCIATION
kucherenko@unia.com.ua

UNITED KINGDOM
Jussi Harju
Vice President, European Strategy
BARCLAYS CAPITAL
jussi.harju@barcap.com

John Millward
Director, Structured Finance
HSBC Bank plc
john.millward@hsbcgroup.com

UNITED STATES
Sabine Winkler
Covered Bond Analyst
CREDIT SUISSE
sabine.winkler.2@credit-suisse.com

CHAPTER 4
RATING AGENCIES & METHODOLOGY

Boudewijn Dierick
Chairman of the Rating Agency Approaches Working Group
EUROPEAN COVERED BOND COUNCIL
boudewijn.dierick@uk.bnpparibas.com

DBRS
Keith Gorman
Senior Vice President, U.S. & European Structured Finance
DRBS
kgorman@dbrs.com

Claire Mezzanotte
Managing Director
DBRS
cmezzanotte@dbrs.com

FITCH
Suzanne Albers
Senior Director
FITCH RATINGS
suzanne.albers@fitchratings.com

Hélène M. Heberlein
Managing Director
FITCH RATINGS
helene.heberlein@fitchratings.com

Beatrice Mezza
Senior Director
FITCH RATINGS
beatrice.mezza@fitchratings.com

MOODY'S
Nicholas Lindstrom
Associate Managing Director
MOODY'S INVESTOR SERVICE LTD
nicholas.lindstrom@moodys.com

Jane Soldera
Vice President - Senior Credit Officer
MOODY'S INVESTOR SERVICE LTD
jane.soldera@moodys.com

Juan Pablo Soriano
Managing Director
MOODY'S INVESTOR SERVICE LTD
juanpablo.soriano@moodys.com

STANDARD & POOR'S
Roberto Paciotti
Senior Director, Analytical Manager Covered Bonds
STANDARD & POOR'S
roberto_paciotti@standardandpoors.com

Karlo Fuchs
Senior Director, Analytical Manager Covered Bonds
STANDARD & POOR'S
karlo_fuchs@standardandpoors.com

Nicolas Malaterre
Senior Director, Covered Bond Ratings
STANDARD & POOR'S
nicolas_malaterre@standardandpoors.com

Sabrina Miehs
Director, Covered Bond Ratings
STANDARD & POOR'S
sabrina_miehs@standardandpoors.com

CHAPTER 5
COVERED BOND STATISTICS

Florian Eichert
Chairman of the Statistics & Data Working Group
EUROPEAN COVERED BOND COUNCIL
florian.eichert@ca-cib.com

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and Fritz Engelhard, Barclays Capital

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and Boudewijn Dierick, BNP Paribas

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and Kees Westermann, Linklaters LLP

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FOREWORD

For two and a half centuries, through many crises, Covered Bonds have played an increasing role in the financing of real estate, public sector and ship assets. The crisis that began in 2007 introduced many significant changes. The G20 post crisis reform agenda, launched some years ago, continues to reshape the regulatory landscape for banks. Central banks play a highly proactive role in providing liquidity and are now a major stakeholder in the development of the Covered bond asset class. Investors are asking for more and more information, a demand which is being met by a major initiative to deliver greater transparency by issuers. We are seeing new issuers come to market and new covered bond frameworks being established in many countries.

The covered bond industry's capacity to respond to the challenges of the current crises and its ability to share market best practice creates a dynamic which results in a continuous fine-tuning and updating of national covered bond legislation. This has maintained a high level of quality and transparency of the asset class throughout the present market turmoil, and importantly, has maintained the confidence of investors.

Throughout the past year, the European Covered Bond Council (ECBC) enhanced its role as the industry's leading information platform and discussion forum. Through the activities of its working groups and its Steering Committee, the ECBC enables the covered bond community to share market best practises, analysis of market dynamics and legal issues, and to respond to the current regulatory and market challenges. Moreover, the ECBC provides market participants with increased levels of information via the ECBC Fact Book and the ECBC Covered Bond Comparative Framework Database (www.ecbc.eu).

With over EUR 2.67 trillion outstanding at the end of 2011, covered bonds are playing an important role in the European capital markets, contributing to the efficient allocation of capital and, ultimately, economic development and recovery. The EUR 695 billion issuance and arrival of 30 new issuers during 2011 evidence the ability of the asset class to provide essential access to long-term capital market funding. This is achieved even during volatile market conditions, notably thanks to a stable investor base. Their consistently strong performance and quality features attract the attention of regulators and market participants worldwide, which, in turn, leads to an increasing recognition of the macro-prudential value of the asset class.

Although the origin of the covered bond is linked to the financial traditions of Europe, the strategic importance of covered bonds as a long-term funding tool is recognised at a global level. Several major jurisdictions such as Australia, Brazil, Canada, India, Japan, Mexico, Morocco, New Zealand, Peru, Singapore, South Korea and the United States, are in the process of adopting covered bond legislation or investigating the potential introduction of this funding tool. A key driver of this development is the fact that as a private sector, long-term funding tool, the asset class facilitates lending to the real economy.

The challenge today for the covered bond industry is to assimilate the lessons learnt from the financial crisis whilst reinforcing the essential features and qualities that have made the asset class such a success story.

From an issuer's perspective, covered bonds provide a significant contribution to the enhancement of a banks' funding profile and the management of liquidity. Benefits provided by covered bonds include:

1) adding duration to liabilities, allowing banks to properly match their long-term asset portfolios;
2) providing stability to the funding mix, allowing ALM teams to increase predictability in the maturity profiles;

3) enabling issuers to increase diversification in the investor base, both in terms of geography and investor type; and

4) serving the Industry as one of the most reliable funding tools, even in times of turmoil.

From an investor's perspective, the major strengths and regulatory advantages of the covered bond can be summarised as follows:

1) double recourse to issuer and cover pool;

2) higher rating than unsecured debt;

3) lower-risk weighting for EU/EEA Covered Bonds bought by EU/EEA banks;

4) favourable treatment under Solvency II;

5) generally better liquidity through larger issue size;

6) favourable repo treatment at ECB and other central banks;

7) eligible as liquid assets under upcoming Basel III rules; and

8) no risk of bailing-in.

After several years of turmoil in the financial markets, we need to take the opportunity to increase the resilience of our funding models to protect against future funding crises. As global demand for covered bonds grows, there is a need for vigilance against measures that reduce the quality of the asset class through relaxing asset eligibility criteria or through overextending the dependence of the system on covered bond funding.

Regulation in many European jurisdictions addresses this by establishing clear limits and safeguards for covered bond issuance such as license requirements, imposition of strict collateral asset eligibility criteria and insistence on risk mitigants. These regulatory and/or legal provisions safeguard the interests of depositors and senior debt holders.

In jurisdictions where covered bond legislation is in the process of being adopted, such as Australia, Canada and the United States, regulators and supervisors are drawing from best practices in established covered bond jurisdictions.

The anticipated increase in long-term secured funding needs over the coming years - not only from balance sheet growth but also from regulatory liquidity regimes - will place additional pressure on the funding plans of financial institutions. Such pressures could tempt some market participants to innovate using covered bonds as an all-purpose tool for collateralised funding. We believe that Covered Bonds should be preserved as a quality funding tool for core asset classes.

The covered bond community is developing a quality label for covered bonds. The ECBC Covered Bond Label initiative provides for a greater level of transparency and facilitates access to relevant and comprehensive information for investors, regulators and other market participants. This initiative demonstrates the commitment of the covered bond community to maintaining the quality of the collateral assets, to improving transparency, and ultimately, to the strengthening of secondary market activity.

The Label Initiative, which is based on a national transparency approach, aims to improve access to issuer and bond level information, thereby allowing investors to do their due diligence and reduce their reliance on ratings. Improved market liquidity and higher levels of post-trade transparency will increase the attractiveness of the asset class for investors.

We recognise that it is necessary to respond to the needs of new classes of investors, by achieving higher levels of transparency to help them make their investment decisions. In this respect, we are collating and distributing relevant macro-level information:

> The ECBC website is the primary site for aggregate covered bond market data and comparative framework analysis; and

> The ECBC Fact Book, now in its seventh edition, remains the most widely read source of covered bond market intelligence.

The European Covered Bond Council, which represents over 95% of the covered bond industry, believes that the quality of the asset class should continue to be the basis of our strength in the future. The key to covered bonds' success lies in their simplicity: a classic, plain vanilla instrument, mostly backed by mortgages and/or public sector assets. Strong supervision and the underlying regulatory and legislative framework, designed to assign collateral in case of resolution, are also important features. More work needs to be done, but we believe that the initiatives underway will strengthen the asset class. The increased recognition by policymakers and regulators of the central role that the asset class has for the banking system and also for financial stability reinforces the need for an appropriate regulatory framework for covered bonds at European and international levels.

FACT BOOK

This Seventh Edition of the ECBC European Covered Bond Fact Book builds on the success of previous editions, as the benchmark and the most comprehensive source of information on the asset class. Chapter I presents an analysis of eleven key themes of the year, offering an overview of the industry views on these themes.

Chapter II provides a detailed explanation of covered bond fundamentals, including reviews of some of the current European regulatory changes that are bound to have a direct, significant impact on covered bonds, mainly the Commission's CRD IV Proposal, Solvency II and MiFIR. This chapter also includes articles investigating the relationship between covered bonds and other asset classes such as senior unsecured and government bonds.

Chapter III presents an overview of the legislation and markets in 33 countries. Chapter IV sets out the rating agencies covered bond methodologies and, finally, Chapter V provides a description of trends in the covered bond market as well as a complete set of covered bond statistics.

We welcome the broad range of views expressed in this Fact Book and extend a special thank you to Mr Wolfgang Kälberer, Chairman of the ECBC Fact Book Working Group, for guiding the Fact Book so expertly towards completion, as well as to the members of the "Fact Book" and "Statistics & Data" Working Groups, whose enthusiasm and dedication resulted in this 2012 edition of the ECBC European Covered Bond Fact Book.

Paul O'Connor
ECBC Chairman

Annik Lambert
EMF Secretary General

ECBC
European Covered Bond Council
The Covered Bond Voice of the European Mortgage Federation

ABOUT THE ECBC

By Luca Bertalot, ECBC

The European Covered Bond Council (ECBC) is the platform that brings together covered bond market participants including covered bond issuers, analysts, investment bankers, rating agencies and a wide range of interested stakeholders. The ECBC was created by the European Mortgage Federation (EMF) in 2004. As of August 2012, the Council has over 100 members across 25 covered bonds jurisdictions and many different market segments. ECBC members represent over 95% of covered bonds outstanding.

The purpose of the ECBC is to represent and promote the interests of covered bond market participants at the international level. The ECBC's main objective is to be the point of reference for matters regarding the covered bond industry and operate as a think-tank, as well as a lobbying and networking platform for covered bond market participants.

ECBC STRUCTURE

The Plenary Meeting is a bi-annual discussion forum where all ECBC members gather around the table to discuss issues and to establish strong network links.

The Steering Committee, headed by the ECBC Chairman, and composed of representatives from the major covered bond issuing jurisdictions and industry experts, is responsible for the day-to-day activities of the ECBC. It comes together once every quarter and addresses strategy related questions. Furthermore, it coordinates the agenda of the various working groups.

ECBC WORKING GROUPS

> **The EU Legislation Working Group**, chaired by Mr Frank Will, has over the past five years been closely following the debate on the Capital Requirements Directive (CRD) and has been successfully lobbying at EU level to obtain treatment that recognises the low risk profile of the instrument. In this respect, the group has drafted and passed comments to the European Institutions.

> **The Technical Issues Working Group**, chaired by Mr Ralf Grossmann, represents the technical think thank of the covered bond community, drawing on experts from across the industry to tackle key issues for the industry. Recent work includes covered bond analysts and country experts working together to describe the key features of each covered bond jurisdiction, presented in an easy to use, comparable format on line. The database is available from www.ecbc.eu.

> **The Market Related Issues Working Group**, chaired by Mr Richard Kemmish, discusses topics such as conventions on trading standards and the market-making process. The Working Group is currently leading the discussions on improving liquidity in secondary markets.

> **The Working Group on Statistics and Data**, chaired by Mr Florian Eichert, is responsible for collecting and publishing complete and up-to-date information on issuing activities and volumes outstanding of covered bonds in all market segments. With over 20 different covered bond jurisdictions and numerous issuers, the collection of data is of utmost importance, particularly given that the ECBC data is increasingly viewed as the key source of covered bond statistics.

> **The Fact Book Working Group**, chaired by Mr Wolfgang Kälberer, is responsible for the publication of the annual European Covered Bond Fact Book. This publication covers key themes in the industry, market developments, provides a detailed overview of legislative frameworks in different countries as well as statistics.

> **The Rating Agency Approaches Working Group**, chaired by Mr Boudewijn Dierick, examines the rating approaches applied by rating agencies and has been active over the past year monitoring, analysing and reacting to the changes underway in covered bond rating methodologies.

The ECBC's objective now is to press ahead in its work with a view to further strengthening its role in facilitating the communication among the different covered bonds stakeholders, in working as a catalyst in defining the common features that characterise the asset class and in facilitating improvements in market practices, transparency and liquidity.

More information is available from **http://ecbc.hypo.org/**

Luca Bertalot,
Head of the European Covered Bond Council

ECBC MEMBERS

ABN Amro

AIAF

Aktia Real Estate Mortgage Bank plc

Allen & Overy

Allied Irish Banks Plc.

Asociación Hipotecaria Española

Association of Hungarian Mortgage Banks

Association of Swedish Covered Bond Issuers - ASCB

Associazione Bancaria Italiana - Italian Banking Association - ABI

Banca Popolare di Milano

Banco Espírito Santo

Bank of Ireland Mortgages

Bankia

Barclays

Barclays Capital

Bayerische Landesbank - Bayern LB

Belfius Bank

BGC Partners

Bloomberg LP

BNP Paribas

BNP Paribas Fortis

BPCE

BRFKredit A/S

Caisse Centrale du Crédit Immobilier de France - 3CIF

Caisse de Refinancement de l'Habitat - CRH

Caixa Geral de Depósitos S.A.

Citigroup

Clifford Chance LLP

Commerzbank Securities

Council of Mortgage Lenders - CML

Crédit Agricole Corporate & Investment Bank

Crédit Agricole Home Loan SFH - CM-CIC Home Loan SFH

Crédit Foncier

Crédit Mutuel - CIC Home Loan SFH

Crédit Mutuel Arkéa

Credit Suisse

Danish Ship Finance

Danske Bank

DBRS

Depfa ACS Bank

Deutsche Bank AG

Deutsche Hypothekenbank AG

Deutsche Pfandbriefbank AG

Dexia Municipal Agency

DLR Kredit A/S

DnB NOR Bolligkreditt

Dutch Association Of Covered Bond Issuers (DACB)

DZ Bank

EAA Covered Bond Bank plc.

EBS Building Society

Eurex Bonds

Europäische Hypothekenbank S.A. - EUROHYPOLUX

Eurohypo AG

EuroMTS

Finance Norway - FNO

Fitch Ratings Ltd

GE Money Bank

GOH Portugal

Goldman Sachs

Grupo BBVA

Gruppo Banca Carige

HSBC Bank Plc

ICAP

ING Group

Intesa Sanpaolo

Irish Banking Federation - ACS Ireland

JP Morgan

Landesbank Baden-Württemberg

Linklaters

Lloyds Banking Group

Marfin Egnatia Bank

Merrill Lynch

Moody’s

Morgan Stanley Bank AG

Mortgage Credit Foundation

Münchener Hypothekenbank eG

Nationwide Building Society

Natixis

Nederlandse Vereniging van Banken - NVB

Netherlands Social Housing Guarantee Fund - WSW

NIBC Bank N.V.

Nomura International Plc.

Nord/LB Covered Finance Bank SA

Norddeutsche Landesbank Girozentrale

Nordea

Nykredit A/S

OP Mortgage Bank

Pfandbrief & Covered Bond Forum Austria

Pfandbriefbank schweizerischer Hypothekarinstitute

Realkredit Danmark A/S

Realkreditforeningen

Realkreditrådet - Association of Danish Mortgage Banks

Royal Bank of Canada - RBC

Royal Bank of Scotland - RBS

Santander UK PLC

SEB

SNS Bank

Société Générale - Corporate & Investment Banking

Société Générale Société de Crédit Foncier (SG SCF)

Stadshypotek - Svenska Handelsbanken

Standard & Poor’s

TradeWeb

TXS

UBS

UKRCBC - Regulated Covered Bond Council

UniCredit Group

Verband Deutscher Pfandbriefbanken e.V. - vdp

Westfälische Landschaft Bodenkreditbank AG - WL

August 2012

CHAPTER 1 - KEY THEMES OF THE YEAR

1.1 INTRODUCTION

By Alexandra Hauser and Uwe Burkert, LBBW

We are now in the sixth year of the financial crisis. The focus in this regard is particularly on those assets that make up the primary collateral for covered bonds: real estate and public credits. At present, the financial markets – including the covered bond market – are undergoing profound restructuring processes. The covered bonds asset class is still the main pillar for real estate financing in Europe, and covered bonds are also a critical source of refinancing for public financing in some countries. Given the experience gained over the last five years, the regulatory undertakings, especially CRD IV with the LCR (see 1.5 Empirical evidence for the use of covered bonds under EU liquidity coverage rules) and profound adjustment processes in the finance sector of European countries, there are major questions – for many investors as well – which the ECBC Factbook hopes to provide some answers to. The great volatility, combined with the great uncertainty, means that some of these answers may only be temporarily correct. Therefore, the following factbook is a current "screenshot" of the status of the discussions of each topic today.

The performance of the mortgage asset class

The consolidation on the housing market continued in 2011. This had the greatest impact on the markets that reported steep price increases during the boom. Laden with overcapacities, construction activity in some of these markets is developing very weakly. Alone Germany, Belgium and France have reported rising real estate prices. In this environment, Europe has also faced some influencing factors that allowed the housing mortgage market to expand only by a moderate 1.8% in 2011. This was not all due to the EUR debt crisis, but mainly to the shrinking demand for real estate, the stricter lending criteria in some countries, and the more difficult bank funding situation. Nonetheless, the differences between individual markets is quite drastic in some cases. For example, most of the growth came from the UK, Germany and France (see 1.2 EU Mortgage and housing markets in 2011: an overview).

The reaction of issuers to the EUR sovereign debt crisis

Issuers react in a very defensive way to the EUR sovereign debt crisis. New issues this year were primarily slowed by the ECB's LTRO. The flood of liquidity also overshadowed the ECB's second purchase program (CBPP 2) (see 1.4 Focus on peripheral economies: input factors for covered bond spreads and ECB purchase programme).

Issuers were unable to distance themselves from the ratings of their sovereigns. Or were they? At the start, there are very close ties between the sovereign and its banking system. Following the EUR sovereign debt crisis, however, some covered bonds managed to show narrower spreads than their own sovereigns (see 1.3 Covered Bonds in a Sovereign Debt Crisis). The search for (physical) security and stable values in times of crisis surely played the main role in this. The advantage of collateralizing with physical assets is "suddenly" gaining a value of its own. But this is only the case if the asset has a sustainable value. Consequently, investors' interest is shifting more and more to meaningful information about the content of cover pools. This, in turn, prompts issuers to go full speed ahead in optimizing the information they provide for the qualified analysis of the cover pools (see 1.6 Transparency in trading and investor information). This is putting the focus on a topic that was rightly only of niche interest before: the topic of asset encumbrance (see 1.7 Asset Encumbrance).

Because of the current (market) uncertainties, both issuers and investors have become more cautious, but also more flexible. Otherwise, it would hardly have been thinkable for the boundaries between sub-jumbos and jumbos to get increasingly blurrier (see 1.8 Sub-jumbo sector).

However, there are also issuers that are unaffected by the EUR sovereign debt crisis and that increasingly use the attractive covered bonds asset class. These markets outside Europe are consequently reporting significant growth. The main winners are Canadian issuers and the newcomers from Australia, who are very active, especially on the USD market (see 1.9 The US Dollar market).

The role of the rating agencies

Rating agencies continue to be (quite) important. Books could easily be written about the interaction between ratings, market reactions, bank reactions, political reactions, and the reactions of individual investors. Rating agencies are part of the entire system, which is constantly undergoing realignment in the present environment, as reflected in the great number of updated or new rating methodologies.

Rating agencies attempt to represent the most comprehensive view of risk when conducting their analyses. This is why all eyes very quickly turn toward any critical situations. For covered bonds, this means the failure of issuers and the consequences of this. The focus of rating agencies is directly on the construction of each particular covered bond. The main question becomes how well the assets in the cover pool are suited to the timely repayment of the covered bond when it matures. In doing so, rating agencies study a multitude of criteria focused on determining the extent to which the cover pool can provide sufficient liquidity in a stress case (see 1.11 Timely payment and the role of soft-bullet structures). Given that there has been no precedent for such a default situation as yet, all studies are based on theoretical considerations – and the attempt to remain as far as possible on the safe side....

The future role of derivatives

Another topic gaining importance are derivatives in the cover pools, including their counterparties, most of whom have the same claim to the covered bond as the investors in the event of insolvency. The increase in the complexity of cover pools is being separately analyzed and evaluated by all rating agencies. The rating agencies do not always agree with each other. On top of this, regulators institute requirements that create new challenges for covered bond issues with derivatives in the cover pool, making the use of each one becomes a question of tallying up the advantages and disadvantages (see 1.10 Derivatives in cover pools).

The investors' view

Investors have stated their needs relatively clearly and rightly so. The declared objective of the Covered Bond Investor Council (CBIC) is to support the high quality, the clarity and the transparency of covered bonds. For this purpose, the CBIC demands that each issuer place special emphasis on the high quality of the assets in the cover pool. Transparency is also of special importance to the CBIC, tied with easier access to information, particularly to the cover pool (see Annex: the Covered Bond Investor Council). Investors view the ECBC labeling, to begin in early 2013, as an important step in the right direction, and the ECB and EBA agree.

A major issue for investors is the analysis of information so that they can derive a concrete recommendation for action. However, the extremely important individual pieces of information on the composition of the cover pool have to be embedded in the overall context. The covered bond, in connection with the cover pool, is part of a system that can only function as a whole. That is what the investors are looking at – in the future even more closely than to date. And the investors' perspective and their conclusions are critical in the end for the success of the covered bonds asset class. They affect the purchase decision and determine the future (see 1.12 The investor's perspective).

1.2 EU MORTGAGE AND HOUSING MARKETS IN 2011: AN OVERVIEW

By Alessandro Sciamarelli, Head of Statistics, EMF

INTRODUCTION

Further to moderate recovery observed in 2010, during 2011 mortgage and housing markets across the EU recorded mixed performances. Several adverse factors impacted quite severely upon mortgage and housing demand: subdued macroeconomic environment; depressed housing demand; tightened lending criteria; ongoing sovereign debt crisis in some euro area countries; and drought in funding markets and inter-bank lending. These formed the background for mortgage lending activity throughout 2011.

The macroeconomic context proved rather unsupportive of mortgage demand in 2011, resulting in feeble GDP growth and rising unemployment rates, partly offset by a very low interest rate environment. Real GDP growth in the EU27 in 2011 was 1.5%, lower than in 2010 (2%), ending the year with slowing growth in Q3 2011 (0.3%), which then turned negative in Q4 2011 (-0.3%); the annual average unemployment rate in the EU27 was 9.7%, i.e. the same level as in 2010, showing significant country heterogeneity (ranging from 22.9% at year-end in Spain to 4.9% in the Netherlands). As a response to their sovereign debt crises, over the course of 2011 some euro area economies also adopted severe austerity packages in order to adjust their budget deficits. These tight fiscal measures further depressed domestic demand and economic growth in these countries, contributing to a gloomy economic outlook for 2012. According to the latest European Commission forecast, in 2012 real GDP will stagnate in the EU27 and plunge by 0.3% in the euro area.

MORTGAGE LENDING MARKETS

In a nutshell, in the EU27 the aggregate volume of residential mortgage lending outstanding[1] recorded a lower annual growth rate in 2011 than in 2010 (1.8% after 4.9% in 2010 – revised, formerly 5.1%) and went from EUR 6.4 trillion in 2010 to EUR 6.5 trillion in 2011 (equating to 51.7% of the EU27 GDP).

Once this positive performance is put in a historical context (Figure 1), it can be clearly seen that it was much lower compared to the growth rates recorded in the previous years, particularly during the 2002-2007 boom cycle when mortgage lending increased by 7.8% on a compound annual average, with a peak of 11.6% in 2006. In 2007, the annual growth rate slowed to 8%, and the year 2008 marked a real turnaround: mortgage lending in the EU27 recorded its first year-on-year recession on record (by 1.2%), as a result of negative developments in Q3 and Q4 and the start of the financial crisis. In 2009, moderate recovery in most markets resulted in an increase of 0.9% in outstanding mortgage lending compared to 2008, and suggested that the worst effects of the housing and mortgage recession in the EU were already over. In 2010, further to the recovery experienced in 2009, year-on-year growth in aggregate EU27 mortgage lending gained momentum and reached 4.8%, before the arrival of the slowdown observed in 2011.

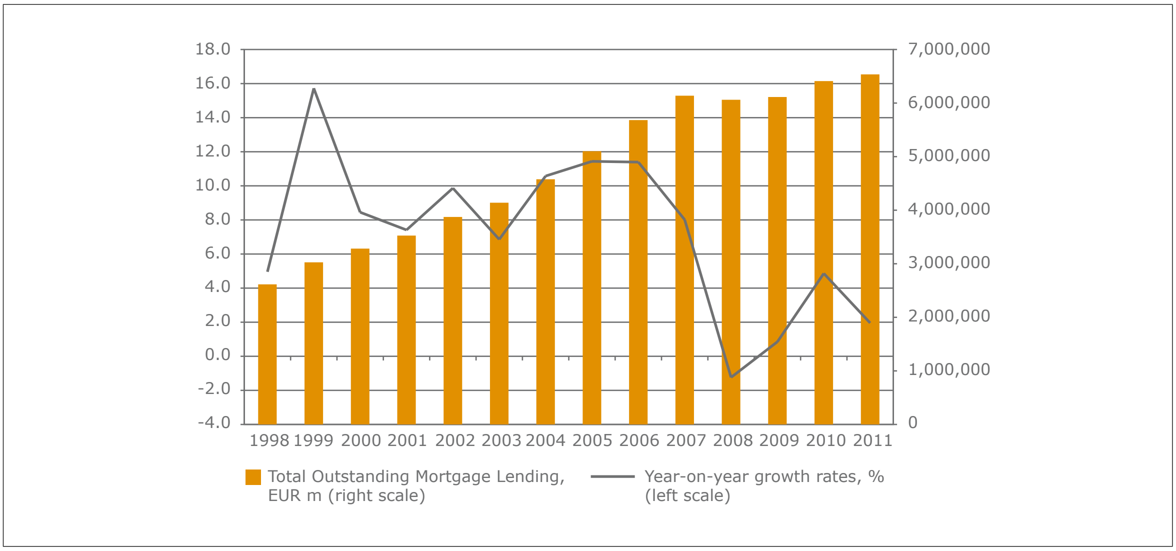
The positive performance of the aggregate EU27 mortgage market in 2011 was mainly due to developments in the three largest markets, i.e. the UK (with an annual increase of 0.5%), Germany (1.2%) and France (6.6%). However, the general trend in mortgage markets in 2011 on a year-on-year basis saw most markets record lower increases in outstanding lending values in 2011 compared to 2010. Only five economies out of 27 (the Czech Republic, Germany, Luxembourg, Poland and the UK) experienced higher year-on-year growth rates in outstanding mortgage loan volumes in 2011 than in 2010, at marginally

[1] Please note that this data is based on information available as of June 1st, 2012, and may be revised, albeit marginally.

higher rates. The countries which experienced recession in outstanding mortgage lending were the three Baltic Republics (Estonia, Latvia and Lithuania), Greece, Ireland, Spain and Portugal. Amongst these countries, the three Baltic Republics and Ireland experienced mortgage market recession for their third consecutive year. The outstanding mortgage market fell on a yearly basis for the second consecutive year in Greece (by 2.6%) and for the first time on record in Spain and Portugal, albeit at low rates (of 1.9% and 0.5% respectively) (Figure 2).

During 2011, gross mortgage lending (i.e. new mortgage lending) in the EU continued to decline in line with the general subdued trend which had started in Q4 2010, further to vigorous developments from Q1 to Q3 2010. Generally, gross lending markets recorded poor performances, which in most cases resulted in sharp year-on-year falls in volume, with, levels in new mortgage lending far below those observed prior to the crisis in every individual market. Continued tightening in lending criteria, persistent funding difficulties due to the drought in the inter-bank lending market (on the supply side), macroeconomic uncertainty stemming from the sovereign debt crisis and declining consumer confidence (on the demand side) have all paved the way for subdued performances in new mortgage lending markets in 2011. As a result, all EU countries experienced falls in new lending, albeit with great country heterogeneity (i.e. more pronounced in Portugal, Ireland and Spain; more moderate in Germany, Sweden and Hungary), with the only exceptions being Belgium and the UK (Figure 3).

> Figure 1: Outstanding Residential Lending, EU27, 1998-2011

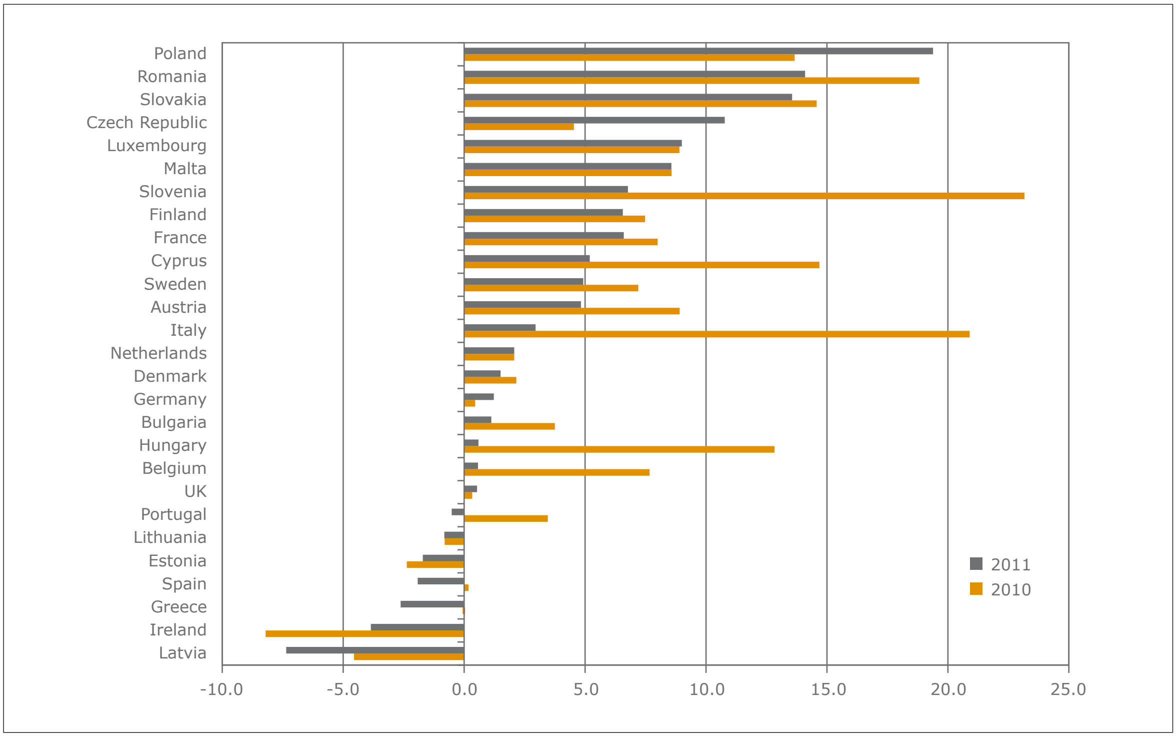


Source: European Mortgage Federation

As far as quarterly data is concerned, it is worth noting that mortgage market conditions have continued to deteriorate since Q1 2011 but some clear signs of a levelling off in activity were recorded in many markets in Q3 and Q4 2010, anticipating the subdued developments observed in 2011. Q3 and Q4 2011 in particular marked the toughest periods for mortgage markets since the onset of the financial and economic crisis in Q3 2008[2].

[2] For further details, see *EMF Quarterly Reviews*, 2010 and 2011, available at www.hypo.org.

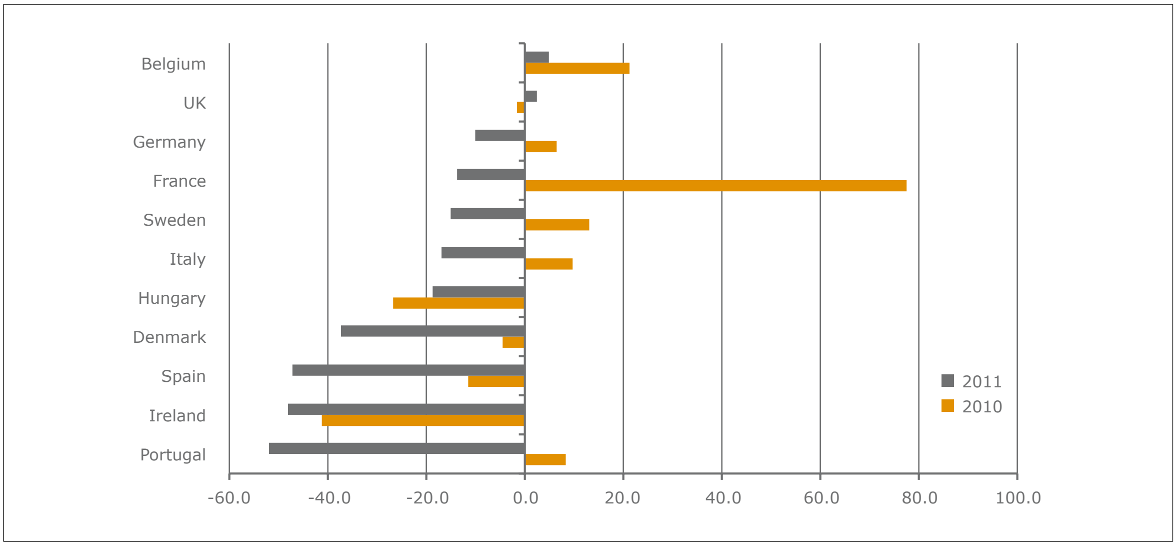
> Figure 2: Outstanding Residential Lending, annual year-on-year growth rates,%, 2011 and 2010



Source: European Mortgage Federation

Please note that annual growth rates are calculated on values expressed in national currencies. Please also note that the BGN/EUR, the DKK/EUR, the LTL/EUR and the LVL/EUR exchange rates are pegged.

> Figure 3: Gross Residential Lending, annual year-on-year growth rates,%, 2011 and 2010



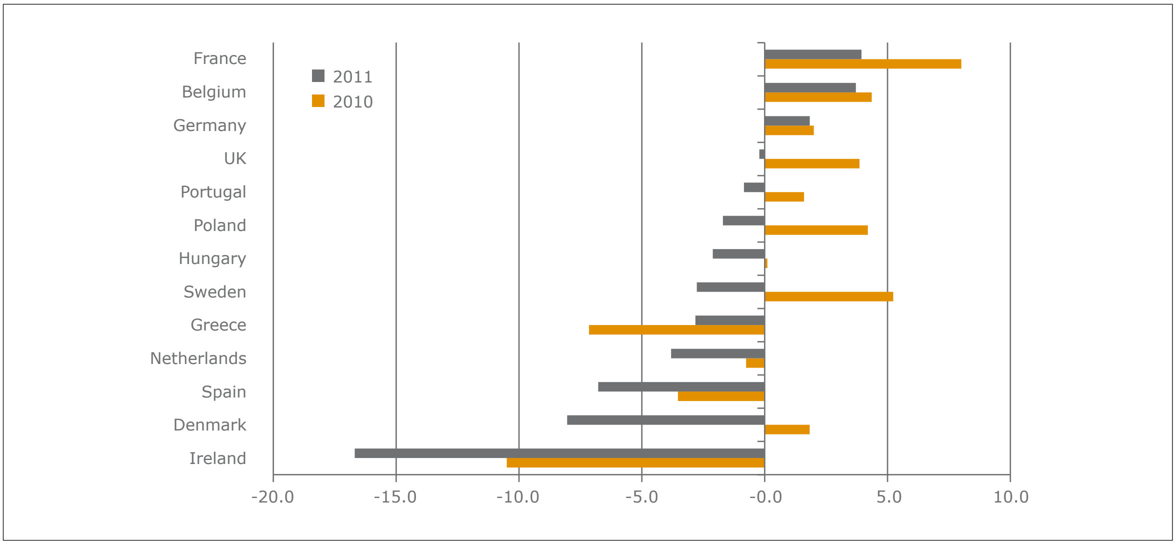
Source: European Mortgage Federation

HOUSING MARKETS

The sharp correction process in housing supply from the peaks observed prior to the crisis, both in terms of housing starts and building permits, continued during 2011. This downward trend in residential construction activity had resulted in severe falls in 2008 and 2009, being more pronounced in the markets which had experienced very strong house price increases during the boom cycle from 2002 to 2007, and then eased in 2010. However, building permits and housing starts also fell in several EU markets in 2011. Despite falling residential construction activity, there is still excess supply in some national housing markets, which makes such correction likely to continue. In some countries, residential construction activity did not even respond to increases in house prices, which generally anticipate increases in housing supply (reflecting expectations of higher housing demand) and remained very weak.

House prices increased in nominal terms on 2010 only in Germany, Belgium and France, and at lower rates than in the previous year (Figure 4). At a glance, housing demand remained depressed throughout 2011, with few exceptions, resulting in different developments in house prices across markets. National trends in house prices continued to diverge across the EU throughout 2011, signalling a slowdown of the recovery in some markets and falls in others. Among the former group, Belgium, France, Germany and Sweden continued to outperform the rest of the EU countries from Q1 to Q3 2011, but experienced a clear slowdown in Q4 2011, which resulted in negative growth in house prices in Q4 in Sweden (Figure 4). Some country-specific factors can also be pointed out: depressed (or insufficient) housing supply and interest rates at record lows contributed to keep housing demand up (in Sweden), as did positive demographic developments and the good macroeconomic conditions (in France).

> FIGURE 4: HOUSE PRICES, NOMINAL ANNUAL GROWTH RATES,%, 2011 AND 2010

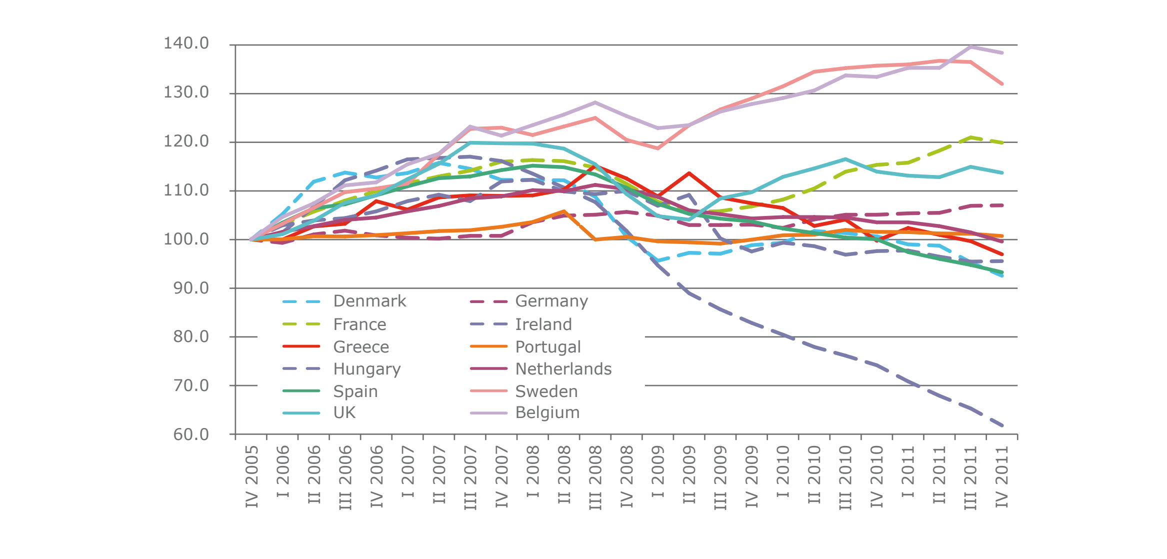


Source: European Mortgage Federation

In the latter group, house prices continued to fall both on a quarterly and yearly basis, mirroring an ongoing correction from the peaks in prices reached before the crisis. House prices continued to fall on a yearly basis in Greece (by 2.8%, for the third consecutive year), in Ireland (by 16.7%, for the fourth), in the Netherlands (by 3.8%), and in Spain (by 6.8%). In Denmark (by 8%), Hungary (by 2.1%), Poland (by 1.7%) and Portugal (by 0.8%), house prices decreased for the first time on record. In Spain, the cumulative peak-to-trough correction in house prices (i.e. from Q1 2008 to Q4 2011) was 19% and in Ireland it reached 47% (from Q3 2007 to Q4 2011).

In Q4 2011, house prices were higher than Q4 2005, i.e. before the onset of the crisis, in Germany, France, Sweden and the UK, while in all other markets prices have not recovered from the falls experienced since the crisis yet (Figure 5).

> Figure 5: House Price Indices, Q4 2005=100



Source: own calculation on EMF data

MONETARY POLICIES AND MORTGAGE INTEREST RATES

Mortgage interest rates across the EU went up slightly during the first half of 2011 as a result of monetary policy tightening – due to accelerating inflation from late 2010 onwards – but remained low in historical terms. Over the last quarter of 2011, however, mortgage interest rates were falling again as a result of the Central Banks' actions.

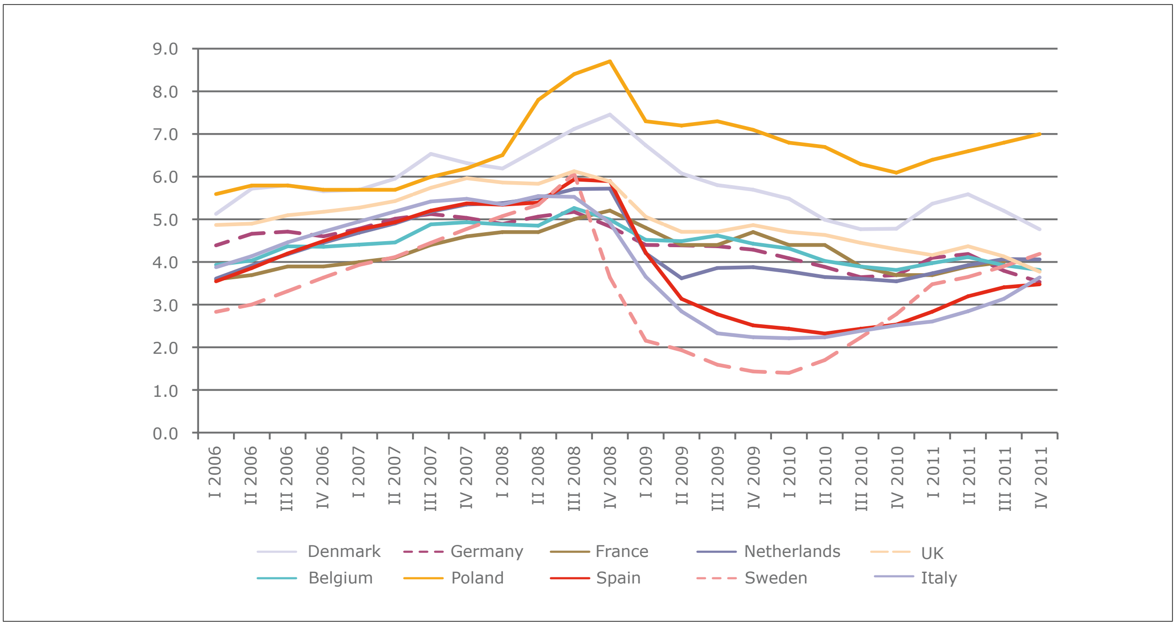
In fact, the ongoing tensions on sovereign debt and funding markets, as well as the weak macroeconomic conditions across the EU, prompted a sharp reversal in Central Banks' monetary policies in H2 2011, and policy rate cuts were made by the ECB and other Central Banks: after two consecutive increases in April and July 2011, during Q4 2011 the ECB cut its main refinancing rate twice, from 1.50% back to its record low of 1.00%, and soon other Central Banks followed[3]. In addition, in order to alleviate the

[3] The Swedish Central Bank cut its repo rate in December 2011 by 25 basis points to 1.75%, and then lowered the repo rate further in February 2012 down to 1.50%. The Danish Central Bank also cut twice by a total of 50 bps leading the official rate from 1.25% to 0.75%. Contrary to this trend, the Hungarian Central Bank raised its policy rate by 100 bps during Q4 2011 from 6.00% to 7.00%.

ongoing unavailability of funding due to drought in the inter-bank lending market, the ECB launched two Long-Term Refinancing Operations (LTROs) on 22 December 2011 and 29 February 2012, granting three-year loans to European banks at the rate of 1.00% for amounts of EUR 489 billion and EUR 529 billion respectively.

The above policy rate cuts were passed on to mortgage interest rates, which then decreased in Q4 2011 both on a quarterly and a yearly basis in many markets following on from the moderate rises observed in previous quarters. Once put in a historical context, in Q4 2011 mortgage rates were at significantly lower levels than before Q3 2008 (i.e. the onset of the crisis) in most markets, such as in Spain (by 245 bps), the UK (234 bps) and Ireland (227 bps) (Figure 6).

> Figure 6: Representative Mortgage Interest Rates, Q1 2006-Q4 2011, %



Source: European Mortgage Federation

1.3 COVERED BONDS IN A SOVEREIGN DEBT CRISIS

By Leef Dierks and Jason Somerville, Morgan Stanley

INTRODUCTION

Covered bonds provide a valuable source of portfolio diversification for rates investors, particularly in times of sovereign debt crises. Under such circumstances, covered bonds benefit from being backed by physical assets - as opposed to sovereign debt which is backed by a promise to fully and timely repay debt holders. By gaining an exposure to physical assets (typically mortgages), in the event of banking and sovereign defaults, recovery values should be significantly higher for holders of covered bonds than for those of sovereign paper. Many of these assertions have been theoretical in nature until recently. However, the development and escalation of the Euro zone debt crisis has provided the preliminary data necessary to explore this relationship in more detail.

SOVEREIGN DEBT CRISES VERSUS FINANCIAL CRISES

At the outset, it is crucial to distinguish between sovereign debt and financial crises. Covered bonds have traditionally traded at a discount of approximately 60bps to the sovereign in a well-behaved market. This spread widened by up to 300bps during the 2008 financial crisis. Even German pfandbriefe, often perceived as one of the most secure forms of collateralised debt, traded at discounts of up to 100bps to the underlying sovereign debt, in this case bunds. This behaviour is typical of financial crises as the problem originates with the banks and not the sovereign. It is therefore unsurprising to see covered bonds (bank debt) underperform the sovereign. In contrast, during a sovereign debt crisis the bank debt of stronger first tier names, in particular that backed by a strong pool of assets can trade inside that of the sovereign, as is currently the case for some European banks.

Of course, banking and sovereign debt crises rarely happen in isolation. As we have seen in the case of Ireland, and more recently Spain, bank assets often end up on the sovereigns' balance sheet and vice versa. Moreover, as part of the Basel III proposals, banks will need to hold a greater amount of sovereign debt in order to maintain liquid asset buffers. Under certain circumstances, this will serve to reinforce the link between sovereigns and banks in times of crises.

THE RELATIONSHIP BETWEEN COVERED BONDS AND SOVEREIGN DEBT

The link between the credit spread of a covered bond and sovereign debt is perhaps most obvious in the case of public covered bonds. Such instruments are backed by loans granted to central, regional and municipal governments. In the event of a default by sovereign or sub-sovereign entities, the value of collateral pool decreases, thus lowering the expected recovery value. At present, public covered bonds account for approximately 25% of the market, with mortgage-backed covered bonds accounting for the vast majority of the remainder[1].

The link between sovereign debt and mortgage-backed covered bonds is less direct; covered bonds are correlated with the senior unsecured claims of other investors, which in turn are correlated with sovereign debt. In the event that the value of mortgages in the collateral pool is insufficient to cover full redemption, investors' remaining claims rank pari passu with those of senior unsecured debt.

[1] Source: ECBC, June 21, 2012

This relationship is most evident in the rating agencies' methodology for assigning ratings to covered bond issuers. For example Moody's Timely Payment Indicator (TPI) leeway measures the number of notches an issuer can be downgraded before the rating of a covered bond is downgraded[2]. If this is zero (as in the case of issuers domiciled in peripheral European economies) a downgrade of the issuer will result in a one-for-one downgrade of its covered bond programs. In addition, banks' typically cannot be rated more than one notch above that of the sovereign "due to multiple channels of shared exposure and contagion for issuers in the same sovereign environment.[3]"

This link is most severe when a housing bubble bursts. The economy and therefore the sovereigns' finances go into decline. The value of assets underlying the collateral pools, typically mortgages, declines. As in the case of Ireland and Spain, in a period of prolonged house price declines, issuers need to compile with a legally determined minimum over-collateralisation. However, issuers often struggle to 'top-up' these pools in an environment of declining prices, contract lending and falling LTV ratios. Therefore overall quality of the collateral pool can come under threat.

Given these dynamics, sovereign and covered bond debt share a mutual macroeconomic risk factor, which cannot be mitigated. However, the magnitude of that correlation is another question entirely.

THE CORRELATION BETWEEN SOVEREIGN DEBT AND COVERED BONDS IN A CRISIS

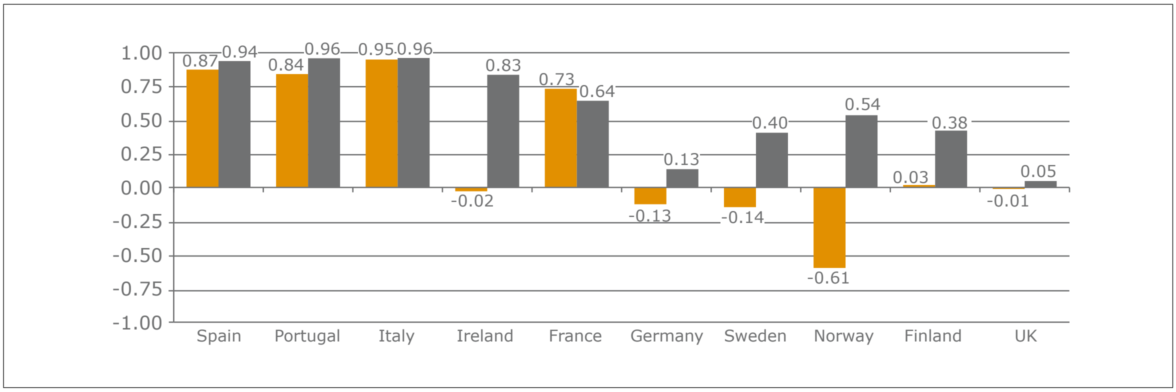
As we have argued above, the correlation between covered bonds and sovereign debt can be, at times, tenuous. However, in times of crisis it should be greatest, with systemic macroeconomic risk driving credit spreads for both wider. Figure 1 presents the correlation between sovereign debt and covered bonds pre (Jan 2007 to Dec 2010), and during (since Jan 11) the Euro zone sovereign debt crisis. As expected, in all markets with the exception of France, the correlation between sovereign debt and covered bonds has been higher during the sovereign debt crisis. In the peripheral economies, the absolute level of this correlation is strikingly high, over 90% on average. Admittedly, in the case of Spain, Italy and Portugal the correlation between sovereign was high during the period prior to crisis (Jan 2007 to Dec 2010), however the same cannot be said for Ireland; from a correlation of zero prior to sovereign debt crisis, it has risen to 0.83.

It is also worth noting the development of this correlation in safe haven assets such as gilts and bunds. While the correlation is higher than before the crisis, it remains negligibly low. The rationale being that bunds and gilts have been driven primarily by 'safe haven' flows as investors have been driven out of peripheral debt due to excessive volatility and increasing probabilities of default. Moreover, rating downgrades have led to some forced selling on behalf of traditional rates investors who have ratings restrictions on their portfolios. While pfandbriefe and UK covered bonds have benefited to some extent due to this development, the allure of 'safe haven' sovereigns such as Germany and the UK during the recent crisis has been unprecedented, at one stage pushing nominal 2-year German yields negative. Therefore, while the peripheral covered bonds and sovereign debt may remain highly correlated during a sovereign debt crisis, a different dynamic plays out in core, 'safe haven' markets.

[2] Source: Moodys, March 4, 2010

[3] Source: Moodys, February 13, 2012.

> FIGURE 1: CORRELATIONS HIGHER DURING SOVEREIGN DEBT CRISIS ACROSS ALMOST ALL MARKETS*



*Grey bars denote the period Jan 2011 to Jun 2012, which the orange bars represent the period from Jan 2007 to Dec 2010.

Source: Morgan Stanley Research

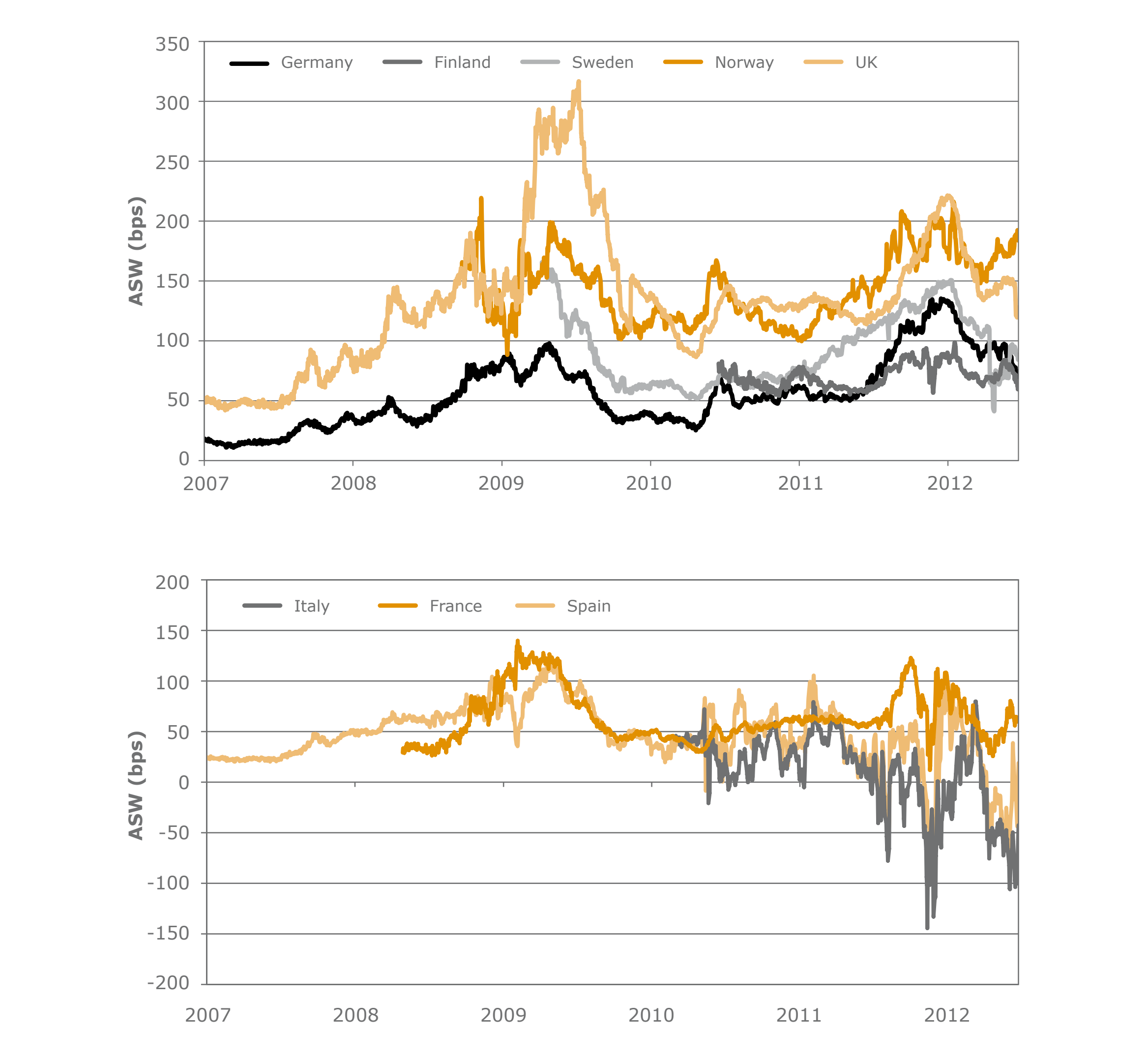
There has been a similar trend in the Nordic markets where 'safe-haven' flows have dominated the price movements. However owing to the significantly smaller size of these markets, both covered and sovereign debt developments have been more highly correlated. France is the anomaly in this analysis, which is to be expected given the changing perception of this market throughout the crisis. Prior to the downgrade of France by the rating agency Standard and Poors in January 2012, it had been regarded as core AAA credit, trading in line with German bunds. However, since then, price developments in the French market have been more correlated with peripheral spreads.

COVERED BONDS VERSUS SOVEREIGN DEBT IN TIMES OF CRISIS

There have been two distinct trends in the performance of covered bonds relative to the respective sovereign over the course of the Euro zone debt crisis, namely that between the core and periphery. The European peripheral economies of Italy, Spain, Greece, Ireland and Portugal have all seen 10-year sovereign borrowing costs temporarily exceed 7.00% over the past 18 months. At a spread of over 500bps to German borrowing costs, many market participants deem such a level unsustainable, especially in a monetary union. As Figure 2 demonstrates, in these markets, covered bonds have outperformed sovereign debt in times of stress and underperformed during periods of relief (generally induced by central bank action).

For example, between October and November 2011, when the sovereign debt crisis was arguably at its most intense, investing in Spanish government debt would have returned a negative 7.6% over the period. Both single and pooled cédulas were considerably less vulnerable to this price decline, falling 2.00% and 3.40% respectively. Similarly an investment in Spanish sovereign debt since January 2012 to present would have yielded a negative return of 7.20%, while single and pooled cédulas gained 0.52% and 4.10%, respectively. Given investors' preference for gaining an exposure to physical assets in times of elevated uncertainty, it is not surprising that we observed this trend in the Spanish market.

> Figure 2: Spread margin between covered bonds and sovereign debt

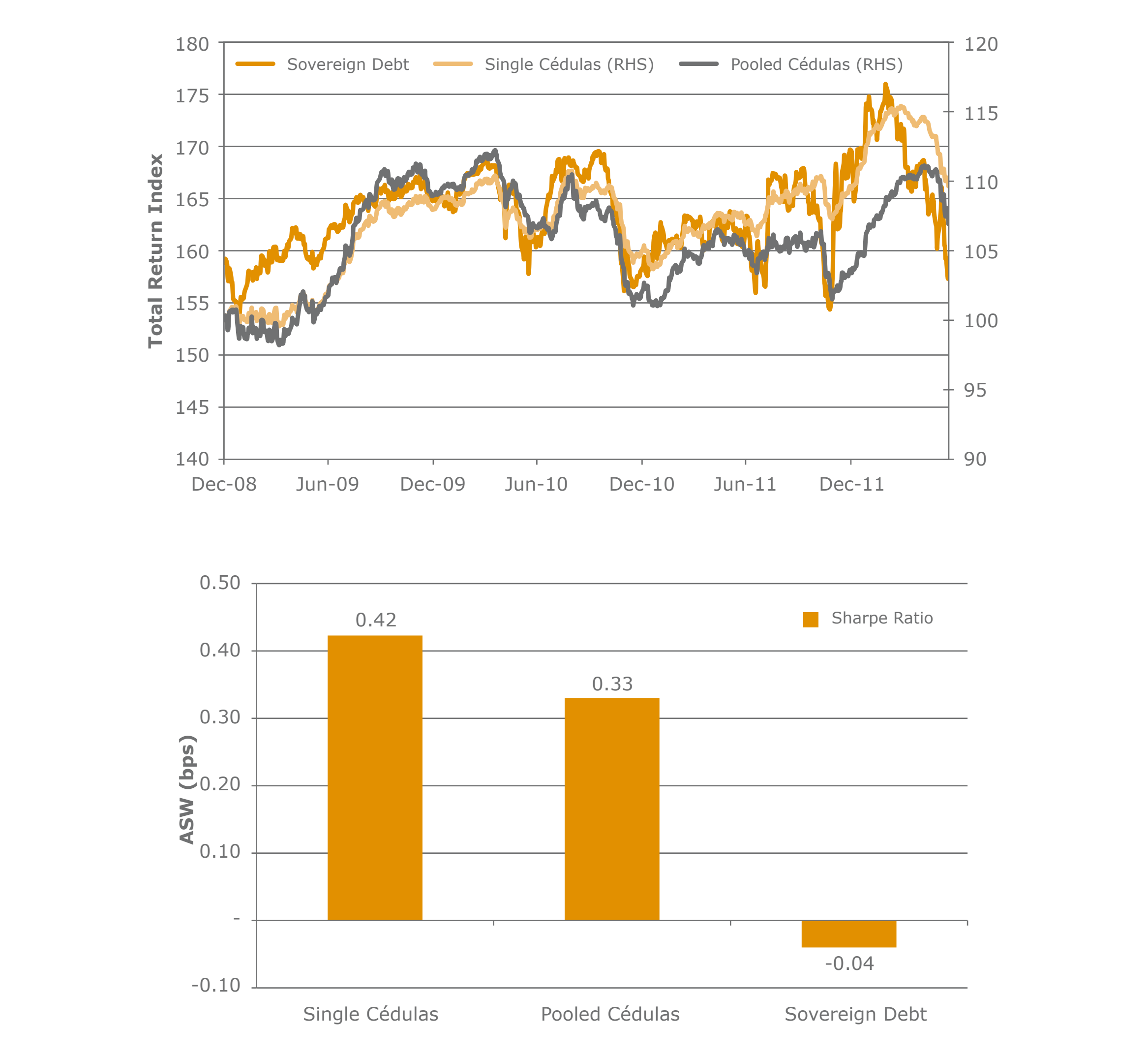


Source: Morgan Stanley Research

The outperformance of covered bonds during such times is due to a significantly lower volatility relative to that of the sovereign. While prices follow the same directional trend, the magnitude of this move is lower for covered bonds owing to the dual nature of the claim afforded to investors. Moreover, in response the bank funding stress, the European Central Bank (ECB) has initiated two Covered Bond Purchase Programmes – CBPP1 and CBPP2. Under CBPP1, the ECB purchased €60bn of euro-denominated covered bonds issued by Euro zone banks. This has contributed to the lower volatility observed in the covered bond market over the past 3 years. At present, CBPP2, which began in November 2011, has bought €13bn of Euro zone covered bonds, and has targeted a total of up to €40bn of purchases by the end of October 2012.

To get a sense of the value of lower volatility, we have computed the Sharpe ratios (that is, the risk-adjusted return) for Spanish sovereign debt, single cédulas and pooled cédulas from January 2009 to present (Figure 3). The risk-adjusted return from owning Spanish covered bonds was significantly higher than for sovereign debt. It is the lower volatility of covered bonds in times of crisis that provides the greatest benefit to investors. This trend has been more strongly reflected in the Italian market, where owing to a relatively more resilient banking sector and stable property market, Italian covered bonds have traded up to 100bps rich to the sovereign.

> Figure 3: Total return on Spanish covered bonds and sovereign debt and equivalent Sharpe ratios

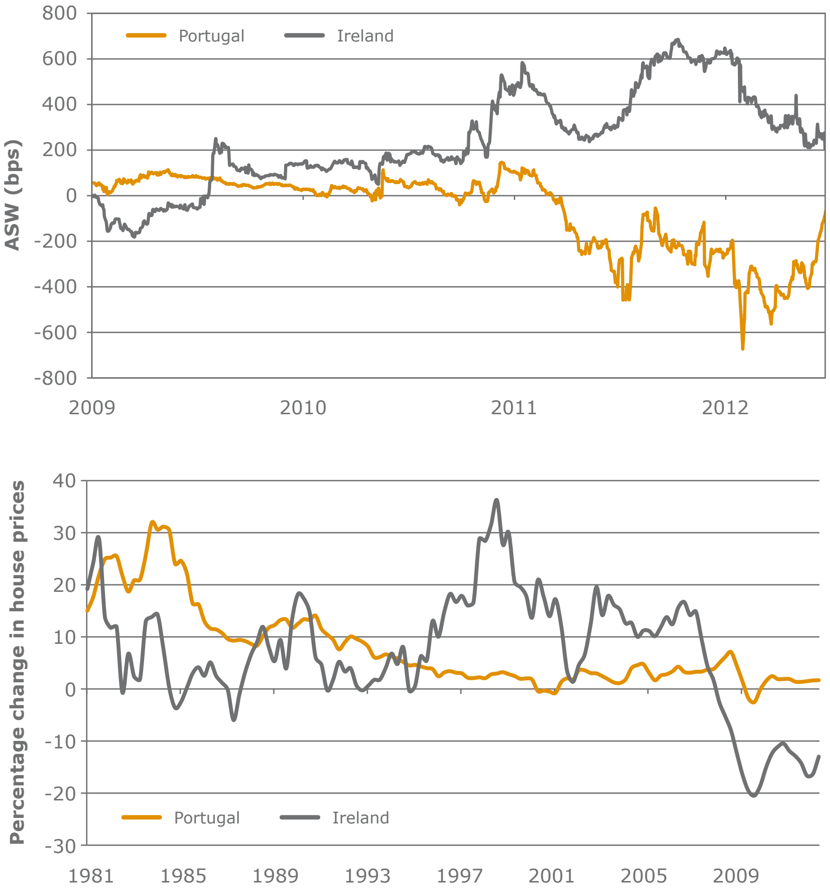


Source: Morgan Stanley Research

Idiosyncratic factors can create persistent deviations in the regional performance of covered bonds versus sovereign debt. Take for example the diverging performance of Portuguese and Irish covered bonds relative to their respective sovereigns. As Figure 4 illustrates, Irish covered bonds have traded at heavy discount to sovereign debt for over 18 months, while the opposite is true for Portuguese covered bonds.

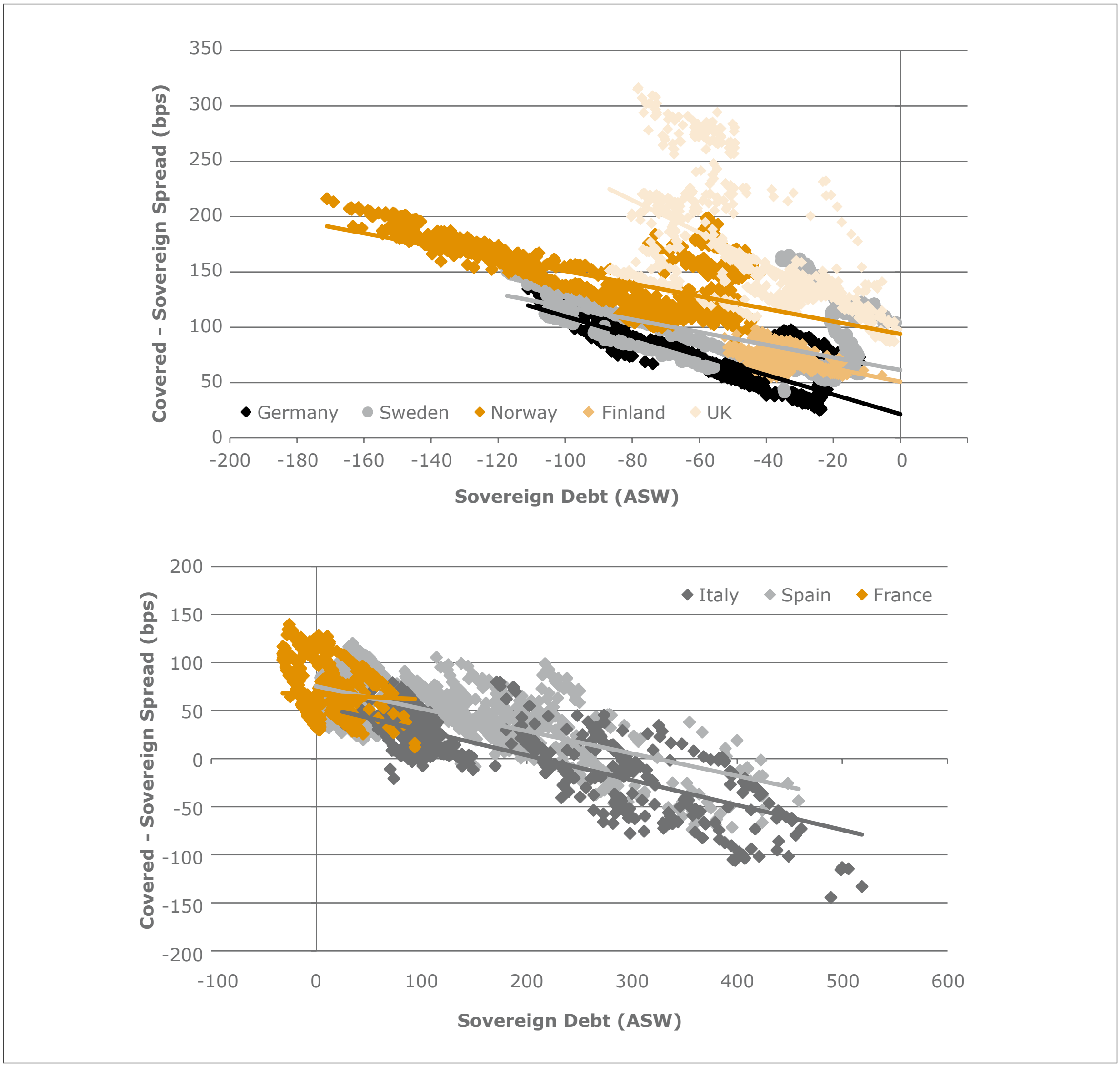
This can be attributed to fundamental differences in the housing markets of these countries. As the lower chart in Figure 4 demonstrates, Irish house prices grew at an elevated pace for almost 15 years. This fuelled a housing bubble, which upon bursting, forced the government to nationalise 5 out of the 6 Irish banks (and take a significant stake in the sixth). In contrast, the Portuguese market experienced only modest growth in the two decades leading up to the financial and sovereign debt crises. Any downturn was therefore shallow and short-lived. These developments have inevitably left their market on the collateral pools of Irish and Portuguese covered bonds. Moreover, the uncertainty surrounding the Irish property market adds to the risk of investing in Irish ACS. It is there unsurprising to see a marked deviation in the performance of both relative to the sovereign.

> FIGURE 4: COVERED BOND SPREADS TO SOVEREIGN AND HOUSE PRICE MOVEMENTS



Source: Morgan Stanley Research

> FIGURE 5: COVERED BOND SPREADS TO SOVEREIGN AND HOUSE PRICE MOVEMENTS



Source: Bloomberg, Morgan Stanley Research

FOCUSING ON THE CORE

So far we have focused on the performance of covered bonds relative to sovereign debt in the stressed peripheral markets; however the development of this relationship in core markets provides further trading opportunities. As we noted previously, the core, UK and Scandinavian markets have received considerable inflows to sovereign debt from investors looking for security in volatile and uncertain market conditions. Covered bonds, owing to the less liquid nature of the asset class, received far less 'safe-haven' buying during these periods. As a result, covered bonds tend to underperform sovereign debt in core markets that receive such flows.

Therefore, while covered bonds and sovereign debt are highly correlated in times of crisis, when sovereign debt sells off, covered bonds will outperform and conversely, when sovereign debt rallies, covered bonds will underperform. In other words, the spread between covered bonds and sovereign debt is highly directional with the level of domestic sovereign rates. This relationship holds for all major European markets and is summarised in Figure 5.

CONCLUSION

The Euro zone sovereign debt crisis is still in progress, but the lessons thus far are clear; covered bonds will become more highly correlated with the sovereign in times of stress. Despite the increase in correlation, covered bonds tend to outperform sovereign debt in such an environment. By gaining exposure to physical assets and reducing the overall volatility of a portfolio, investors can diversify out of traditional safe haven assets (such as sovereign debt), while maintaining a low risk profile. Of course, this implies that in a "risk-on" scenario in which sovereign debt becomes better bid, covered bonds are likely to underperform.

Regardless of the market in question, the spread between covered bonds and sovereign debt remains highly directional with the level of sovereign rates. This implies that different strategies should be followed when navigating a sovereign debt crisis, depending on the market in question.

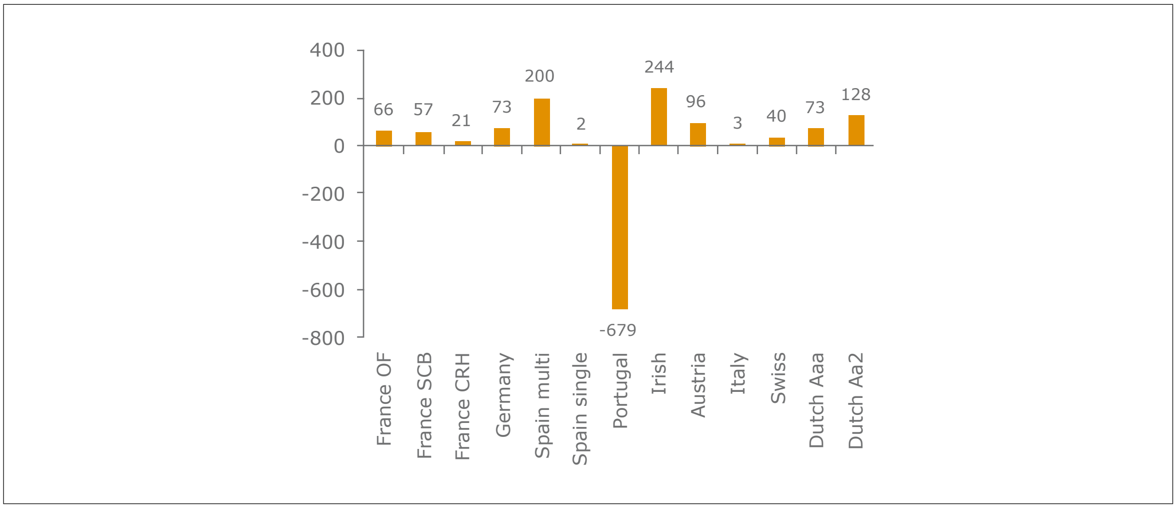
1.4 FOCUS ON PERIPHERAL ECONOMIES: INPUT FACTORS FOR COVERED BOND SPREADS AND ECB PURCHASE PROGRAMME

By José Sarafana, Aurel BGC

SECONDARY SPREADS

As already indicated in the previous article on covered bonds in a sovereign debt crisis, covered bonds are not immune to outside turmoil. They have been severely affected so far in 2012, much like in 2008 and 2010. However, while in 2008 this was due to bank risk, in 2010 it was all about sovereign risk. In 2012 we have had a mix of factors. First, there is sovereign risk again which is the major input factor for pricing covered bonds. Second, there is less supply than originally expected owing to LTRO (Long Term Refinancing Operation). Finally, there is the credit quality of the issuing bank and the cover pool.

> Figure 1: Covered bond spread versus respective sovereign, 5-yr, z-spread, bp



Source: Bloomberg

Covered bond spreads versus their respective sovereigns vary greatly between jurisdictions (Figure 2). The highest spread is currently seen in Ireland, after the strong performance of the sovereign. The richest of all asset classes versus the sovereign are Portuguese covered bonds. There is no general rule on how big the spread between government bonds and covered bonds should be. What can be observed, however, is that covered bonds trade more cheaply than their respective government bonds unless the sovereign bonds are stressed. Then the order is reversed. This is often in peripheral markets the case.

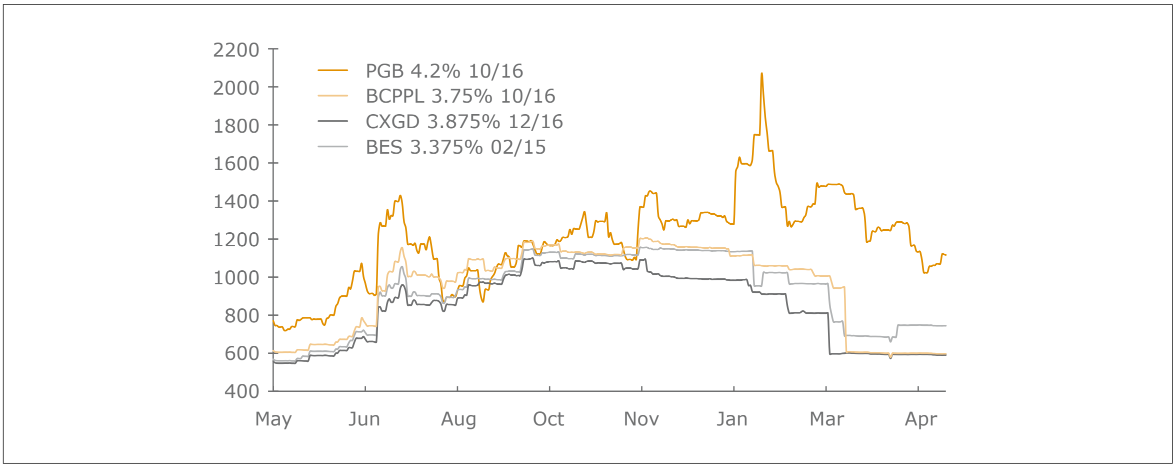
EUROPEAN CENTRAL BANK (ECB)

The ECB's EUR 40 bn 2nd purchasing programme has quickly lost its importance for the ECB. Officials of the European Central Bank stated in May 2012 that they were willing to adapt the purchase programme to market conditions. This included the possibility of either buying less than the originally announced EUR 40 bn or to extend the time frame of the programme to more than 12 months.

The ECB initially wanted to repeat the success of the first purchasing programme in which covered bond spreads compressed and the primary market was immediately opened again. However, conditions end of 2011 and during 2012 have been different. The sovereign crisis deteriorated further and consequently impacted covered bonds with wider spreads in the periphery. Also, LTRO was introduced at the end of 2011 which led to a strong spread compression at the beginning of 2012. As a result, the second ECB purchase programme did not have the same importance for the covered bond jurisdictions than the first programme and this explains the very flexible approach of the European Central Bank. And we do not see a major impact on spreads if the entire programme is not executed.

PERIPHERAL MARKETS

> FIGURE 2: PORTUGUESE SPREADS, Z-SPREAD BP



Source: Bloomberg

The Portuguese jurisdiction is ideal to illustrate spreads in a stressed environment.

Tenders of Portuguese covered bonds have prompted outperformance. Investor interest in Portuguese covered bonds is currently split.

> On the one hand, there are some forced sellers due to rating downgrades (with sub-investment grade ratings now beckoning).

> On the other, many funds see value due to the strong legal framework of Portuguese covered bonds. Liquidity however remains poor in this asset class.

In a stressed market, it is typical for covered bonds to trade richer than the sovereign.

> Firstly, covered bonds are less liquid, so tend to widen more slowly than the sovereign.

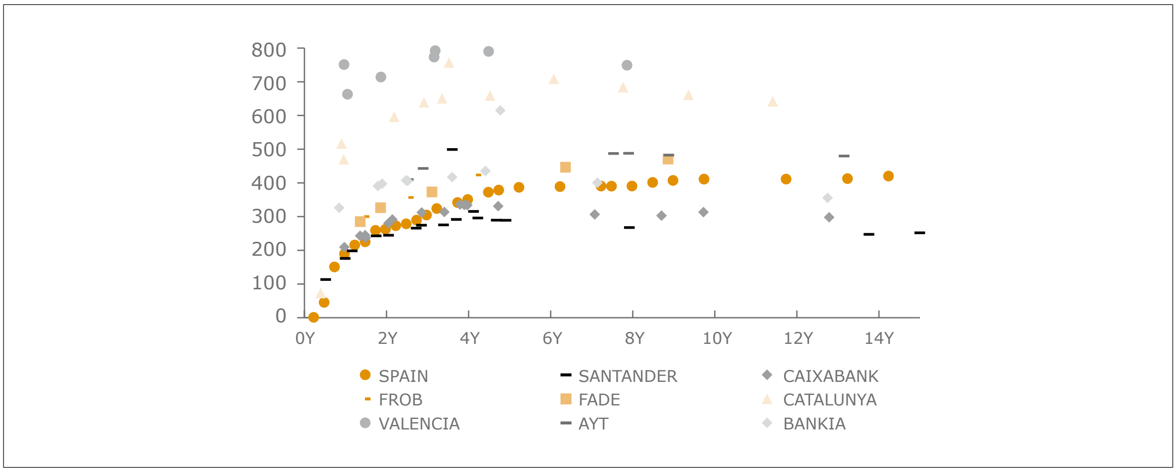
> Secondly, it is not possible to impose a haircut on covered bond holders. Greece is the most recent example. While the sovereign bond holders had to realise losses, Greek covered bonds were tendered back.

> Finally, the recent cheapening of sovereign debt versus covered bonds was not limited to Portugal. We observed a similar move in Italy, Spain, Greece and, in the beginning of 2011, in Ireland.

The case for Spain is somewhat similar Portugal. Cédulas from Santander, BBVA and CaixaBank trade richer than the Spanish sovereign. This is particularly true at the longer end of the curve. This is due to the lack of supply since the beginning of the year. AYT and Bankia Cédulas trade well richer than the

Spanish sovereign due to a lower credit perception by investors. In the current environment, with risk focussing on the Spanish sovereign, many covered bonds are likely to remain richer than the sovereign. Spanish autonomous regions are much cheaper than both asset classes

> Figure 3: Spanish covered bond vs sovereign bonds, z-spread bp

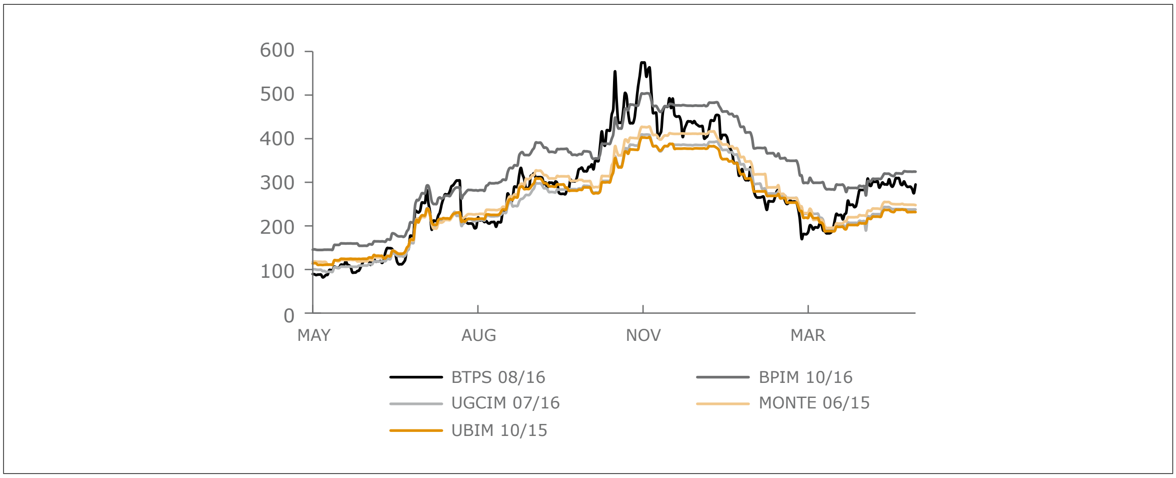


Source: Bloomberg

Spain's situation differs slightly from Italy. Domestic investors behaved much the same in both countries, as Spanish investors use SPGBs as a benchmark; however, unlike Italy, we have seen Cédulas issuance since the beginning of the year (almost EUR 8bn from January to May 2012).

This means that if covered bonds trade too rich versus their sovereign, covered bonds are sold versus the sovereign. When covered bonds are cheap versus the sovereign, the opposite is true. As a result covered bond performance and sovereign bond performance are highly correlated.

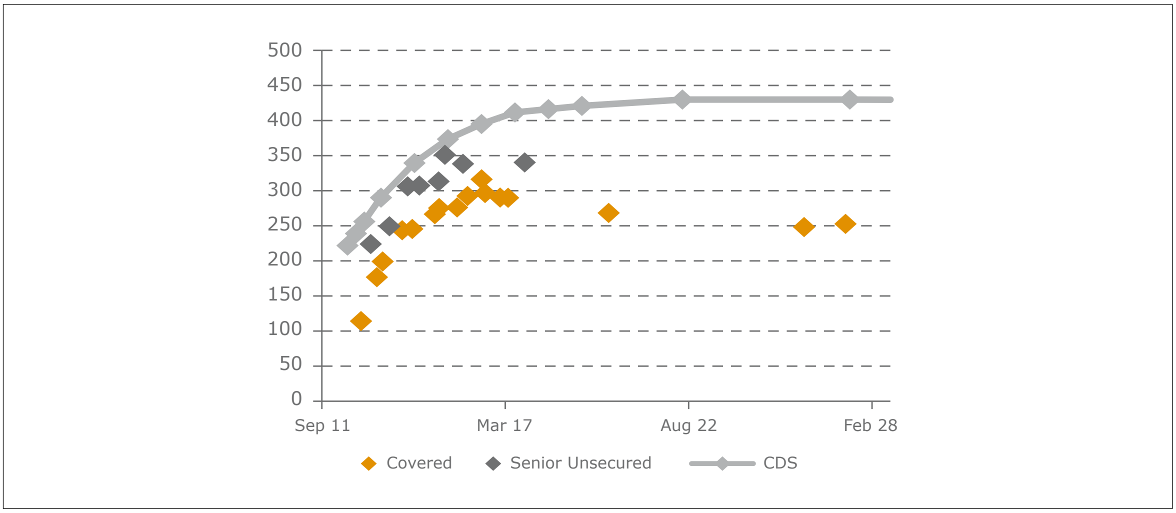
> Figure 4: Italian spreads, z-spread bp



Source: Bloomberg

Spreads remain very compressed in peripheral markets. Sovereign spreads drive covered bond and senior spreads wider, which is clearly illustrated by Santander's credit curve. CDS, Senior and covered trade at similar levels. Santander covered bonds trade richer than even the Spanish sovereign. The patterns of BBVA and CaixaBank are similar to those of Santander.

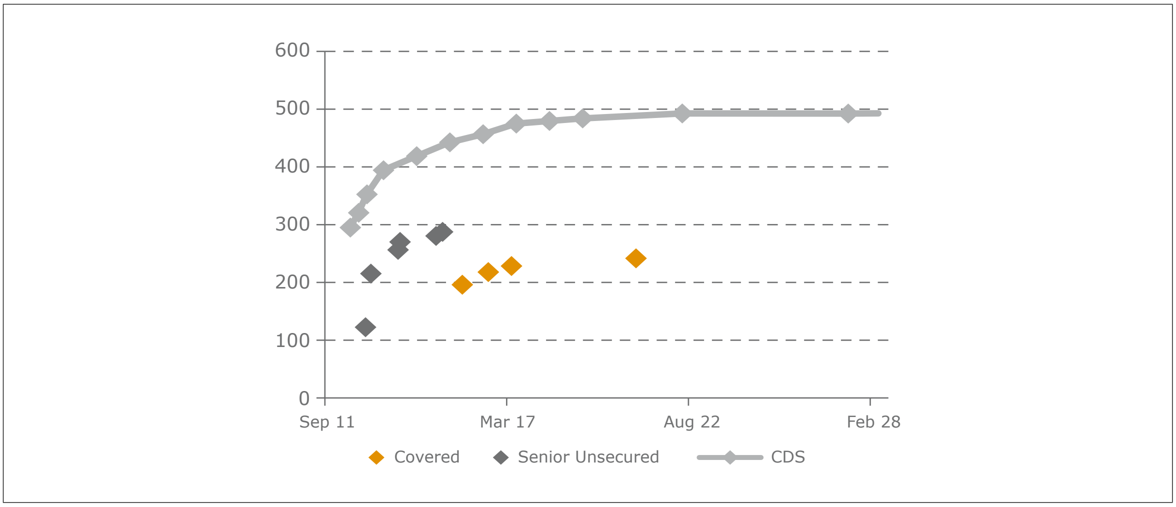
> FIGURE 5: SANTANDER CREDIT CURVES, BP



Source: Bloomberg

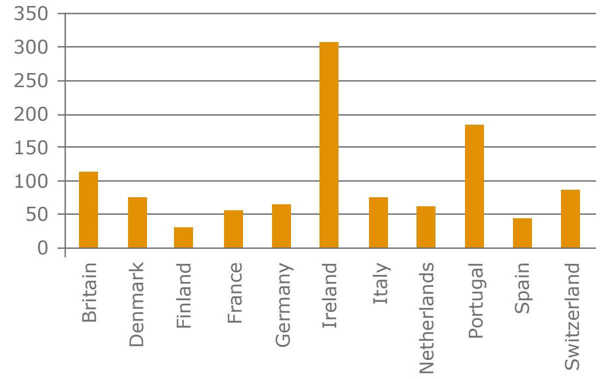
This picture is less pronounced in Italy where covered bonds trade rich vs the sovereign due to the complete absence of supply. Figure 6 illustrates Intesa San Paolo. Senior unsecured bonds here still offer a reasonable pick up over covered bonds. This indicates a less compressed environment in Italy than in Spain.

> FIGURE 6: INTESA SAN PAOLO CREDIT CURVES, BP



Source: Bloomberg

> Figure 7: Senior unsecured vs covered bonds spread 5-year average, z-spread bp



Source: Bloomberg

Figure 7 also shows that spreads between covered bonds and senior unsecured bonds vary widely among jurisdictions. This spread currently is the widest in Ireland. Investors might be worried about Irish bank quality and prefer covered bonds given their dual recourse nature and the additional safety due to the covered assets.

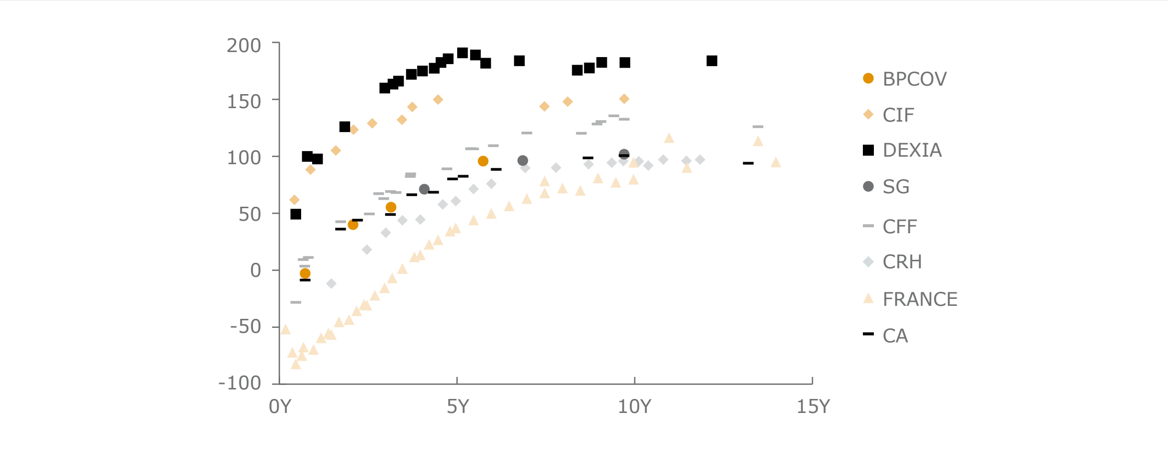
Apart from Ireland, the spread between covered and senior in Portugal is also very wide. The recent tender programmes of Portuguese banks for their covered bonds have led to a strong outperformance of Portuguese covered bonds versus Portuguese sovereign and senior unsecured. Further tenders are possible. That risk therefore will keep Portuguese covered bonds rich vs. senior and sovereign bonds alike.

CORE MARKETS DIFFER FROM PERIPHERAL MARKETS AS THE PICK UP VERSUS THE SOVEREIGN IS HIGH

Within the core segment, Austria, the Netherlands and Germany offer the highest pick-up over their respective sovereign.

Let us take the case of France for example. As a result the perceived credit quality of the issue is the key element in determining the price. The spread to the sovereign is relatively unimportant for pricing the covered bond given spreads are large. Covered bonds trade with a decent pick up over sovereign bonds. This is the normal unstressed picture observed in all jurisdictions before the financial and sovereign crisis started.

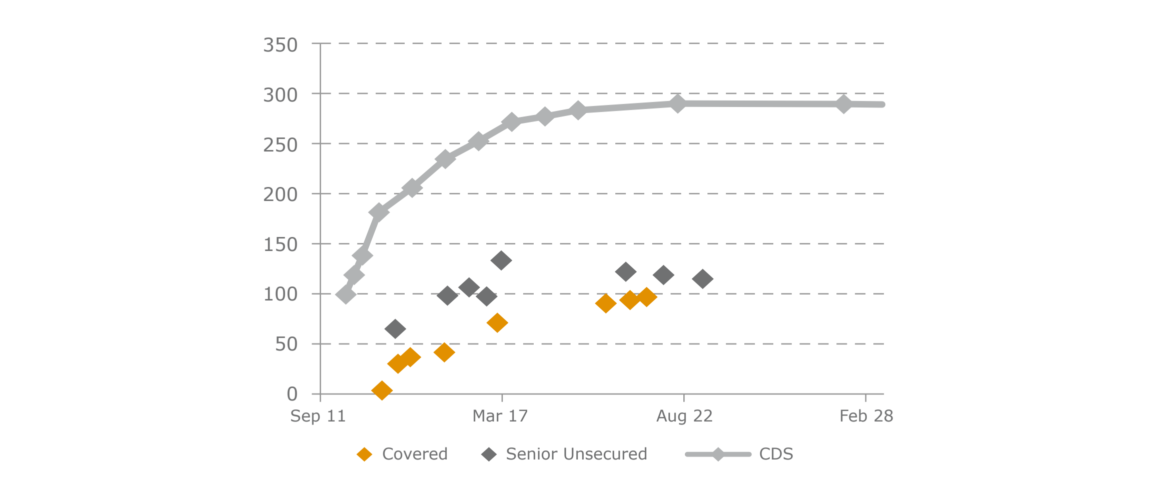
> Figure 8: French spreads, z-spread bp



Source: Bloomberg

BNP is interesting in that it differs from other French issuers. Here again, covered bonds and senior bonds trade very tightly. And the explanation resides in BNP's high credit quality. The higher the quality of a bank, the tighter the senior covered bonds spread and vice versa. Spreads could however widen in the future, if risk aversion rises in France.

> Figure 9: BNP credit curves bp



Source: Bloomberg

1.5 EMPIRICAL EVIDENCE FOR THE USE OF COVERED BONDS UNDER EU LIQUIDITY COVERAGE RULES

By Florian Eichert, Crédit Agricole CIB,
Fritz Engelhard, Barclays Capital, and Jan King, RBS

1. INTRODUCTION

Lehman Brothers' liquidity driven default in 2008 has certainly been one of the defining moments in the course of the financial crisis. As a response, European politicians and regulators have been trying to address the issue in the CRD IV by introducing two ratios aimed at limiting the risk of bank's liquidity or funding profiles driving them into default. The net stable funding ratio (NSFR) is targeted at the funding risk while the liquidity coverage requirement (LCR) focuses on the short term liquidity risk.

The rules for the use of securities as liquidity buffer investments are stipulated in the proposed regulation mainly in Part six (Liquidity) in articles 403, 404, 405, 406) and in Part ten (Transitional provisions, reports and reviews) in article 481. The overall liquidity buffer portfolio is divided into a (level 1) bucket of assets, which qualify for an "extremely high liquidity and credit quality", and a (level 2) bucket of assets with "high liquidity and credit quality". Level 2 can make up a maximum of 40% of the total liquidity buffer and it is subject to a 15% haircut.

According to article 481(2), the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Central Bank (ECB) have the mandate to develop "appropriate uniform" definitions of level 1 and level 2 assets by mid 2013. In this process, it shall test the adequacy of the following criteria and the appropriate levels for such definitions. When it comes to liquidity the following criteria shall apply: (1) minimum trade volume, (2) minimum outstanding volume, (3) transparent pricing and post-trade information, (4) proven record of price stability, (5) average volume traded and average trade size, (6) maximum bid/ask spread, (7) remaining time to maturity and (8) minimum turnover ratio. With regards to quality, the following criteria where stipulated: (1) credit quality steps (2) additional quality criteria on top of those set by central banks (3) support financing of the European economy. At the latest within one year EBA and the European Systemic Risk Board (ESRB) shall evaluate the market impact and the effectiveness in contributing to financial stability.

Quantitative criteria	Qualitative criteria
Minimum trade volume Minimum outstanding volume Transparent pricing and post-trade information Proven record of price stability Average volume traded and average trade size Maximum bid/ask spread Remaining time to maturity Minimum turnover ratio	Credit quality steps Additional quality criteria on top of those set by central banks Support financing of the European economy

In this article we will provide as much information on the metrics mentioned in Article 481 (2) as possible. It is our understanding that the LCR was primarily designed for situations where individual banks run into trouble and have to liquidate assets to cover their cash outflows. In the case of systemic banking crisis, lenders of last resort are central banks and there are good reasons to believe that no set of eligible assets under the LCR will ever fully protect banks in these cases.

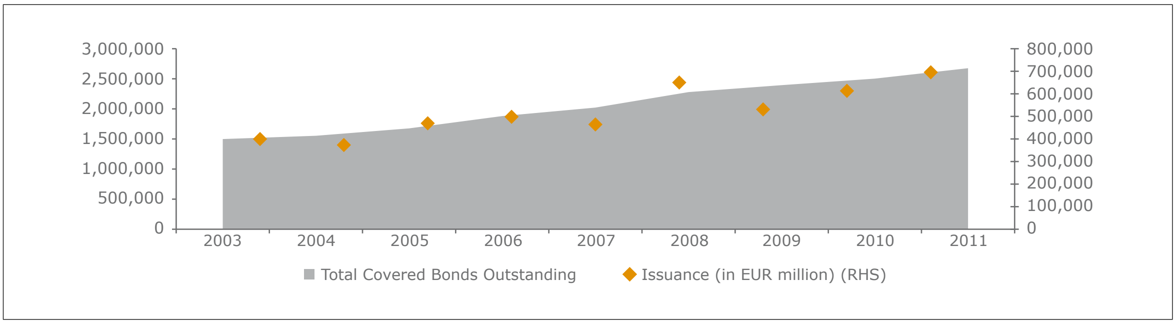
We therefore welcome that the CRD IV text voted by the European Parliament's Economic and Monetary Affairs Committee also includes – in addition to turnover figures – qualitative criteria as determinants of LCR eligibility which were not addressed by the Commission's proposal. We will therefore also add further qualitative evidence to support the claim that covered bonds are safe and stable assets with a wide, diverse and growing investor base.

2. QUANTITATIVE CRITERIA MENTIONED IN ART 481 CRR

2.1 Size of the covered bond market

Covered bonds are one of the largest private sector debt markets in the world. At the end of 2011, the overall volume stood at EUR 2.7 trillion. Overall covered bond issuance in 2011 reached EUR695bn up from EUR613bn in 2010.

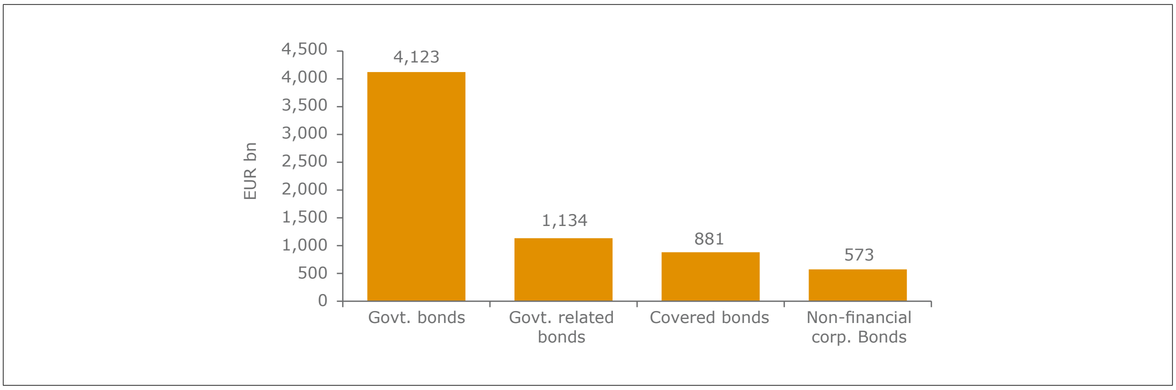
> FIGURE 1: OUTSTANDING COVERED BONDS AS WELL AS COVERED BOND ISSUANCE (EURBN)



Source: ECBC, CA CIB

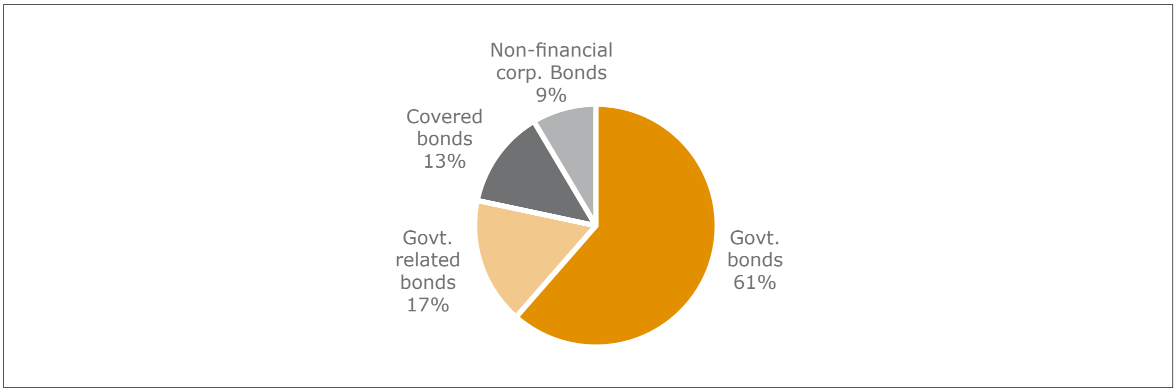
Looking only at the benchmark fixed coupon market, the volume comes in at EUR 880bn as at mid 2012. This compares to EUR 573bn of non-financial corporate benchmark bonds, EUR 1,134bn of government-related bonds (incl. supranational, sub-sovereign, agency and government guaranteed bank debt) and EUR 4,123bn of government bonds.

> FIGURE 2: OUTSTANDING VOLUME OF SELECTED EUR FIXED COUPON BENCHMARK SECTORS WITH AN INVESTMENT GRADE RATING (JUNE 2012)



Source: Barclays

> Figure 3: Market share of selected EUR fixed coupon benchmark sectors with an investment grade rating (June 2012: EUR 6.7trn)

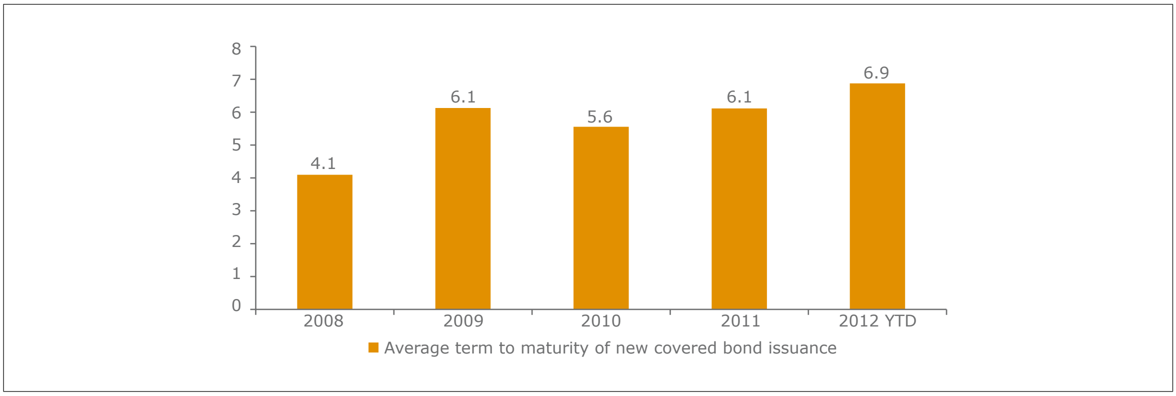


Source: Barclays

2.2 Remaining time to maturity / redemptions

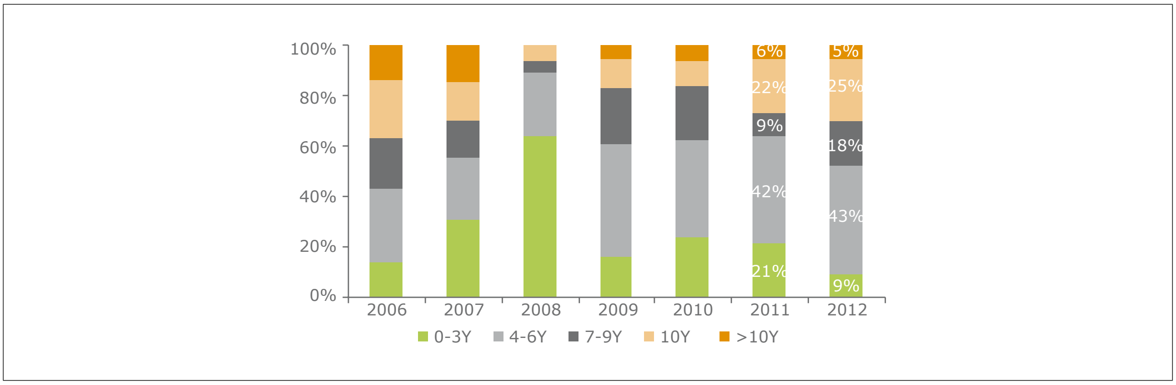
Covered bonds are supposed to provide long term funding to bank treasuries. And when looking at the evolution of the average term of EUR benchmark covered bonds it becomes evident that they live up to their role. In 2012 the average term to maturity of EUR benchmark covered bonds was 6.9 years. At the same time, when looking at the term distribution of new issuance, it becomes apparent that issuance does not concentrate only on one particular part of the curve and thus investor base but is spread along the curve. Shorter dated bank treasury demand is serviced as is longer dated insurance sector demand.

> Figure 4: Average term to maturity new EUR benchmark covered bond issuance



Sources: Bloomberg, CA CIB

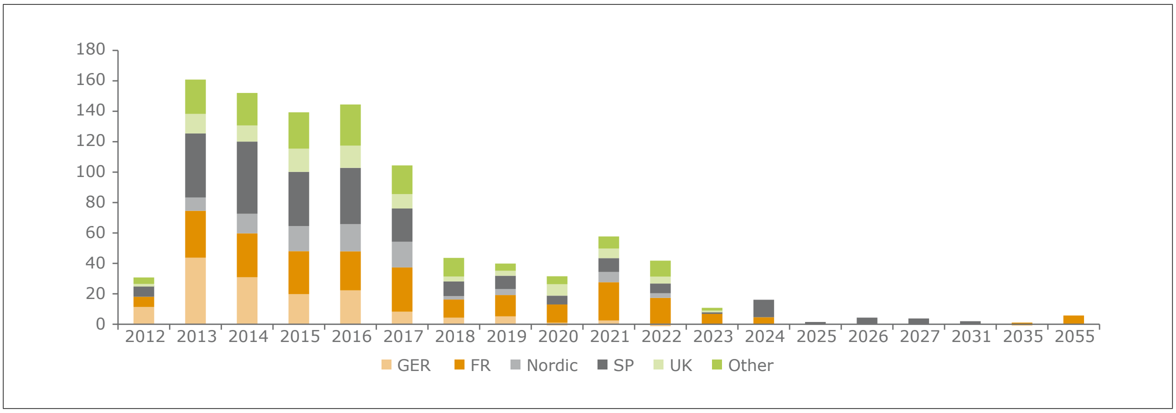
Figure 5: Term split EUR benchmark covered bond issuance



Sources: Bloomberg, CA CIB

Liquidity in a particular investment does not necessarily have to come from secondary market flows. It can just as well come from redemptions. Looking at covered bond redemptions between 2013 and 2016, the number fluctuates between around EUR140bn in 2015 and EUR160bn in 2013. In our experience bank treasuries usually invest in covered bonds with maturities up to 3 years. As a result, they can bank on regular cash inflows from these redemptions irrespective of the level of secondary market activity at the time.

Figure 6: Redemptions EUR benchmark covered bonds (EUR bn)



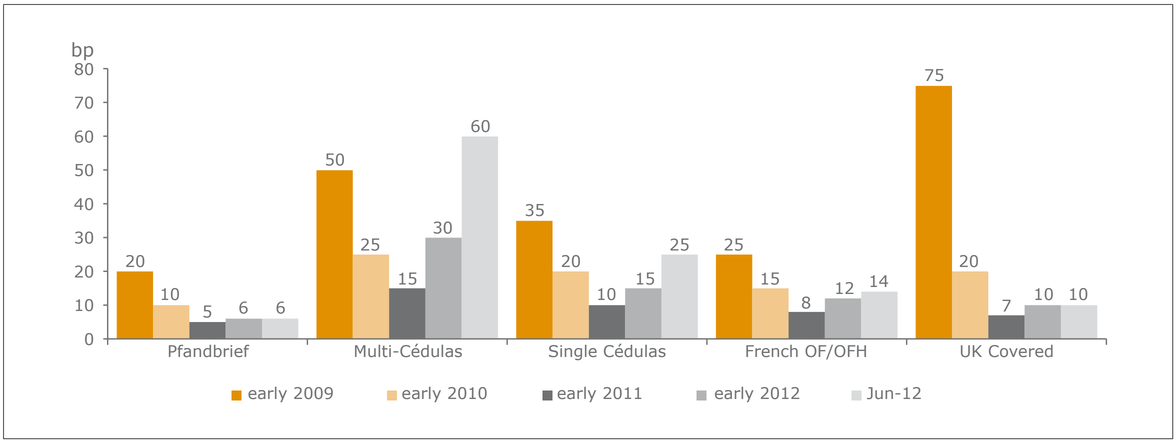
Sources: iBoxx, CA CIB

2.3 Bid/ask spreads

Bid-ask spreads are one additional criterion that the European authorities are mandated to review when assessing which assets can be assigned into the "extremely high liquidity" and "high liquidity" categories. Figure 6 below shows the historical development of 5y generic covered bonds from various jurisdictions over the past three years.

When looking at the numbers, it becomes apparent that bid ask spreads were subject to some variations throughout the financial market crisis and they have also varied substantially across jurisdictions. Particularly those markets, were the volatility in underlying government bonds was pronounced, bid ask spreads of covered bonds were also subject to stronger variations.

> Figure 7: Development of bid-ask spreads of 5Y generic EUR benchmark bonds in selected covered bond jurisdictions*



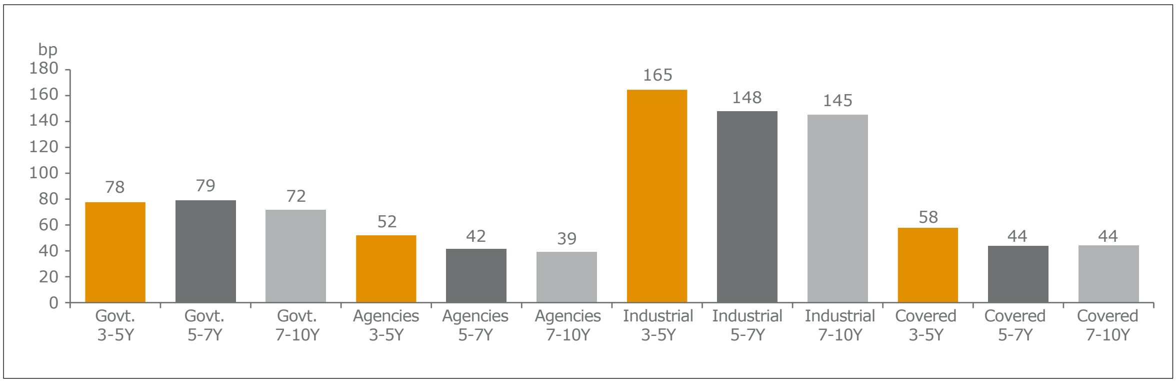
Note: Bid / Ask spreads and sizes are on indicative basis and can vary according to specific request

2.4 Spread volatility

We have analysed the swap spread development in major euro area fixed income market segments with an investment grade rating over the past ten years by using weekly data from Barclays Euro Aggregate indices. The relevant market sectors include government bonds, public-sector agency bonds, non-financial corporate bonds and covered bonds. As spread measures we focus on the maximum swap spread change over a rolling 5 week period. Given the rather distressed market environment over the past five years and given that the value of liquidity buffer investments should be comparatively stable in distressed market situations, we believe that particularly the second volatility measure more then well captures these aspects.

The aggregate measures across the major instruments and across major maturity buckets indicate that maximum swap spread volatility was the lowest in agency and covered bonds, somewhat more elevated in the segment of government bonds and by far the most pronounced in non-financial corporate bonds, where the maximum swap spread change has been about three times as high as for agency and covered bonds.

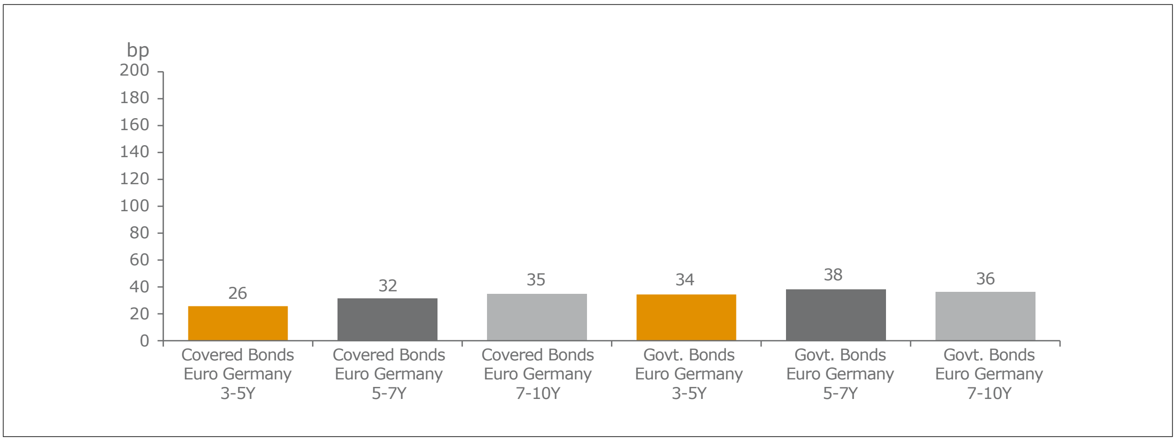
> Figure 8: Maximum five week swap spread change of major market segments over a rolling 5 week period between January 2002 and July 2012



Source: Barclays

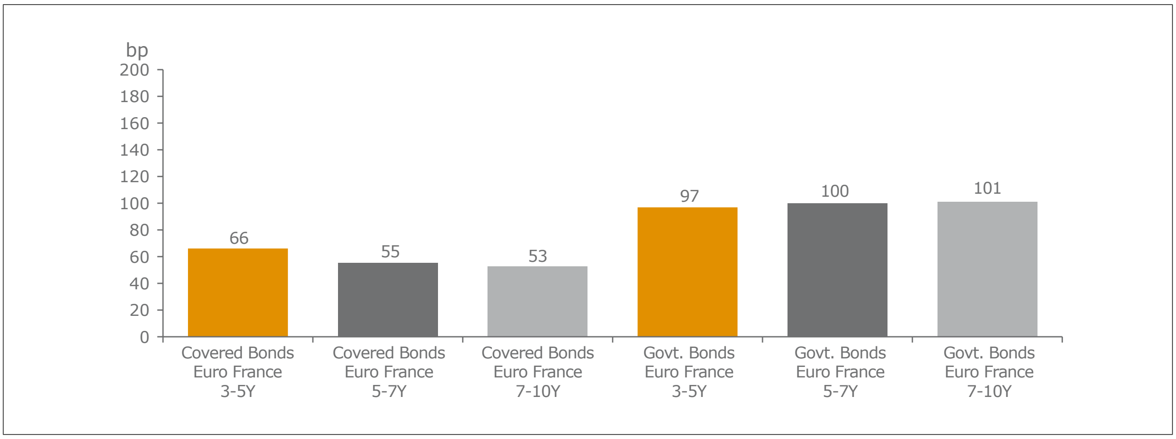
Over the past three years, spread volatility has been strongly influenced by the evolution of the European sovereign debt crisis and consequently volatility measures varied a lot between different countries. What is interesting though is that in extreme situations with major market swings, swap spread volatility of covered bonds has been consistently below the swap spread volatility of underlying government bonds. Figures 9 to 11 show that over the past ten years the maximum five week swap spread change of covered bonds has been below the same measure for government bonds in Germany, France and Spain across various maturity buckets.

> Figure 9: Maximum five week swap spread change of German covered and government bonds over a rolling 5 week period between January 2002 and July 2012



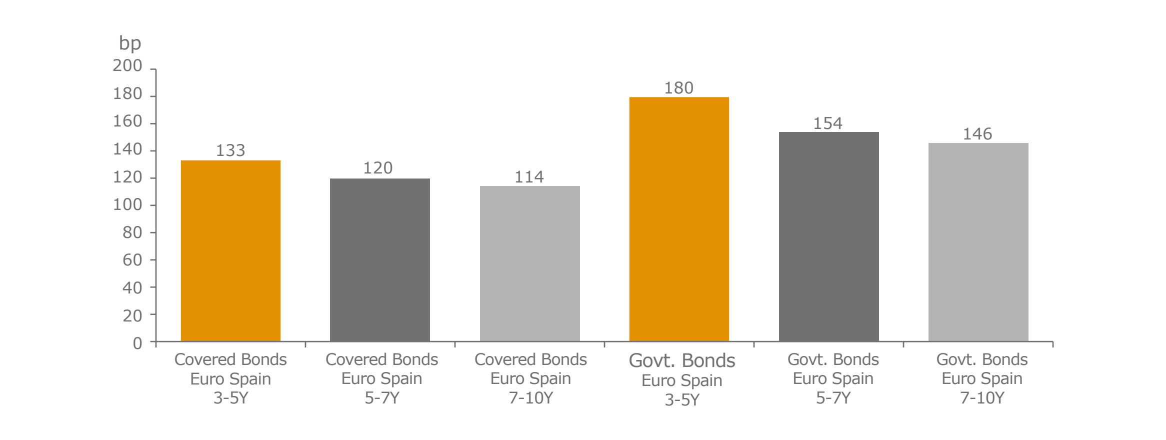
Source: Barclays

> Figure 10: Maximum five week swap spread change of French covered and government bonds over a rolling 5 week period between January 2002 and July 2012



Source: Barclays

> Figure 11: Maximum five week swap spread change of Spain covered and government bonds over a rolling 5 week period between January 2002 and July 2012



Source: Barclays

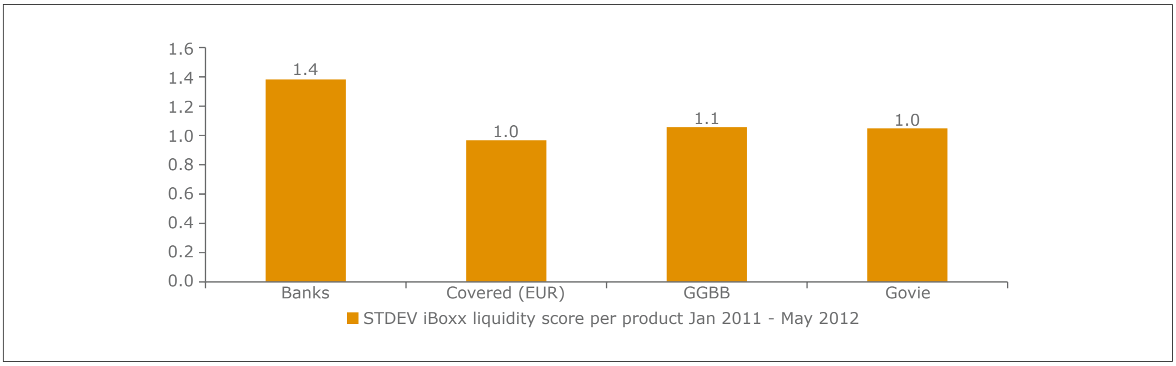
2.5 Market liquidity score

Markit is one of the most widely used index providers in fixed income markets. In addition to providing index data and pricing information for its iBoxx indices, the company also calculates a liquidity score for bonds in various market sectors ranging from covered bonds to agencies, government bonds and corporate credit. The index is not based on actual turnover volumes but analyses the availability and quality of dealer quotes. The score doesn't say anything about the volumes that could be traded but it tries to measure the likelihood that an investor is able to trade in a given bond at all.

We have analysed Markit Liquidity Scores for EUR benchmark bonds from Markit's iBoxx EUR Covered, iBoxx EUR Government Bond, iBoxx EUR Agencies, iBoxx EUR Other Sub-Sovereigns Guaranteed Financials and iBoxx EUR Bank Senior indices. The data covers the period between September 2011 and May 2012. This time can certainly be characterised by very extreme market conditions. Fall 2011 was characterised by very negative markets, low new issue volumes and little trading across asset classes while very euphoric markets dominated after the LTROs in December and February.

Throughout that time levels of liquidity have fluctuated wildly in a number of sectors. However for a sector to be ideal in the context of the LCR its actual level of liquidity should exhibit low volatility as well. We have therefore looked at the variations of the iBoxx liquidity score. Even though not without fluctuations, covered bonds were significantly more stable than senior unsecured debt of banks or government guaranteed bank bonds as well as on par with government bonds.

> Figure 12: Standard deviation per product type - Markit Liquidity Score (period between September 2011 and May 2012)



Source: Markit, Crédit Agricole CIB

3. QUALITATIVE CRITERIA

Although subject to the conclusions of the Trialogue process between the European institutions, the CRD IV text voted by the European Parliament's Economic and Monetary Affairs Committee has introduced a separate category of qualitative criteria. The rating criterion was moved there but two further points were introduced that didn't appear in the common position of Member States:

- Credit quality steps
- Additional quality criteria on top of those set by central banks
- Support financing of the European economy

3.1 Credit quality

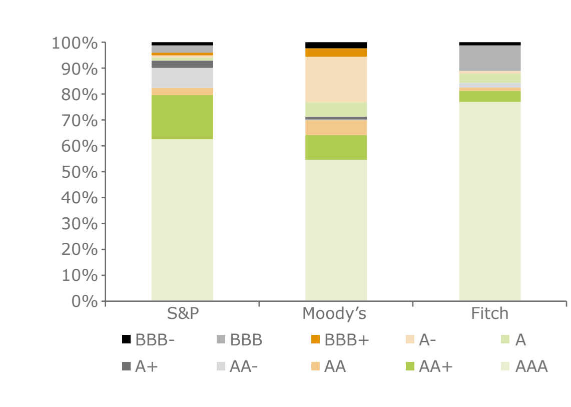
a) Credit quality steps covered bonds + uplift over the issuer / sovereign ratings

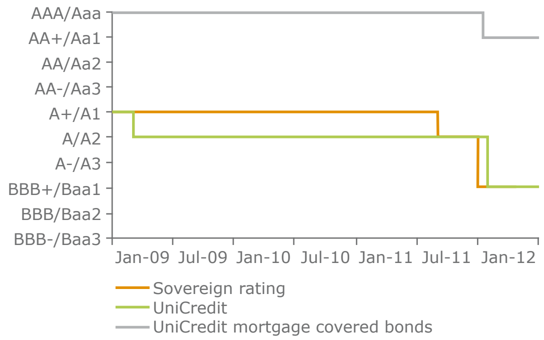
Covered bonds are dual recourse instruments that are offer a preferential claim on a cover pool as well as a claim on the bank issuing the bonds. This fact is also recognised by rating agencies who grant the product several notches rating uplift over the issuer as well as in some cases even above the sovereign rating.

Despite the recent covered bond downgrades, the majority of the EUR benchmark covered bond market is still rated AAA. In addition to this, the downgrades that did take place were mostly triggered by downgrades of the respective sovereigns and didn't have their root in the covered bond product. Essentially, covered bond ratings in countries such as Portugal, Spain or Italy were far more stable than those of their respective sovereigns.

> Figure 13: Rating distribution iBoxx EUR Covered per agency (as of August 2012)

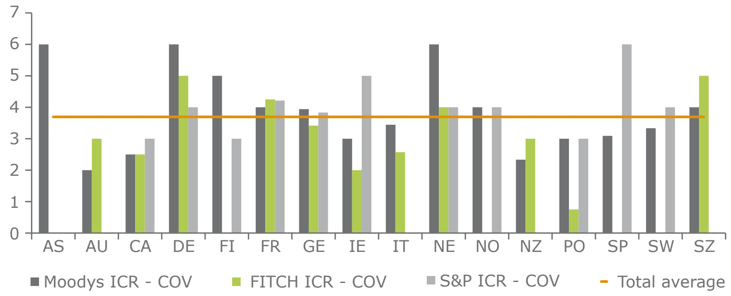
> Figure 14: Rating migration covered vs sovereign (S&P)





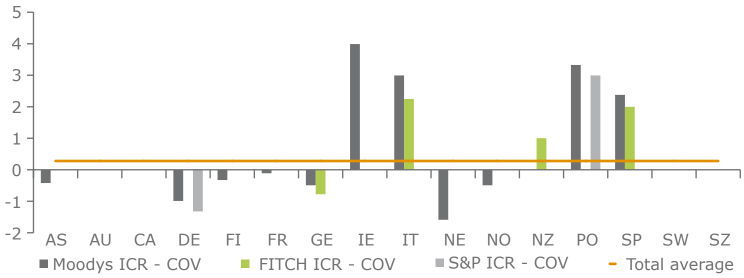
Source: Markit, Crédit Agricole CIB

> Figure 15: Average rating uplift for covered bonds over the issuer rating and average TPI leeway Moody's



Source: Bloomberg, CA CIB

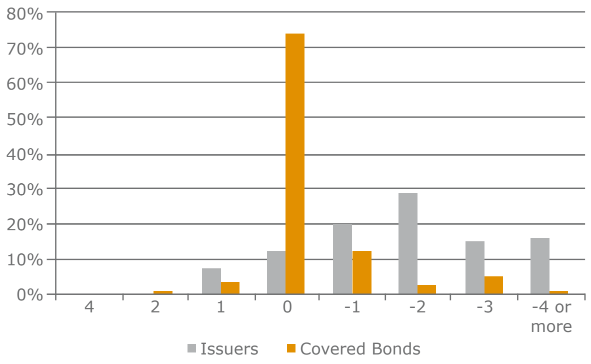
> Figure 16: Average rating uplift for covered bonds over the issuer rating and average TPI leeway Moody's



Source: Bloomberg, CA CIB

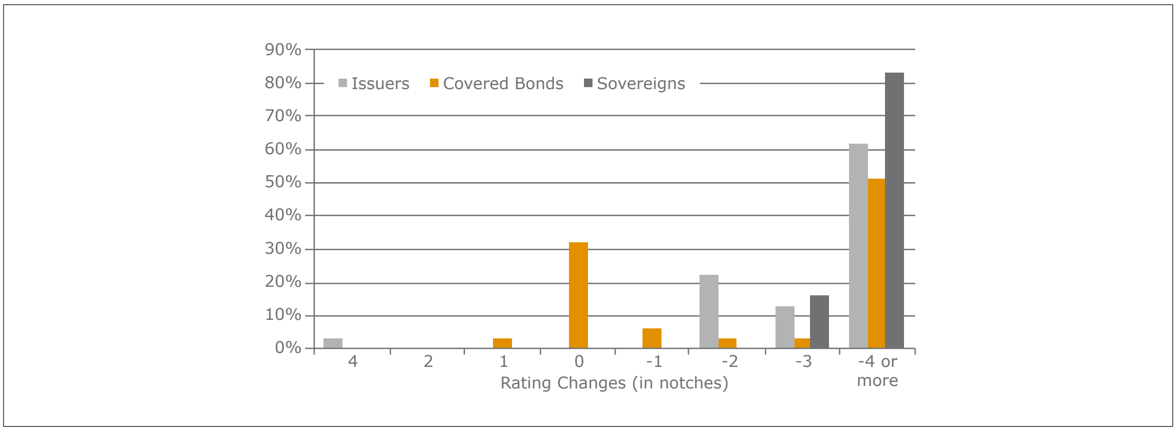
In March 2012, Moody's published a study on the impact of the recent issuer and sovereign downgrades on the rating migration of covered bonds. Moody's analysis is based on data for the 4-year period from January 2008 to February 2012. During that time, many sovereigns have been downgraded, most notably in Europe. Moody's study is split in two parts: one part analyses the covered bond rating migration in countries with stable sovereign ratings and the other part examines the rating behaviour of covered bonds in countries where the sovereigns were downgraded.

In countries, which have experienced stable sovereign ratings since the beginning of 2008, the covered bond issuers have been on average downgraded by more than two notches. On the other hand, the average covered bond downgrades have been limited to less than half a rating notch. The graph below shows that more than 70% of covered bonds have managed to retain their Moody's rating and only ~5% were downgraded by 3 notches or more. In comparison, 80% of the issuers were downgraded, and almost 30% of the issuers were downgraded by 3 notches or more. Hence, covered bond ratings have proved significantly more stable than the issuer ratings. However, Moody's data also shows that they were not completely immune to issuer downgrades.



Source: Moody's, RBS

In countries where the sovereign has been downgraded, the picture looks considerably less rosy. In Moody's study, out of the downgraded countries, 83% of the sovereigns were cut by four notches or more with the remainder being subject to 3-notch downgrades. The average covered bond downgrade in these countries was about 4 notches. At the same time, issuers have been downgraded by an average of 5.5 notches. The chart below shows that 65% of the covered bonds have been downgraded when their respective sovereigns have been downgraded, with the bulk (52%) being in the four-notch area. Over the same period, 97% of issuers have been downgraded with 61% facing downgrades of four notches or more. Interestingly, despite the sovereign downgrades, 32% of the covered bond ratings remain unchanged whilst 3% were even upgraded by one notch. This shows that covered bonds can withstand issuer and even sovereign downgrades up to a certain extent.



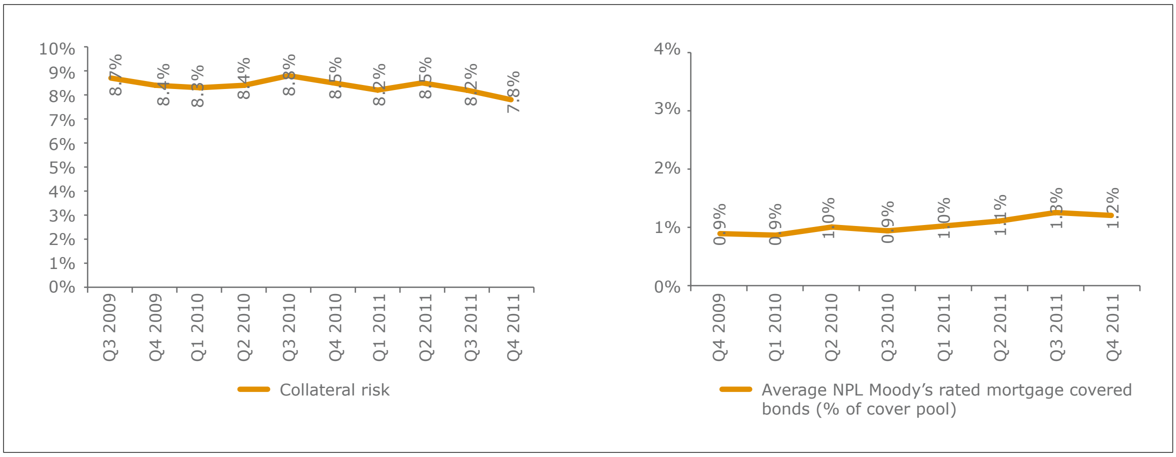
Source: Moody's, RBS

b) Credit quality of covered bonds

One of the objectives of regulators as well as investors these days is to reduce the reliance on ratings. So focussing away from the pure ratings, some of the rating agencies provide the market with additional information that goes beyond the mere ratings assigned.

Moody's Collateral Score is a metric that measures the underlying credit quality of cover pools. Essentially the number stands for the over-collateralisation required to cover any stressed pool losses stemming form credit risk. When looking at the evolution of this ratio, one can see that it has remained virtually flat, even slightly improved since December 2009, a time that can certainly be characterised by worsening loan profiles in many countries across Europe. Moving even further away from agency metrics and into actual pool NPL numbers, it becomes evident that we are looking at very low numbers in a European context. Average NPLs have only increased from 0.9% to 1.2%.

> FIGURE 17: AVERAGE COLLATERAL SCORE AND COVER POOL NPLS OF MORTGAGE BACKED COVERED BONDS (%)

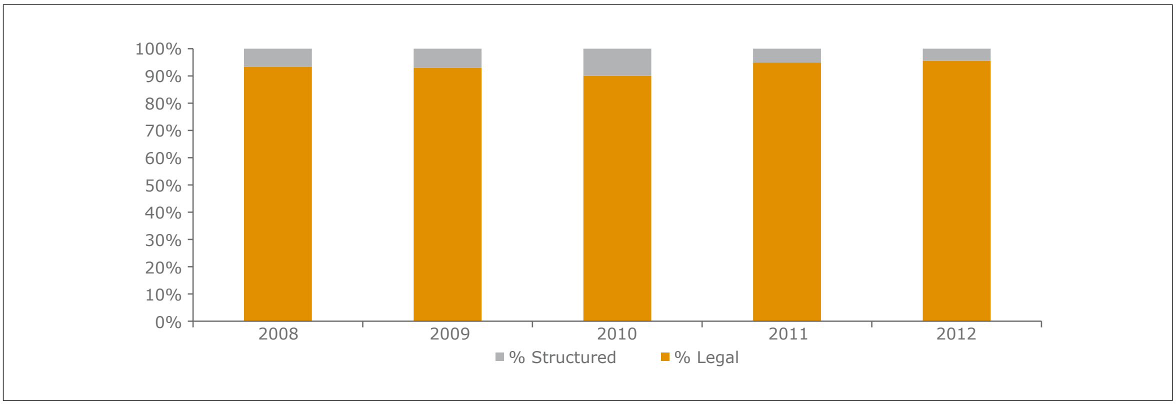


Source: Moody's, CA CIB

Issuers manage cover pool NPLs actively, which is one of the main strengths of covered bonds compared to RMBS. The exception to this is Spain where the overall mortgage book is automatically considered to be part of the cover pool.

In addition to offering investors a priviledged claim on a specified pool of assets, the vast majority of covered bonds (96% of the iBoxx EUR covered as of August 2012) are backed by dedicated covered bond legal frameworks. These don't only regulate aspects such as cover asset eligibility, asset liability management or cover pool transparency but also form the basis for the special public supervision that covered bonds are subject to. This special public supervision is an essential prerequisite for covered bonds' UCITS as well as CRD compliance and is one of the main qualitative criteria that differentiate the product from other market segments such as senior unsecured or agency debt.

> Figure 18: Legal based vs. structured covered bonds in the iBoxx EUR covered index (%)



Source: iBoxx, CA CIB

Last but certainly not least, covered bonds are explicitly excluded from bail ins. Investors can be certain that their claim will not be written down and that it will remain at par even in a bank failure with subsequent bail in.

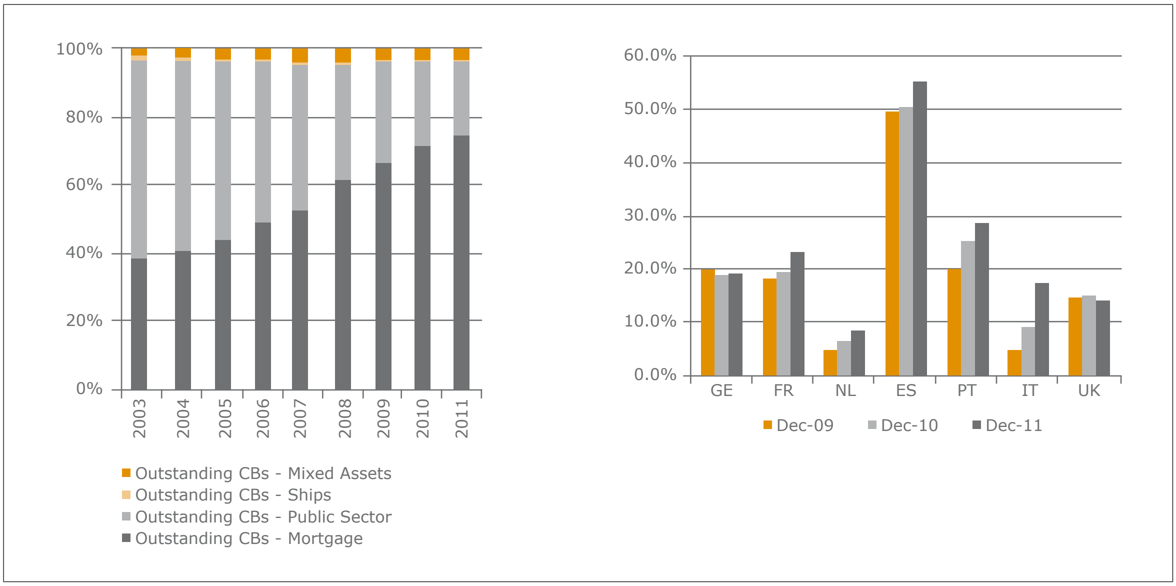
3.2 Support financing of the European economy

Covered bonds have become an integral part of most European countries' financial markets and banks' funding strategies. In fact, the last major European country that did not have covered bonds – Belgium – has just passed its covered bond primary legislation.

The main asset class that covered bonds fund these days are mortgages. Their share in outstanding covered bonds has increased from 40% in 2003 to around 75% in 2011. When comparing covered bond volumes to the underlying mortgage markets one can see just how important the product is. Mortgage backed covered bonds in France, Germany, Ireland, Italy, Netherlands, Portugal, Spain and the UK represent on average around 24% of their respective mortgage markets and 69% and 100% respectively in Sweden and Denmark.[1] This number has been on the way up in recent years as well, and especially countries that have been lagging behind initially such as Italy have been picking up fast.

[1] See the article on the "Overview of Covered Bonds" in the Generic Section for further information.

> Figure 19: Share mortgage backed covered bonds in total covered bond issuance + Covered bonds in % of outstanding residential mortgage markets for selected countries*

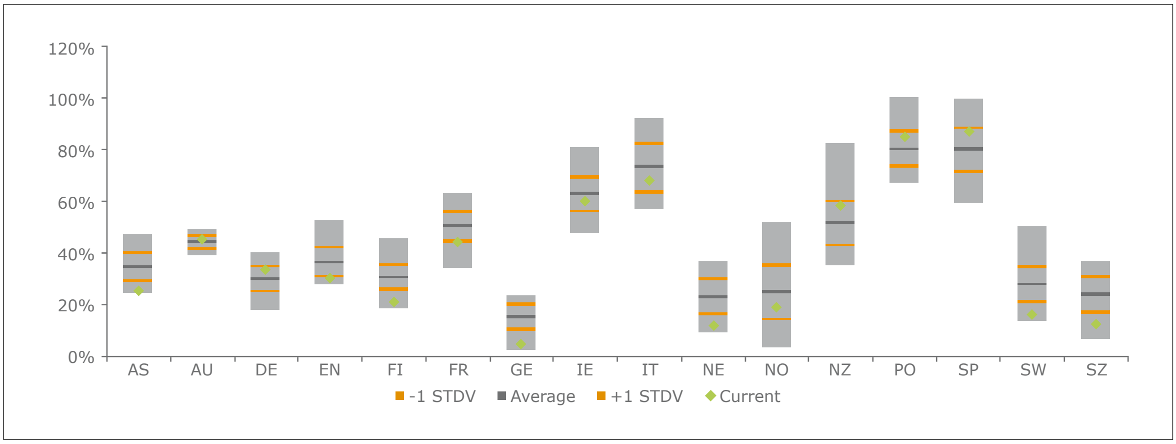


Source: ECBC, CA CIB

* In Spain and Germany percentages are distorted as Pfandbriefe as well as Cedulas cover pools also contain commercial mortgages and the mortgage figures from the EMF only contain residential mortgages. For the other countries the percentages are representative though.

For banks refinancing mortgages, covered bonds are the cheapest wholesale funding instrument available offering banks across countries significant cost savings compared to senior unsecured issuance.

> Figure 20: Average covered bond spreads in % of senior unsecured levels (bp) per country



Sources: Bloomberg, CA CIB

Consequently covered bonds play an important role in lowering the cost of mortgages across Europe and help support in financing the European economy.

3.3 Depth of the investor base

The covered bond market is characterised by a large, growing and above all very heterogeneous investor base. While there are many dedicated covered bond investors in especially the traditional countries such as Germany and France that have stuck with the product throughout the crisis, for large parts of the investor base, CBs are not the benchmark reference of their investment decisions per se. Instead, they consider the government market, the credit market or the securitisation market as their home turf. As a consequence, the investor base for CBs is quite heterogenic including central banks, bank treasuries, asset managers, insurance companies, pension funds and occasionally corporates, allowing issuers to diversify their investor base away from those accounts usually purchasing their unsecured debt or ABS/RMBS transactions. German Pfandbriefe for instance are classified as "eligible for trust investment" according to German law and are thus even sold to retail investors.

Many of these investors mentioned have different portfolio rules, benchmarks and follow different strategies. While some investors would focus on the spread of covered bonds to government bonds, others focus on the spread to senior unsecured, while others could follow a distressed debt approach and focus on pool recoveries.

> This diversity adds stability to the funding of issuers and reduces their reliance upon a limited number of markets. This can become crucial as the recent crisis has highlighted.

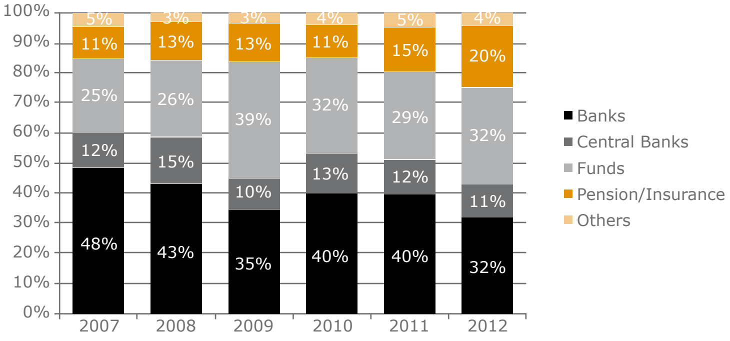
> Furthermore the more different strategies are used in any given market the more likely it will be for a bank treasurer to find an investor that is willing to buy a covered bond from his liquidity portfolio.

a) Who are the investors?

In the following analysis, we have used primary market data available for EUR benchmark CB transactions launched between January 2007 and May 2012.

Five core investor groups encompass about 96% of the total investor base. These are banks or bank treasury accounts and central banks as well as investment funds, pension funds and insurance companies – ie, the so-called real money investors. Corporates and hedge funds are rarely present, while retail investors are usually part of the banks' share. The latter usually act as agents for retail investors. The banks are purchasing the bonds in the primary market and distribute them to the retail investors afterwards.

> FIGURE 21: EUR BENCHMARK INVESTOR DISTRIBUTION BY TYPE



> Figure 22: Changes in Order Books

	2006 - 2008	2009	2010	2011	2012
Average deal size (€bn)	1.45	1.19	1.01	1.05	1.09
Average # of orders per deal	57	105	88	85	115
Average volume of orders (€mn)	44	25	18	21	20

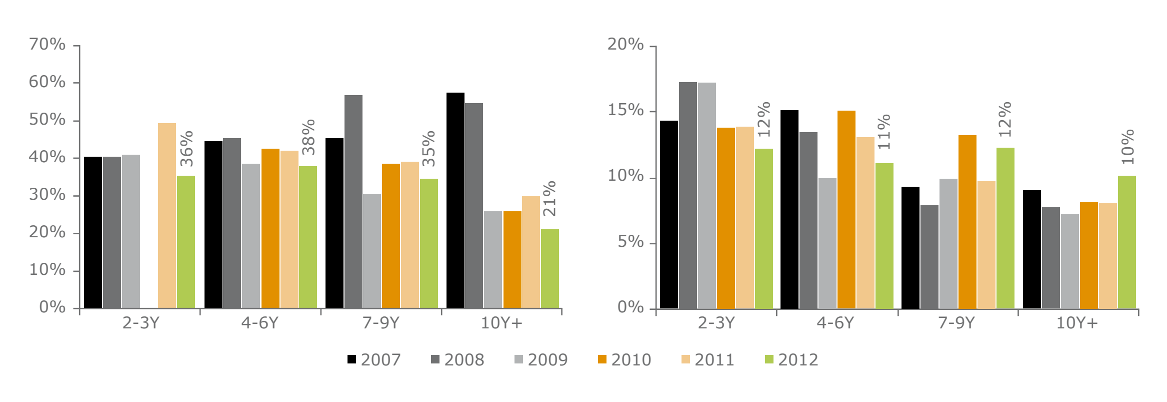
Source: Publicly available deal allocation statistics, RBS

As indicated in the preceding chart, banks account for the largest individual investor group, covering a share of around 40% of demand for all deals since 2007, followed by investment funds (30%) and central banks (12%). The combined share of pension funds and insurance companies stands, at 14%. Year-to-date the participation of real money investors has increased to the highest value in more than five years, reflecting increased demand from insurance companies. Together with the increased demand from real money investors, the average number of orders per benchmark transaction has increased considerably in 2012, reflecting the high granularity of the order books in covered bond transactions (see table below).

The following charts show the different maturity preferences of the four large investor groups. Due to the nature of the source and purpose of their funds, central banks tend to prefer short- and medium-term maturities rather than longer-term maturities. While bank accounts (including bank treasuries) also tend to prefer short maturities for their liquidity portfolios, insurance companies and pension funds show particular interest in longer dated tenors to match the term structure of their liabilities.

> Figure 23: Average participation of bank investors in different maturities

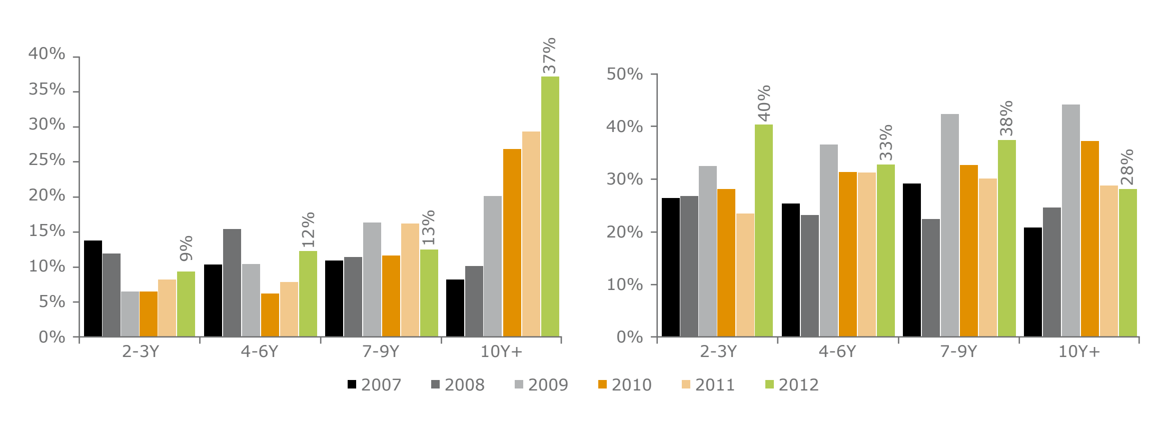
> Figure 24: Average participation of central bank investors in different maturities



Source: Publicly available deal allocation statistics, RBS

> Figure 25: Average participation of pension/insurance investors in different maturities

> Figure 26: Average participation of fund manager in different maturities

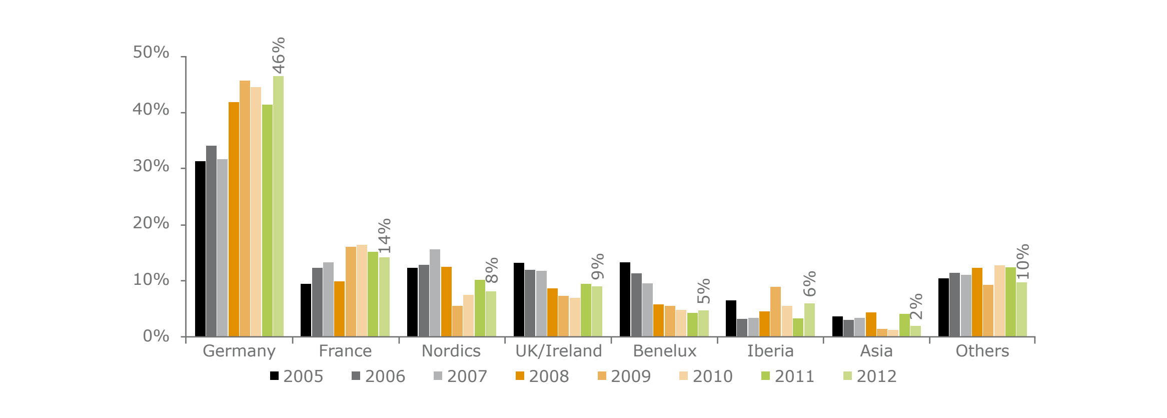


Source: Publicly available deal allocation statistics, RBS

b) Where are the investors based?

With an increasing number of new markets and issuers being established, the investor base is expanding continuously. As seen in the next chart, the vast majority of CB investors denominated in euros are based in Europe. CB investors outside Europe comprise so far only a minor share, and, if they are present, it is predominantly central banks or sovereign entities or wealth funds out of Asia or the Middle East. The demand structure for CBs denominated in non-euro currencies varies. Due to the importance of the respective local markets, there is a strong domestic investor base for CBs denominated in DKr and SKr. The same is true for Switzerland. The recent rise of USD issuance by Canadian, Australian as well as a number of European issuers has increased demand from US investors. The same can be observed for covered bonds denominated in Sterling where record issuance volumes reflect growing demand from the UK investor base.

> Figure 27: EUR Benchmark Investor Distribution by Country

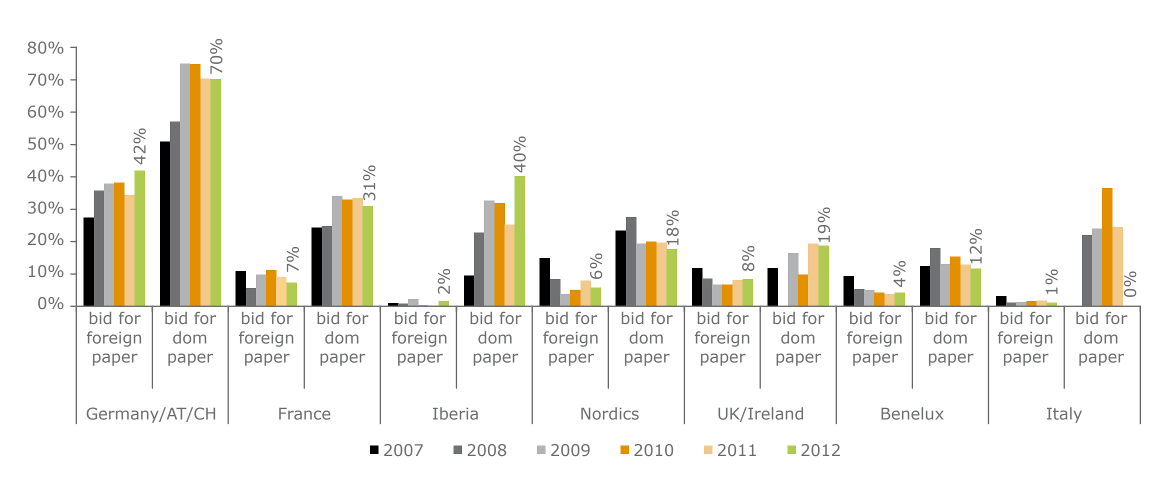


Source: Publicly available deal allocation statistics, RBS

c) The importance of the domestic investor base

Since the beginning of the crisis there has been increasing focus on the domestic investor base for the respective products. Quite often foreign investors consider this an important point of their investment decision, particularly in times of great uncertainty. A large domestic investor base is viewed as a good indication of the degree of a potential backstop, should a product group begin to underperform. It is assumed that domestic investors are more prepared to bid for their domestic paper in a widening spread environment than foreign investors would.

> FIGURE 28: DEMAND FROM DOMESTIC INVESTORS



Source: Publicly available deal allocation statistics, RBS

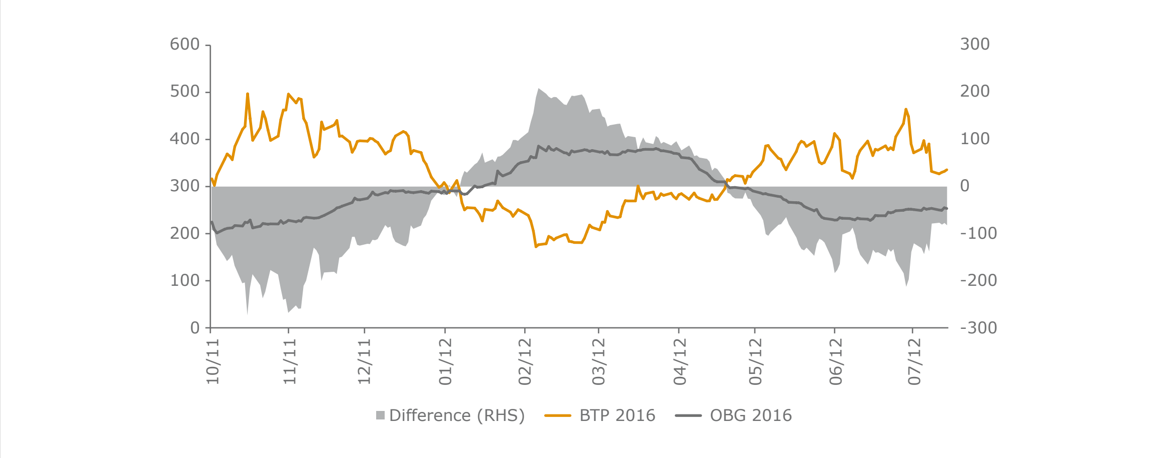
As can be seen in the preceding chart, in each country representing larger supply in recent years the share of domestic investors involved in new domestic transactions exceeds that for foreign transactions. When examining Nordic investors, their share in the placement of euro-denominated Nordic benchmark CBs reached 23% prior to the crisis. At the same time, their share for euro-denominated foreign benchmark CBs was only 15%. In 2008, their share in Scandinavian CBs even increased to 28%, while that for foreign Jumbo CB dropped to only 8%.

The relevance of the domestic backstop becomes most obvious when examining the spread performance of the individual markets. Countries that had the largest share of domestic investors also saw the least spread widening.

3.4 Covered bonds vs. government bonds – spread evolution and correlation

We have mentioned above that covered bonds spreads have been more stable than many other asset classes including government bonds. In some countries covered bonds are actually the tightest product trading tighter than the respective sovereign bonds. Even though the mainstream opinion is still that covered bonds should be wider than their sovereign bonds and no issuer has yet managed to price a new deal at levels through the sovereign spread curve, there have been an increasing number of secondary market tickets that actually took place at these negative spread levels.

> Figure 29: ASW spread evolution of 5Y Italian covered bonds vs. 5Y government bonds



Sources: Bloomberg, CA CIB

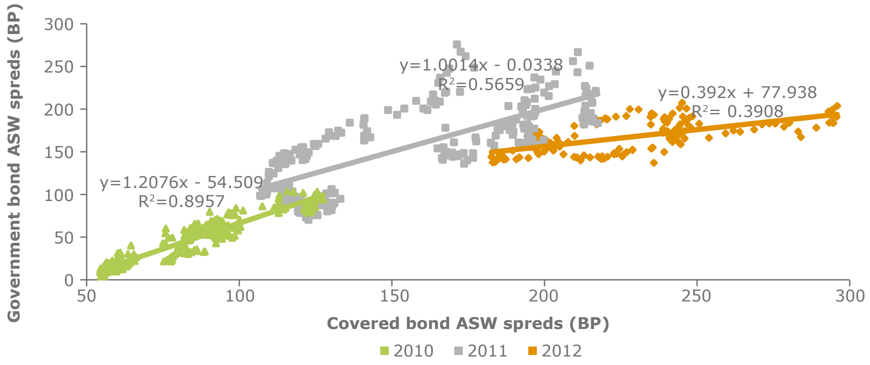
The worse the situation on the sovereign side has become the more investors have started to focus on the collateralised nature of covered bonds that they have more faith in than the "unsecured claim" against a sovereign. More and more investors actually place covered bonds at the top of the quality ladder above sovereign exposure in some countries. However in the context of the CRD IV, they are still treated inferior.

We have also analysed correlations of covered bond spreads to for example government bonds. Even if investors don't follow the same logic as mentioned above and still perceive the sovereign to be the best risk available from a given country can covered bonds improve the overall quality and robustness of their liquidity portfolios.

We have paired EUR benchmark covered bonds with their respective government bonds and analysed how these "pairs" have behaved over time. While exhibiting a very high correlation in 2010 (0.89), this number has come down the more volatile and stressful the situation in markets has become. The correlation in 2011 had already come down to 0.75 and using 2012 numbers has further fallen to 0.65.

Bank treasuries can therefore benefit from diversifying out of a pure government bond portfolio to one including covered bonds as well.

> Figure 30: Correlation of EUR benchmark covered bonds to their respective government bonds per year based on daily ASW spread figures



Sources: Bloomberg, CA CIB

3.5 Repo eligibility of covered bonds

Generating liquidity out of an asset in one's possession can happen in a number of ways and an outright sale is just one of them. In many cases, using assets as collateral in repo markets with either private counterparties or central banks is the cheaper and more efficient way to raise liquidity. The credit quality of an asset is a decisive factor when using it as collateral. We have already discussed the credit quality of covered bonds above. Below we show the haircuts currently used by the Eurosystem. Covered bonds receive haircuts well below those of corporate debt or securitisations while being on par with those of agencies, supras and close to even government bonds.

> Figure 31: Haircuts applied by the Eurosystem (%)

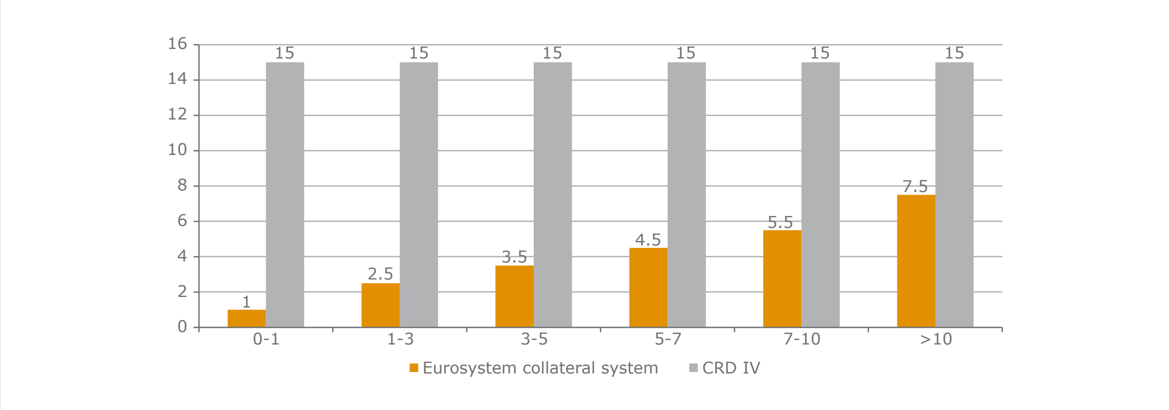
	Liquidity categories								
AAA to A-	**Category I** (Government Bonds)		**Category II** (Local & Regional Govt, Supras & Agencies, Jumbo Covered Bonds)		**Category III** (Traditional Covered Bonds, Structured Covered Bonds, Multi-Issuer Covered Bonds, Corporate Bonds)		**Category IV** (Unsecured Bank Bonds)		**Category V** (ABS)
Residual maturity (years)	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed / Zero coupon
0-1	0.5	0.5	1.0	1.0	1.5	1.5	6.5	6.5	16.0
1-3	1.5	1.5	2.5	2.5	3.0	3.0	8.5	9.0	16.0
3-5	2.5	3.0	3.5	4.0	5.0	5.5	11.0	11.5	16.0
5-7	3.0	3.5	4.5	5.0	6.5	7.5	12.5	13.5	16.0
7-10	4.0	4.5	5.5	6.5	8.5	9.5	14.0	15.5	16.0
>10	5.5	8.5	7.5	12.0	11.0	16.5	17.0	22.5	16.0

	Liquidity categories								
BBB+ to BBB-	**Category I** (Government Bonds)		**Category II** (Local & Regional Govt, Supras & Agencies, Jumbo Covered Bonds)		**Category III** (Traditional Covered Bonds, Structured Covered Bonds, Multi-Issuer Covered Bonds, Corporate Bonds)		**Category IV** (Unsecured Bank Bonds)		**Category V** (ABS)
Residual maturity (years)	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed / Zero coupon
0-1	5.5	5.5	6.0	6.0	8.0	8.0	15.0	15.0	26.0
1-3	6.5	6.5	10.5	11.5	18.0	19.5	27.5	29.5	26.0
3-5	7.5	8.0	15.5	17.0	25.5	28.0	36.5	39.5	26.0
5-7	8.0	8.5	18.0	20.5	28.0	31.5	38.5	43.0	26.0
7-10	9.0	9.5	19.5	22.5	29.0	33.5	39.0	44.5	26.0
>10	10.5	13.5	20.0	29.0	29.5	38.0	39.5	46.0	26.0

Sources: Eurosystem, CA CIB

While the CRD IV text still requires bank treasuries to apply a 15% haircut on level 2 assets irrespective of their maturity, central banks do make a difference. While short dated 1-3Y jumbo covered bonds receive a haircut of 2.5% as long as they are rated above BBB+, this haircut goes up to 7.5% for bonds with maturities beyond 10Y. We would strongly encourage that this approach of a differentiated haircut is replicated in the CRD IV.

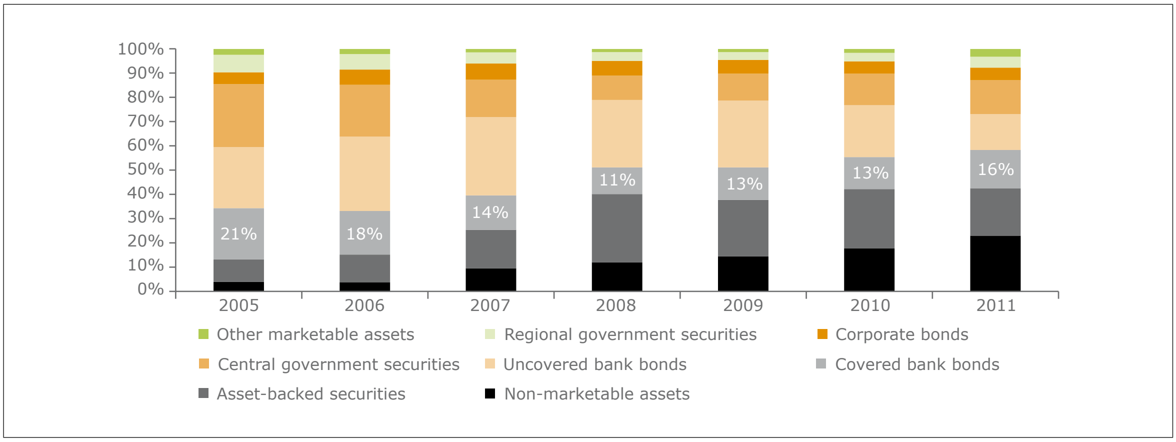
> Figure 32: Haircuts applied to A- and better rated jumbo covered bonds in liquidity category II compared to proposed haircuts in CRD IV



Sources: CRD IV, Eurosystem, CA CIB

While it is difficult to find exhaustive data on covered bonds' use in private sector repo markets, the Eurosystem publishes annual data on the collateral pledged by banks that take part in its monetary operations. The popularity and use of covered bonds as collateral has increased between 2008 and 2011. While in 2008 only 11% of the collateral posted with the Eurosystem, the number has increased to 16% at end 2011.

> Figure 33: Posted collateral in the Eurosystem for monetary policy operations (%)



Sources: Eurosystem, CA CIB

Even the CRD IV text does not require assets from the liquidity portfolio to only generate liquidity via outright sales. The text refers to repo markets as being one acceptable source of liquidity. According to Article 404 (3), which deals with reporting for the LCR, banks have to show to the regulators that the assets they hold:

> "…are tradable on active outright sale or via simple repurchase agreement…"

Outright selling and buying back positions would be a fairly expensive way of proving an asset's worth in the context of the LCR. Being able to show that assets can be used as collateral in repo operations is sufficient.

4. CASE STUDY DENMARK - WHAT HAPPENS IF THERE ARE NOT ENOUGH LEVEL 1 ASSETS...?

The definition of high quality liquid assets raises a question of particular relevance to financial institutions based in small open economies with a currency of their own; how will financial institutions meet the liquidity buffer requirements if public debt is in short supply?

Shortages in the supply of public debt is by no means a global problem. The majority of countries runs a public sector deficit and have done so for many years. Public debt to GDP has therefore reached a staggering approximately 70% by end 2010 in the OECD area with no turnaround in sight.

A few countries have maintained public sector budgetary discipline and have run a public sector surplus (at least until the financial crisis unfolded). In these countries public debt to GDP is substantially lower than the OECD average and the supply of public debt may well prove insufficient to cover the demand from financial institutions necessary for them to meet the liquidity buffer requirements. Although the Basel liquidity framework allows possible waivers for countries with a low supply of level 1 assets, it would be a paradox if these countries were to go further than other countries in adapting to the liquidity framework envisaged.

Denmark is an example of a small open economy short of public debt. Public debt to GDP stands at approximately 40% by end 2010. Credit provisioning by financial institutions to the real economy to GDP stands at approximately 200%, hence, Denmark presents a combination of a below average public debt to GDP ratio and an above average size of financial sector to GDP ratio. This combination implies that for Danish financial institutions to comply with the Basel III liquidity framework the institutions would need to import foreign currency assets to an extent more than likely to be a source of financial instability – or not within the objectives of the framework.

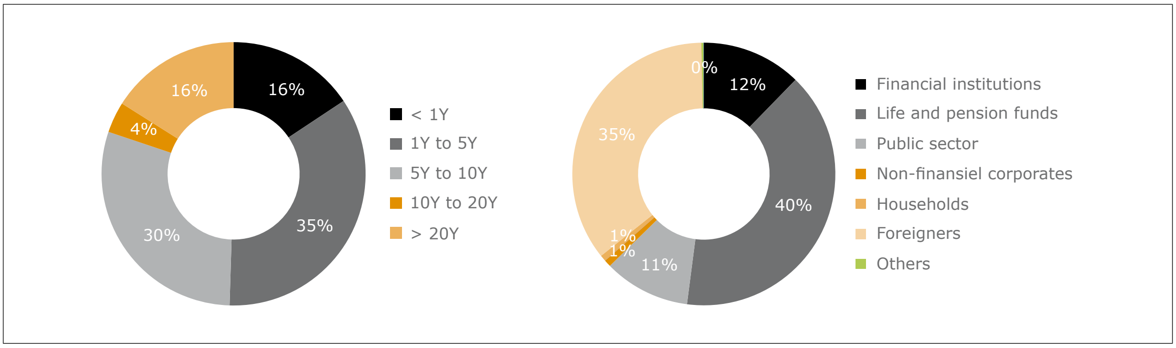
For Denmark the best solution would be to include Danish covered bonds as level 1 instruments in the liquidity buffer. Danish financial institutions have long employed Danish covered bonds for liquidity management purposes, and as studies made by Danmarks Nationalbank (the Danish central bank) concludes, throughout the financial crisis, covered bonds have performed at par with public debt in terms of liquidity[1]. The outstanding volume of DKK-denominated Danish covered bonds was EUR 310bn equivalent by end 2011 making up approximately 75% of the DKK-denominated fixed income securities market.

The five largest financial institutions in Denmark takes part in the Quantitative Impact Studies (QIS) on the Basel III proposal. The combined QIS results for those institutions alone have never been conveyed to the public, however, in 2010 Danmarks Nationalbank and the Danish Financial Supervisory Authority estimated the shortage of level 1 assets for the five Danish financial institutions taking part in the QIS to fully comply with the LCR to be EUR 28bn equivalent[2]. If the five financial institutions are assumed to be representative of the whole Danish financial industry the shortage can be estimated at EUR 48bn equivalent. If further assuming a 10% buffer is necessary (110% LCR compliance) for prudential reasons the shortage can be estimated at EUR 60bn equivalent.

This compares to an outstanding volume of DKK-denominated public debt of EUR 88bn equivalent by end 2011. Of these, EUR 9.3bn are held by government funds and another EUR 31bn are held by foreign investors. The gross volume of DKK-denominated public debt accessible to Danish financial institutions is thus EUR 47.7bn.

The largest domestic investor group in DKK-denominated public debt is life and pension funds with combined holdings of EUR 35bn equivalent. Life and pension fund are not likely to reduce holdings of DKK-denominated public debt in consequence of the implementation of the Solvency II regime tightening asset liability regulations imposed on life and pension funds. DKK-denominated public debt holdings by life and pension funds will therefore only be accessible to financial institutions at high costs.

> Figure 34: DKK-denominated Danish public debt split by term and investors



Sources: Danmarks Nationalbank

In conclusion, the estimated need for additional DKK-denominated level 1 assets for Danish financial institutions up to EUR 60bn equivalent by far exceeds the outstanding volume of DKK-denominated public debt accessible in volume of EUR 30bn to 50bn equivalent – i.e. compliance with the LCR based on DKK-denominated public debt is simply impossible.

The shortage of public debt in Denmark is compensated for by a great supply of high quality liquid covered bonds which have proven resilient to past crises. The inclusion of these assets into the liquidity buffer at no constraints would not run counter to the overall objectives of the Basel III liquidity framework and financial stability would be maintained.

5. CONCLUSIONS

The LCR was primarily designed for situations where individual banks run into trouble and have to liquidate assets to cover their cash outflows. Over the longer term, the aim of this ratio is to also address systemic banking crisis where the whole market faces significant levels of stress and liquidity in many markets including sovereign debt is reduced significantly. At present, lenders of last resort in the latter cases are central banks and no set of eligible assets under the LCR will ever fully protect banks in these cases. The recent history has shown this very clearly.

Consequently we want to stress that putting a lot of focus on current turnover figures that are very hard to obtain in the first place is in our view not fully reflecting the purpose of the LCR. In this respect, we welcome that the CRD IV text as voted by the European Parliament's Economic and Monetary Affairs Committee also includes qualitative criteria as determinants of LCR eligibility and takes into account an asset's impact on economic growth in Europe.

We still feel that only having government and government related debt in category one is not justified. We also don't think that applying a flat haircut of 15% independently of maturities for level two assets makes any sense. We would argue that the risk on shorter dated assets is lower than for longer dated ones. Consequently we would rather expect that haircuts are lower for shorter dated assets and increase the longer maturities. The collateral framework of the Eurosystem has been reflecting this fact for many years.

In this article we have tried to present evidence for both quantitative as well as qualitative benefits of covered bonds. We have shown that:

> Covered bonds are one of the biggest private sector bond markets in the world with an outstanding volume of EUR2.7trn at the end of 2011.

> Covered bonds are predominantly used to refinance mortgages these days. They have grown to become a very relevant mortgage funding tool for a wide range of countries within Europe. Since covered bonds offer banks significantly cheaper funding than via senior unsecured issuance, they lower funding cost of banks' mortgage business and enable them to lend to the real economy at lower interest rates. As such they support European mortgage markets and economic growth in Europe.

> We have also shown that covered bonds have been less volatile than many government bonds throughout the crisis.

> Covered bonds continue to exhibit strong credit quality. They are rated well above issuer ratings and in some countries even well above sovereign rating levels. Credit quality in cover pools has also remained fairly stable in the past quarters as issuers manage pools actively.

> We have also shown that despite having on average long initial tenors at issuance, redemptions in the covered bond market provide investors with an ongoing source of liquidity beyond secondary market trading activity.

- Covered bonds are bought by a very diverse and growing investor base, which follows a wide variety of investment strategies making it easier to find a buyer in a number of different scenarios.
- In addition to this, covered bonds are widely accepted as collateral in repo transactions both with private parties as well as with central banks. The CRD IV text mentions that repoing bonds is an alternative which is equally acceptable in the context of the LCR than outright selling. This option is however not captured by turnover volumes in secondary market trading.

Last but not least we want to highlight the fact that one of the goals of the CRD IV is to create a regulatory framework that makes banks safer but also avoids any unintended consequences. When determining LCR eligibility regulators will therefore have to ask themselves what would happen:

- If particular instruments are excluded,
- If banks are pushed into holding a too narrowly concentrated portfolio of eligible assets that all react in a similar way in times of stress

In this context we have shown what consequences a narrow definition can have for smaller countries such as Denmark that don't even have a sufficiently large stock of government bonds to fulfil CRD IV requirements. We have also shown that covered bonds and government bonds have been far from being perfectly correlated and that covered bonds would thus add to the stability of banks' liquidity portfolios.

On a final note, the IMF recently highlighted the positive aspects of covered bonds and said:

- The production of safe assets by the private sector is an important source of supply and should not be unnecessarily impeded.
- Well-conceived and regulated covered bond structures of mortgages (with overcollateralization and the ability to replace impaired loans) are one good example of this.

The European debt crisis highlights that private sources of funding are needed to reduce the funding burden of governments and support economic activity. Covered bonds can make a strong contribution. A regulatory environment reflecting properly the high quality and the importance of the covered bond product in Europe could help to make a further step to overcome the currently very challenging situation.

1.6 TRANSPARENCY IN TRADING AND IN INVESTOR INFORMATION

By Florian Hillenbrand, Unicredit, and Michael Schulz, NordLB

The transparency requirements of the various market participants have risen again in the past few months and it is not just investors who are increasingly calling for a greater flow of information. The interested stakeholders include the European Banking Authority (EBA) as well as national regulators and the European Central Bank (ECB), which for sometimes differing reasons also have a keen interest in a high level of transparency in the covered bond market.

Home to over 300 issuers from more than 25 different countries, the global covered bond market is a heterogeneous landscape of institutions with different legal and structural conditions. It is therefore understandable that the question of "what is a covered bond?" is currently being examined by several stakeholder groups. In 2007, the covered bond community agreed on the lowest common denominator of four defined criteria. However, these remained largely superficial at the time. A uniform understanding of a common product is very important for all market participants. In addition, the number of countries and issues continues to rise, making differentiation essential. Transparency therefore starts with the conceptual demarcation of the term compared to other products.

The question of pricing is also at the very top of the agenda. It is not primarily the issuers of covered bonds that desire transparency; they work closely with their partner banks and therefore have a good feeling for the fair price of their bonds. Investors, however, are sometimes floundering in the dark and this situation became even worse with the start of the financial crisis in the aftermath of the Lehmann bankruptcy. Since then, in line with the respective market conditions, transactions have been taking place at much more illiquid levels. In times of major market dislocations, this has meant that many covered bonds have also been more difficult to trade. Efforts here to boost liquidity in the covered bond market, with the aid of central trading platforms, have not produced any notable results. For this reason, the EU Commission simultaneously launched several initiatives to make the bond market, and hence trading in covered bonds as well, more transparent in terms of price. These initiatives relate to rules for pre and post-trade transparency for bonds. These are included in the EU Commission's proposal for the MiFID II Directive dated 20 October 2011 and are currently at the draft stage. As the approval from the Committee on Economic and Monetary Affairs (ECON) is still outstanding, this article only encompasses the commission proposals that are presently scheduled to be adopted in the second half of 2012. The regulation (MiFIR) is scheduled to be valid for two years after the directive comes into force and only then will the pre and post-trade transparency obligations have to be implemented. The rules not only target transactions that are executed on a trading system but also affect transactions conducted by phone (over the counter – OTC).

MIFIR REGULATION

The scope of application of the pre and post-trade transparency regulations for bonds extends to bonds for which a prospectus has been published or which have a stock exchange listing as well as to all other bonds traded on stock exchanges, multilateral trading facilities (MTF), organised trading facilities (OTF) and those traded OTC. The information to be published relates to the price and volume of the transaction and the time at which it was concluded. While stock exchanges, MTFs and OTFs are to publish information in real time, for OTC transactions the plans are to disclose the information via approved publication arrangements (APA). Although deferred publication for large ticket sizes is permitted, this has to be approved by the respective competent national authorities. Waivers can be specified in this regard that take account of liquidity aspects as well as the type and size of the transaction or bond. Consideration is being given to firming up the provisions for individual financial instruments, and this is also aimed at structuring these in line with market requirements.

With regard to the pre-trade transparency rules for OTC transactions, the decisive factor is whether the institution in question qualifies as a Systematic Internaliser (SI). These include credit institutions or investment firms, which, on an organised, frequent and systematic basis, deal in bonds on their own account by executing client orders. Trading by phone and dealing using proprietary trading systems are accordingly to be viewed as classic transactions. What is important here is that these transactions are executed outside an organised market (stock exchange, MTF, OTF). In accordance with the MiFIR, for OTC transactions, only SIs are subject to the rules on pre-trade transparency and when quoting a price to clients have to make this quote accessible to all other clients. If the volume of the transaction exceeds the size for a specific financial instrument, the price quoted is binding for all other clients and there is a publication obligation. However, in this case the EU Commission has proposed that the number of price quotes from the SI can be restricted. If the volume of the transaction falls short of the size for a specific financial instrument, the price quote is not binding for other clients and there is therefore no publication obligation either. Markus Ferber, the Rapporteur for ECON and a member of the European parliament, has already made a statement regarding the MiFIR and submitted several content-related proposals. Some of these are to be seen as a tightening up of the previous wording. For instance, in future, institutions that are not classified as SIs may no longer conduct any OTC bond transactions. Moreover, all transactions are to be conducted via bilateral systems which would mean the abolition of traditional trading by phone.

The initiatives on pre and post-trade transparency are to be seen as regulatory attempts to increase the transparency of prices in the bond market. The focus here is very clearly on the interests of investors, while the repercussions for banks and investment firms are ignored. Only small concessions have been made, such as limiting the number of price quotes an SI is obliged to provide. Although the rules outlined above are aimed at increasing transparency, which directly and indirectly presupposes a liquid market because of the required obligation to make the same offer to other clients, they run the risk of having the opposite effect. Dealers who go to the market with a sizeable order are taking an incalculable risk when they make price quotes widely available. The result would be that only a few large tickets will be traded, which will reduce liquidity and therefore also transparency in the covered bond market. The obligation to make price quotes available to several clients will tend to reduce the volume of offers and cause price variation based on volume differences to disappear. Consequently, the fact that a major portion of today's dealing is conducted by phone should not be viewed as a problem. In the midst of the financial crisis, this meant that transactions could be executed without allowing the market to dry up completely. The covered bond segment in particular benefited from continued marketability, while central trading systems failed to improve or revive it. Moreover, restricting OTC trading by phone to SIs and introducing an obligation to use bilateral systems is not expedient. What use is it to an investor if he has to use different systems to obtain quotes for a bond? It may be that he is not even authorized on the system he needs to use.

The price transparency initiative of the Verband deutscher Pfandbriefbanken (Association of German Pfandbrief banks – vdp) is to be seen as a step in the right direction for post-trade price transparency. Every trading day, spreads based on mid-asset swap versus six-month Euribor are published for Pfandbriefe on the website. The bonds have a minimum term of two years. However, this information is only intended as a guide for investors. It does not have to be based on the spreads traded every trading day, which means that it is not necessarily possible to trade at this level. It would be desirable if spread levels were available as a point of reference for all covered bonds with an outstanding volume of EUR 500mn or more. However, these disclosures should be voluntary and not lead to any binding price offers. Unlike the post-trade transparency proposed by the EU Commission, an approach that safeguards the interests of the market and investors should be based on average secondary market spreads and include a time delay that protects the market. Implementing the transparency rules under MiFIR in full runs the risk that these rules will achieve the exact opposite of the desired intention. Liquidity will continue to shrink and price transparency in the covered bond market will then also decline.

COVER POOL TRANSPARENCY

While transparency with regard to pricing and volumes traded is still at a very early stage, in the context of cover pool disclosure, transparency has shown quite an improvement in the past few years. If we take a look back in history, it was along with the amendment of the Pfandbrief legislation in July 2005, when for the first time a legal minimum was stipulated as to what should be published with regards to collateral composition. However, other countries have shown that a legal stipulation is not necessarily required to achieve high-quality cover pool transparency.

As an integral part of the ECBC Label Initiative (the official initiative of the ECBC to set a definition of the term “Covered Bond”) issuers shall be committed to providing regular information enabling investors to analyze the cover pool. In line with the initiative, it was agreed, that guidelines are to be developed on a national level in view of the different characteristics of each market. However, the national templates are based on common guidelines. In this regard, the aim is to have National Transparency Templates finalized before September 2012 in order to allow issuers to apply for the ECBC Covered Bond Label.

In the following we provide a short walkthrough of the current state of all relevant covered bond countries with particular interest in the degree of detail as well as frequency, harmonization and method of disclosure vis-à-vis the investing public (explicitly not vis-à-vis the supervisory authority). In addition, we will – where applicable – provide a brief state of play of the ECBC lead transparency initiative. Afterwards, we shed some light on how rating agencies play a role in enhancing transparency as well as on the “big aim” of a common transparency platform as currently planned by the Covered Bond Investors Council (CBIC).

Austria

Checking and comparing collateral data in Austria has become a very easy task in the last few years. While some years ago collateral data was sometimes a well kept secret, the development is quite impressive. A key role in this respect was played by the Pfandbrief & Covered Bond Forum Austria. Since December 2010, Austrian issuers have provided homogenous information on common templates on the webpage of the Pfandbriefforum. Investors are informed – so far only annually – about loan size, currency and regional distribution. In addition, information is provided about the type of debtor, the loan seasoning, the remaining life both on a collateral basis and in direct comparison to the covered bonds and last but not least about the interest payment type and matching.

Frequency and publication language (German) are certainly still fields for improvement. As already stated, the publication archive only allows investors to acquire annual information whereas quarterly information is considered the minimum market standard. Nevertheless, we understand that in particular the frequency is something that is currently being worked on in line with the ECBC Label Initiative. The national template is already ready and available in the Pfandbrief Covered Bond Forum website. It is based on the CBIC template which is covered in a separated paragraph later on.

Denmark

In comparison with the large domestic DKK-denominated market, the EUR market which is in our primary focus, plays a marginal despite ever growing role. With only one player active in the EUR benchmark covered bond market, harmonization is not the question. Danske provides investors with easily accessible, useful and practical (Excel) disclosure documents. Historical developments can easily be produced with an archive of old reports being available. The degree of detail is slightly below the European average of disclosures, with the document being concentrated on the breakdown of indexed LTVs, loan sizes, regions and property types.

In a broader context, the disclosure template which then is applicable for all Danish issuer is finalized, subject to the final approval of the different boards.

Finland

As in most of the countries in Europe, Finnish banks also do not have the obligation to publish cover pool reports. Nevertheless, issuers publish quarterly information on their web pages. However, in a European comparison, the degree of homogeneity and detail is slightly less pronounced. Despite the fact that in EUR benchmark terms only four issuers are active, the disclosure documents lack a common format and content. Some names use pdf formats and some go for web-based publishing; some choose a graphical method of informing investors, while others use relatively detailed templates that resemble the formats provided in France or the UK. In any case, the disclosure data ranges from issuers providing only very rough average loan size and LTV figures in addition to a vague information about loan size and regional distributions to other issuers that inform investors about detailed breakdowns including seasoning, LTV, interest rates and property types all in tabular form.

France

French law does not stipulate any details on when and how issuers have to present information about the cover pool. In practice, however, the frequency, detail and homogeneity of publication is exemplary – in particular this applies to the more recent covered bond programs. The template, which is broadly used by 90% of all market participants, contains a full presentation of the Asset Coverage Test as well as a breakdown of the cover pool, not only with regards to quite usual data like LTV, seasoning and arrears breakdown, but also information covering loan purposes, occupancy and borrower type. In addition, most issuers of Obligations à l’Habitat provide an overview of trigger levels, where they are and whether or not they have already been broken and what were the consequences of such a breach.

French issuers have set up a working group and agreed on the ECBC relevant template. The final version will need to receive a final approval although it is planned that issuers publish it on their websites over the summer 2012. The template is said to be based on the CBIC version (see separate paragraph below).

Germany

As stated above, cover pool information regarding Pfandbriefe found its way into primary legislation quite some time ago. As also laid out in the country chapter of this book, §28 PfandBG requires issuers to publish detailed data on the composition of cover pools. These include the total volume of Pfandbriefe outstanding as well as the related cover pools in terms of nominal, net present and stressed net present value; the share of derivative financial instruments in the cover assets; the share of further cover assets; the maturity structure of the Pfandbriefe and cover assets; information on the granularity of the cover assets; information on the mortgages by property type, type of use and region; and state information on the claims against the public sector by state and type of issuer as well as on ship mortgages/aircraft registered liens by register country, and on non-performing cover assets.

A particular qualitative improvement has been achieved at an association level. Within the scope of the vdp transparency initiative, the transparency reports of vdp member institutions are published in a uniform format both in pdf and Excel form.

The §28 PfandBG is also a highly developed basis for the ECBC targeted template. However, issuers have been speaking to the national regulators in order to expand §28 in order to include some of the extra information required by the ECBC Label Initiative and the CBIC template (see paragraph below). An implementation of an expansion of §28 looks reasonable to come together with the transposition of CRD IV into German law.

Ireland

Despite the fact that issuance was not possible in the past few years, Irish issuers kept a high standard of the cover pool disclosure. Although, the setup of the documents are not harmonized, the degree of detailis strong. The documents are published quarterly and are available in pdf format and provide a good overview of the general characteristics of the cover pool (weighted average figures) as well as breakdowns of LTV levels (current as well as indexed), loan sizes, seasoning figures, remaining life, payment repayment type, interest rate type, arrears figures, region and market segment (loan purposes).

Irish issuers are currently discussing which information in the CBIC Template is available and will be shortly collecting data and finalizing the ECBC National Transparency Template. They will keep the same structure as the CBIC template although their final template will be in Excel format.

Italy

At the inception of the OBG regime, there was a strong aim to stick relatively closely to the UK system, also in terms of disclosure formats. More specifically, this means detailed, regular and high frequency reporting but no legal obligation to do so: a mostly monthly but at least quarterly schedule of publications, full Asset Cover Test calculations and trigger reports are standard in Italy. The banks also provide information on standard aspects like loan size, LTV ratios, interest types, seasoning, payment delays etc. not only in the form of weighted averages but also broken down into several brackets. The degree of homogeneity of the reports and therefore the comparability across the entire market is quite good, with minor exceptions. Investors are also able to track changes over time since issuers provide the full history of reports in pdf format.

Even before a regulatory framework for OBGs had been put in place in Italy, the securitization business was very well developed. Some readers might remember that the OBG law was actually developed as an add-on to the securitization law. This also explains, why the reporting of a few issuers – in addition to the above mentioned features – also provide some securitization-typical data such as series-specific collection and cash-flow data.

Regarding the ECBC Label Initiative, Italian issuers are working on the details of the template and should be able to meet the September deadline.

Netherlands

Regarding frequency and detail, everything said about Switzerland (see below) also holds true for the Netherlands. However, despite only a small number of issuers being active in the regulated EUR covered bond market, the templates are not identical. However, they have a common content and quite a similar setup. Investors are provided with a full Asset Coverage test calculation in addition to a full breakdown of the cover pool with regards to mortgage loan type, interest type and rate, loan vintage, loan maturity and seasoning, region, LTV, loan amount and property type. In addition, issuers inform investors about the occupation status of the debtor, the mortgage payment frequency and the debt-to-income ratio as well as whether or not there are additional guarantees in place and for how long a debtor has been delinquent. Again the only element missing in this respect is information about matching in order to understand refinancing or reinvestment risks.

Regarding the ECBC Label Initiative, as a starting point, Dutch issuers have used for the development of their covered bond National Transparency Template the RMBS Template they agreed on for disclosing RMBS information, which does not require loan by loan data. They have removed the sections which are not relevant for covered bonds and added new sections which are important for covered bond investors. Dutch issuers have agreed on the content of the Template and now are just trying to select the best way to implement it. They expect to be operational in Q4 2012.

Norway

Despite the lack of a legal obligation to provide cover pool data, the information base in Norway is quite detailed albeit a little heterogeneous, in particular regarding content. All issuers provide tabular data reports on a monthly basis, however some are in Excel and some in pdf form or both. As regards content, investors can gather information about LTV distribution, seasoning, repayment schedule of the loans, interest rate types and arrears distribution. In particular, the property type distribution (whether in private or shared ownership as a condominium vs. detached etc.) is quite informative. Facts about the employment status of the mortgage debtors are not provided by all issuers. Investors would benefit from a common platform or format which currently – despite the limited number of issuers, in particular in the EUR market – is not in place.

However, one issuer in Norway even provides sample loan date (random selection of 200 loans) which actually goes in the direction of what many former securitization-driven investors wish to have.

Norwegian issuers have already agreed and finalized the National Transparency Template which can be accessed on the internet page of Finance Norway. The template so far only deals with residential mortgages, which is the only business of the largest issuers (which issue in the international markets) and also of the large majority of smaller issuers.

Portugal

Portugal is probably the country with the highest degree of heterogeneity of disclosure documents. Investors are able to find issuers providing quarterly reports which compare to the most detailed documents in the market while others only provide rough figures, sometimes only in graphical form, hardly allowing investors or analysts to work with the data. One issuer – most likely due to technical problems – was not able to provide any data.

In an ECBC labeling and transparency context, the six major Portuguese issuer banks are currently working on developing a transparency template, based on the CBIC template, but applying its own structure.

Spain

Despite the fact that the Spanish covered bond market is one of the largest in terms of outstanding volumes and has for quite some time been the largest as measured by new issuance – investor information has never managed to match this development. In fact, individual information on the homepages of the issuers is quite rare, heterogeneous and irregular at best. BBVA and Santander unsurprisingly appear more positive than the average issuer since they do provide information in tabular report form (BBVA) or presentation form (Santander).

Spanish issuers have developed a transparency template based on the ECBC requirements. So far, the data the Asociación Hipotecaria Española has received from its members indicates that the information requested is easily retrievable, although the main problem their members have faced is the compilation of public sector asset information. They are unsure as to when the final template will be published.

Sweden

Although there is no legal obligation regarding cover pool disclosure, the Association of Swedish Covered Bond issuers (ASCB) is strongly fostering harmonization and transparency in cover pool disclosure practice. Both aspects have always been a key focus for the ASCB. Furthermore, the ASCB recommends to its members to have common cover pool information set up largely in line with the proposal of the Covered Bond Investors Council which will be presented later on in this article.

At the time of writing, Swedish issuers provide quarterly information about their cover pools. While the detail in most cases is sufficient, the degree of standardization of both information and format, however, is not too high. There is no common template or common set of information provided: in addition to the standard features like LTV distribution or distribution of loan types (Swedish covered bonds are backed by a common pool of public and mortgage debt) and geography, some issuers report distribution of payment frequency, arrears ranking of the loans and loan parts or even report all figures separately for each type of property used as collateral for the mortgage loans in the pool. Other issuers even go beyond this and provide investors with information, e.g. about the distribution of interest rates (in 50bp brackets) as well as information about the term to the next interest adjustment.

As regards format, in addition to pdf and Excel, there are also issuers that still use web-based formats. The disadvantage of the latter format to investors is that handling the data is more difficult and an archive of older data is not available.

In this respect, the ASCB's aim in the direction of harmonization is fully justified and will surely be welcomed by investors. This will certainly be fuelled by the ECBC initiative. Swedish issuers have been working on the basis of the ECBC transparency requirements and not on the CBIC template. The goal is to already publish information based on the Q3 reports.

Switzerland

Being one of the few truly structured markets among EUR denominated covered bonds, it goes without saying that there is no legal basis for investor information. However, as one would expect from the Swiss but also as one would expect from a market with only two issuers in the EUR market, investors benefit from an identical template which more or less matches the information provided by French Obligations à l'Habitat issuers and UK names, meaning a full Asset Coverage Test calculation, a full list of bonds and breakdowns of remaining terms of the assets, current loan values, total property balances, interest rate types, region, property types, and arrears. In addition to the monthly publication frequency and the extremely short time lag of publication in relation to cut-off date of just a few days, investors can be quite happy with the situation in Switzerland. One item on the wish list might be more information about asset and liability durations in order to get a more precise idea about possible refinancing or reinvestment risks.

United Kingdom

Even without the legal obligation to publish data, UK issuers were among the first to set standards regarding cover pool disclosure. Elements like a full presentation of the Asset Coverage Test were published first in UK Covered Bond investor reports. While a common template is not yet in place, the monthly frequency and the flexibility of many issuers in providing Excel and pdf reports is quite investor friendly. Regarding content, all issuers provide roughly the same range of information. At some issuers, the cover pool disclosure documents even show classical features of securitization reports in that cash flow figures are also provided. In particular, the former ABS investor base in the UK likes to see this type of reporting since it tackles one of the key elements ABS investors have when examining covered bond investor reports: the ability to track loan performance and to draw conclusions on future financial wellbeing. Irrespective of whether from a normative perspective such an analysis does not really apply to covered bond collateral – due to the dynamic nature and, consequently, due to the low correlation between pre and post-insolvency cash flow performance, providing these figures helps to promote UK covered bonds to new investors.

The FSA has set up a national template, which will be fully operational in January 2013. The current draft version resembles a slightly more detailed version of what UK issuers are providing today but on a harmonized form which also means harmonized brackets for the breakdown of certain features (such as LTV bands). The national template of the FSA will also be applicable for the ECBC Label Initiative.

CBIC INITIATIVE – AIM FOR THE IMPOSSIBLE TO ACHIEVE WHAT IS POSSIBLE

Although the overall reporting situation has developed positively in the past few years – mostly driven by peer pressure and new entrants into the covered bond market – the initiative has been solely on the side of the issuers. Investors were sidelined for quite some time but since the CBIC (Covered Bond Investors Council) was founded, the broad mass of investors have been able to speak with a single voice; and one of the first challenges the CBIC tackled was the heterogeneous cover pool reporting situation. Back in October 2011, the CBIC presented its ideas about the features that cover pool reports should have.

> The information should be made freely available to all investors.

> It must be presented in an Excel sheet format

> Data should be reported on a half-yearly basis and shortly after issuers' results are published.

> The CBIC through the ICMA owns the template. The ICMA is to draft appropriate disclaimers.

> The issuers will post a link to the CBIC European transparency standards webpage – and can add or remove the link, should they want to.

> This link must give access to the CBIC template with information provided by the issuer. Issuers are responsible for the information posted. Additionally, issuers may wish to consider giving access to additional information to investors through the link.

The template was amended most recently in May 2012 in order to capture numerous remarks and comments of other market participants. The full detail of the template is currently met by hardly any issuer. However, already at a very early stage of the template development process, the CBIC made clear that it never expected all issuers to fill in all the fields since not all information is relevant for each single issuer. However, discussions of the blank fields on a bilateral basis with issuers should hopefully help individual issuers and/or national organizations identify where to enhance transparency levels incrementally.

The current version of the template is four-fold and captures the fields of:

> General issuer data

> Cover pool data

> Key concept explanations

> Additional information

The cover pool data is more or less a collection of current state of disclosure and ranges from general information about nominal and net-present value coverage calculations and the reason for overcollateralization (legal, contractual, random) to the inclusion of substitute assets and ABS. The breakdowns that are required are more-or-less in line with what parts of the industry are already providing today. The great achievement of the CBIC template in this respect is to provide a homogenous definition of the brackets and bands for the breakdowns. Last but not least the CBIC template requires the presentation of the figures to be split up in any respect by the type of collateral residential mortgage, commercial mortgage and public sector debt. In particular the split between commercial and residential is an element that currently is not performed very often in current disclosure documents.

A quantum leap in the CBIC concept, however, lies in the fact that the quantitative presentation of cover pool data is amended by a qualitative chapter. This lifts the entire exercise of cover pool disclosure to a whole new level. A short example might illustrate the necessity for such a qualitative exercise when trying to harmonize reporting on a European level: at first glance the LTV ratio might appear to be a trivial figure – loan amount over property value. However, the first degree of complexity sets in, when taking a look at the different property valuation practices in Europe: market value vs. mortgage lending value vs. foreclosure value. All three are based on various methods of calculation such as the income approach, the cost approach, the comparison approach or a combination thereof. In some countries we find legally stipulated methods of calculating the property value, whereas in other countries there are informal industry standards and in some others banks are even free to chose whether to go for a mortgage lending or a market value. In some countries an indexation of the property value is current practice – in others it is not. In other words, simply examining the denominator of the LTV figure leads to the conclusion that merely looking at the LTV figures of certain issuers is like comparing apples with pears. In addition, this is completely aside from differences in the treatment of the loan amount: the classic example of this is Sweden where it is long-standing practice for mortgage debtors to raise various tranches of mortgage loans with different banks constituting various ranks of mortgage loans. While, thanks to the excellent mortgage register in Sweden, keeping track of the various ranks is an easy job, the correct calculation of the individual LTV of a subordinated ranking mortgage loan tranche is almost impossible. This is why the Swedish ASCB has set an industry standard of how the LTV ratio is to be calculated.

As we already indicated in the subtitle of this paragraph, and also as the CBIC has stated from beginning, the template will not be able to be fully completed by all issuers – and this is not only the case because of the inapplicability of some features to the programs. Some data simply might not have been captured so far. In this respect, relatively new players in the market have a competitive advantage over issuers with a long-standing history, since the former ones are still more flexible and can more easily adapt to new requirements.

RATING AGENCIES – ENLIGHTENING THE BLIND SPOT

One of the most crucial problems regarding cover pool transparency is actually that one has to clearly differentiate between transparency and quality assessment of a specific cover pool. All transparency efforts made so far and laid out in the above paragraphs lack information that would allow for a qualitative absolute or relative assessment. The data provided so far – with only negligible exceptions – come in the form of distributions with regards to specific characteristics, e.g. the distribution with regards to LTV, loan sizes etc. Only very few issuers provide investors with stressed values of certain characteristics such as the presentation of the extent of the impact a 15% fall in prices would have on the LTV distribution and therefore on the amount of assets that would still be eligible as collateral.

From a technical point of view, the missing link to absolute or relative quality assessment however is the lack of information regarding how the distributions are connected with one another, for example are high LTVs associated with low loan sizes or with high ones. In other words, are potential problems culminating or are they mitigating one another. The link could be bridged either by loan-level data or a full variance-covariance matrix of the respective distributions published in the disclosure documents. Without this data, investors and analysts might be able to track the overall development of cover pools, which is in itself a valuable task, as well as being able to compare whether certain developments in the cover pool reflect overall developments of the issuing bank; however, producing a clear order of issuers regarding cover pool quality is technically impossible.

A possible compromise might be something like one can observe at Sparebank 1 Boligkreditt, where data of a random sample of 200 loans is provided on the webpage. However, one has to be precise and acknowledge the difference between a true random sample or a representative sample. 200 out of 100,000 loans might be a sample size where a true random sample might have the same characteristics as the overall pool, nevertheless, there is also the risk that certain variances or covariances deviate from the true value. In any case, this practice provides investors the ability to at least perform rough quality assessments.

Hence, in the absence of **1.** a technically clean possibility to perform quality assessments and **2.** a broad mass of issuers publishing at least random sample data, the only chance investors and analysts have is to use ready-made assessments by rating agencies. Disadvantage: black box. Advantage: based on true portfolio data and available for a broad mass of issuers.

In particular in the past few years, rating agencies have significantly improved their service with regard to publishing "by-products" or "intermediate results" of the full covered bond rating process. With regards to the quality assessment, the Moody's collateral score in combination with collateral risk and market risk and S&P's assessment of weighted average foreclosure frequency and weighted average loss severance are quite helpful tools to provide investors with a clear answer to the question of which of a group of cover pools has the highest overall quality.

CONCLUSION

The development over the past 5-7 years as regards both data requirements as well as data availability has been quite impressive. Nevertheless, the more important a non-domestic investor base becomes, the higher the data requirement will become, simply because the degree of familiarity decreases; and a lesser degree of familiarity – in a positive interpretation – paves the way for more questions being asked and aspects that have been taken for granted being challenged. In addition, the fact that, particularly in the past few months and years, the “zero default risk” assumption of various asset classes has diluted. This will also lead to investors wishing to know more and to run more sophisticated analyses themselves. Hence, pressure on issuers to work on the detail as well as on homogeneity will remain high and the current CBIC data requirement is just the beginning.

1.7 ASSET ENCUMBRANCE

1.7.1 THE IMPACT OF COVERED BOND LEGISLATION ON ASSET ENCUMBRANCE

By Ralf Berninger, Dexia Crédit Local

KEY ASPECTS OF COVERED BOND LEGISLATION

Asset encumbrance was often not a prime concern when covered bond legislation was put in place, with the focus being on the creation of a legal basis for a secure and transparent financial instrument. However, many aspects of covered bond legislation can have a strong impact on encumbrance. The three most important questions in this respect are:

> Does national covered bond legislation impose a special banking principle?

> Do regulations impose a limit on covered bond issuance?

> What is the required level of overcollateralization?

SPECIAL BANKING PRINCIPLE

The business scope of specialized lenders in the covered bond market is generally limited to a few business areas, with mortgage lending and/or public sector lending as principal activities. In particular, specialized lenders will generally not be taking client deposits. By nature, a very large part of the balance sheet will be used as cover assets for covered bond issuance, and the proportion of unencumbered assets will be relatively small.

A number of countries have moved away from a special banking principle in recent years, in order to create a level playing field between commercial banks and specialized mortgage lenders. Providing access to covered bond funding to commercial banks without the need to transfer assets to a specialized mortgage lender was one of the key objectives. Examples are Germany with the Pfandbrief Act (Pfandbriefgesetz), introduced in 2005, and Denmark with the Særligt Dækkede Obligationer, which can be issued directly by commercial banks since 2007.

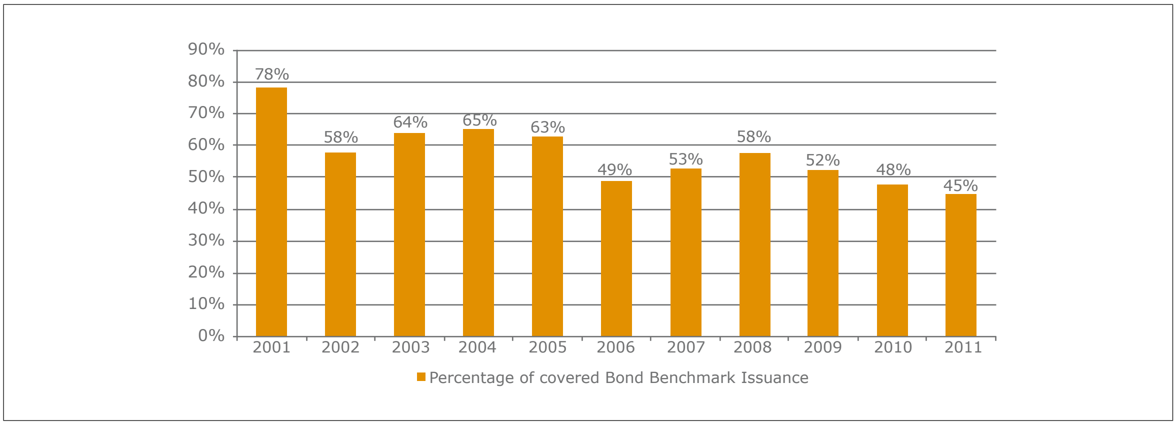
Country	Special Banking Principle
Austria	Yes, under the Mortgage Bank Act (Hypothekenbankgesetz) with exceptions, but not under the Secured Bank Bond Legislation (Gesetz betreffend fundierte Bankschuldverschreibungen) and not under the Pfandbrief Act (Pfandbriefgesetz)
Australia	No
Canada	No
Denmark	Yes, for Realkreditobligationer and Særligt Dækkede Realkreditobligationer but not for Særligt Dækkede Obligationer
Finland	No
France	Yes, under the Obligations Foncières, Obligations à l'Habitat and CRH framework
Germany	No
Greece	No
Italy	No
Ireland	Yes
Luxembourg	Yes
New Zealand	No
Norway	Yes

Country	Special Banking Principle
Portugal	No
Spain	No
Sweden	No
Switzerland	Yes, for Pfandbriefbank Schweizerischer Hypothekarinstitute AG and for Pfandbriefzentrale der Schweizerischen Kantonalbanken AG but not for the general-law-based programs
UK	No

LEGAL LIMITS ON COVERED BOND ISSUANCE

The discussion about covered bond issuance limits is relatively new as covered bonds were mainly issued by specialized mortgage and public sector lenders in the past. The use of covered bonds backed by residential mortgages as funding tool by commercial banks is a relatively recent development. In this respect, Spain is an exception with a well established Cedulas Hipotecarias market without special banking principle. A look at past issuance provides a good illustration with 78% of all Euro benchmark transactions issued by specialized mortgage and public sector lenders in 2001. For the year 2011 this percentage has declined to 45%.

> EUR Covered Bond Benchmark Issuance - Percentage Issued by Specialized Mortgage Lenders and Issuance Vehicules



Source: Dealogic Bondware, all EUR Covered Bond Transactions above EUR 500mm, two or more bookrunners, years to maturity greater or equal 1.5 years

A number of countries have moved to impose limits on covered bond issuance in order to better protect the interests of depositors and/or senior bondholders. These limits can explicitly be part of the covered bond legal framework, as for example in New Zealand, with the same issuance limit applied to all issuers. Alternatively, issuance limits may be agreed on a case-by-case basis between the regulator and the issuer. In this case, the regulator may initially take a hands-off approach, only setting limits when covered bond issuance reaches a certain level. Maximum issuance levels are set on a case-by-case basis in the Netherlands and in the UK.

Country	Required coverage ratio
Austria	Minimum coverage ratio of 102%
Australia	The value of the cover pool must not exceed 8% of the issuers assets in Australia for authorized deposit taking institutions
Canada	All issuers are required to comply with the maximum issuance limit of currently 4% of total assets set by the OFSI
Denmark	None
Finland	None
France	None
Germany	None
Greece	Additional capital may be required in case cover assets exceed 20% of available assets (assets not used for securitization transactions, reverse repo transactions or otherwise encumbered in favour of third parties)
Italy	There are no limitations for banks with a Tier 1 capital ratio equal to or above 7% and a total capital ratio equal to or above 11%, up to 60% of total eligible assets can be used as cover assets for banks with a Tier 1 capital ratio equal to or above 6.5% and a total capital ratio of at least 10%; up to 25% of eligible assets can be used as cover assets by banks with a total capital ratio of at least 9% and a Tier 1 capital ratio above 6%
Ireland	None
Luxembourg	None
The Netherlands	Agreed on a case-by-case basis between the issuer and the Dutch Central Bank
New Zealand	Banks are prohibited from encumbering more than 10% of their total assets to support the issuance of covered bonds
Norway	None
Portugal	None
Spain	None
Sweden	None
Switzerland	None
UK	Agreed on a case-by-case basis between the issuer and the FSA

LEGALLY REQUIRED LEVELS OF OVERCOLLATERALISATION

Overcollateralisation levels will have direct influence on asset encumbrance. However, the practical impact of covered bond legislation is currently limited, as actual overcollateralisation levels are often much higher than the legal minimum. Different rules on overcollateralisation and more fundamental differences from one framework to another will also influence the level of asset encumbrance. One example is the Cedulas Hipotecarias market, where the whole eligible mortgage book of an issuer will be part of the cover pool, independently of the outstanding volume of Cedulas Hipotecarias.

Country	Regulatory limit on covered bond issuance
Austria	None
Australia	Minimum coverage ratio of 103%
Canada	By contractual obligation (all four existing programs have stipulated a maximum Asset Percentage of 97%, which ensures a minimum overcollateralization of at least 3%)
Denmark	Coverage ratio of at least 108% for mortgage banks but not for commercial banks
Finland	Minimum coverage ratio of 102%
France	Minimum legal coverage ratio of 102% for Obligations Foncières and Obligations à l'Habitat and 125% for Caisse de Refinancement de l'Habitat
Germany	Minimum coverage ratio of 102%
Greece	Minimum coverage ratio of 105.26% (nominal value of covered bonds must not exceed 95% of nominal value of cover assets)
Italy	Minimum coverage ratio of 100%
Ireland	Minimum coverage ratio of 103% but 110% for Commercial Mortgage ACS
Luxembourg	Minimum coverage ratio of 102%
The Netherlands	By contractual obligation
New Zealand	By contractual obligation
Norway	Minimum coverage ratio of 100%
Portugal	100% for Obrigações Sobre o Sector Público but 105.26% for Obrigações Hipotecárias
Spain	Issuance is limited to 80% of eligible assets for Cedulas Hipotecarias leading to a minimum coverage ratio of 125%. For Cedulas Territoriales issuance is limited to 70% of eligible assets leading to a minimum coverage ratio of 143%
Sweden	Minimum coverage ratio of 102%
Switzerland	108% for Pfandbriefbank Schweizerischer Hypothekarinstitute AG and for Pfandbriefzentrale der Schweizerischen Kantonalbanken AG and 111% on a contractual basis for UBS Covered Bonds and for CS Covered Bonds
UK	By contractual obligation

1.7.2 ASSET ENCUMBRANCE

By Sabine Winkler, Credit Suisse Securities (Europe) Limited

RESOLUTION – SUBORDINATION – IMPLICATIONS

Because of the shortcomings in the tools available to the authorities to deal with failing or likely-to-fail financial institutions, governments around the world have had no choice other than to bail out financial institutions facing difficulties. Between October 2008 and October 2011, the European Commission (EC) approved EUR 4,500bn[1] of state aid measures to financial institutions. Although this is likely to have been necessary to prevent widespread disruption to financial markets, supporting failing or likely-to-fail financial institutions with squeezed public finances is becoming increasingly unsustainable. There is international interest in establishing frameworks for the recovery and resolution of financial institutions. For example, work is currently being undertaken by the Financial Stability Board (FSB), the EC, and the national policymakers.

In November 2012, the FSB is expected to release its final views on the key elements of recovery and resolution plans for global systemically important financial institutions (SIFIs). In June 2012, the EC released a *Proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms*[2], and thus completed the roadmap for financial sector reforms launched in 2009. The EC said that a more integrated banking union, including a single supervisory authority, a common resolution authority and fund, a uniform single rule book for the prudential supervision of EU financial institutions, and a single EU Deposit Guarantee Scheme (DGS) would be additional steps. In the US, the Dodd Frank Wall Street Reform and Consumer Protection Act introduced financial regulatory reforms and a resolution framework for financial institutions.

Resolution measures impair the rights of shareholders and creditors. Thus, in addition to the traditional risk assessment factors, investors need to consider new aspects associated with resolution regimes – for example, covered bond investors have to understand how the bonds will be affected if resolution powers are enforced in relation to an issuer, its holding company or third parties playing a role in the covered bond structure – and the related re-pricing of securities. In our view, investors in a security of an institution have to understand whether this institution would be subject to an ordinary wind-up, orderly wind-up, or a restructuring with bail-in. The choice of the resolution tool is likely to affect the price of the securities of the respective institution pre and post (potential) resolution.

> Effective resolution regimes would contribute to lower moral hazard. A removal of public sector support may help restore market discipline by aligning risk premiums with exposure to losses. Bail-in should affect the financial institutions' **funding costs** and **credit ratings**.

> Going forward, investors in bail-in-able instruments are likely to experience losses in an orderly wind-up, ordinary wind-up, or a restructuring with bail-in. Thus, they may demand a higher **risk premium**, i.e. bail-in-able debt issuance may become more expensive.

[1] European Commission, New Crisis Management Measures To Avoid Future Bank Bail-Outs, June 2012.

[2] http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm.

> A financial institution's **funding mix** appears to be determined by the trade-off between the marginal costs and the marginal benefits of leverage. Higher funding costs of bail-in-able instruments may result in changes in an institution's funding structure.

> As resolution increases the marginal costs of debt, its portion of total liabilities could fall. Financial institutions may either increase capitalisation to alleviate the negative impact of resolution on bail-in-able debt, or **shift** towards non-bail-in-able instruments.

> The price **differential** between an institution's senior unsecured debt and covered bonds is well established in favour of covered bonds. The price differential is likely to increase further if covered bonds are regarded as non-bail-in-able instruments.

> An accelerated introduction of bail-in may create uncertainty causing additional **volatility** (in particular in bail-in-able securities), which, in turn, may speed up financial institutions' de-leveraging efforts and cause reduced credit availability and further economic drag.

> Differences in national rules lead to an uneven playing field. The introduction of different resolution regimes may result in further **tiering** of financial institutions and bank funding products, and additional fragmentation of the covered bond market.

> The resolution authorities retain discretion regarding the choice of resolution measures. The application of different tools to different financial institutions may lead to further **tiering** of financial institutions and fragmentation of the covered bond market.

> The application of different resolution tools to different financial institutions may perpetuate the capital market funding **advantages** of going-concern (too-big-to-fail or too-complex-to-fail) over other (allowed-to-fail) financial institutions.

Whilst covered bonds present risks to the claims of the other creditors of a financial institution, in particular when they are a key source of funding, other **asset-backed instruments** such as securitisations, derivatives, and repurchase transactions also pose risks to the other creditors. Covered bonds present benefits and risks. The product's inclusion in a financial institution's funding mix makes for further diversification and helps institutions to extend the term profile of their liabilities, but the implied structural subordination is prejudicial to the interests of the other creditors. The balance of benefits and risks of asset-backed instruments depends on a financial institution's business model and credit profile, and needs to be assessed on an institution-by-institution basis.

> The **importance** of asset-backed instruments in an institution's funding structure varies across institutions, and is often higher for specialised lenders. For universal banks, it depends on their access to unsecured funds. For some, the reliance on covered bonds may not be healthy going forward in terms of funding mix.

> The business model of (stand-alone) specialised lenders may not be **viable** in an environment where profitability is under pressure because of rising capital market funding costs and asset quality deterioration, and where institutions have to meet stricter regulatory requirements.

> Depending on an institution's business model and the asset encumbrance level, the total funding cost **differentiation** by financial institution and funding instrument is likely to play an even larger role going forward.

The use of asset-backed (funding) instruments does not necessarily have an impact on a financial institution's capitalisation, i.e. their use does not directly affect an institution's risk of failure. It may even reduce the funding pressure experienced by a financial institution unable to raise unsecured debt, thereby lowering the probability of this institution failing. However, a growing use of asset-backed instruments and the related encumbrance of assets for the benefit of selected creditors mean that those assets would not be available to the other stakeholders of the institution in an (ordinary) wind-up, i.e. the other stakeholders would experience a higher loss. There is a trade-off between structural subordination and reduced funding pressure for institutions due to the use of asset-backed instruments.

> The use of asset-backed instruments leads to a smaller pool of **unencumbered** assets on a financial institution's balance sheet. Given that there are collateral eligibility criteria, a rising use of asset-backed instruments lowers the quality of the pool of unencumbered assets as concentration of higher-risk, lower-grade unencumbered assets rises.

> As the level of encumbered assets on a financial institution's balance sheet increases, the **recovery rate** on unsecured securities in an (ordinary) wind-up falls. In other words, as the level of unencumbered assets decreases, unsecured stakeholders' losses in an (ordinary) wind-up grow.

> As the level of encumbered assets on an institution's balance sheet rises, the decline in the recovery rate on unsecured debt falls more quickly, i.e. the decline in the recovery rate on unsecured debt is **not linear**. The recovery rate would be affected by a potential subversion of the principle of pari passu treatment of creditors within the same class.

> As the level and quality of the unencumbered assets on an institution's balance sheet falls, the economic value of the **recourse** of the covered bond holders to the issuer (full recourse structure) declines, and the more difficult it may be for an issuer to maintain the required quality and size of the cover pool.

> As the level of encumbered assets on an institution's balance sheet rises and the quality of the unencumbered assets deteriorates, the **credit quality** of the institution is likely to be undermined and its (senior) unsecured credit ratings may need to be reviewed taking into account structural subordination.

> As the use of asset-backed instruments and the related structural subordination rises, **downgrade risk** is growing on both the financial institution's unsecured debt ratings and covered bond ratings because of the covered bond ratings' sensitivity and link to senior unsecured debt ratings.

> As the level of unencumbered assets on an institution's balance sheet falls, unsecured debt investors may demand a higher **risk premium**, i.e. unsecured debt issuance would become more expensive. Increasing funding costs and limited access to capital market funding could further test the resilience of financial institutions.

> As the use of asset-backed instruments and the related structural subordination rises, and downgrade risk on both unsecured debt and covered bonds grows, investors may demand a higher **risk premium**, i.e. unsecured debt and covered bond issuance would become more expensive.

> As the stock and quality of the unencumbered assets on a financial institution's balance sheet decrease and asset encumbrance for the benefit of its covered bond investors increases, a wider **price differential** between the institution's (senior) unsecured debt and covered bonds is justified on a credit fundamental basis.

> As the level of unencumbered assets on an institution's balance sheet falls, and as unsecured debt issuance would become more expensive due to a fall in the stock and quality of the unencumbered assets, the institution's reliance on asset-backed funding instruments may rise further, i.e. there would be a **negative loop**.

> If an institution has to raise its **capitalisation** as soon as the amount of asset-backed instruments exceeds a pre-set level, or if there is a limit on the use of those instruments relative to an institution's capitalisation, the adverse impact with regards to structural subordination of unsecured creditors could be alleviated.

The extent to which covered bonds have been used and their track record and systemic importance in a particular market differs across jurisdictions. As we have stated, we think investors need to take into account new aspects associated with resolution regimes and the related re-pricing of securities of financial institutions. Investors should continue to analyse, understand and eventually fully price the effects of the use of asset-backed (funding) instruments by financial institutions on both (senior) unsecured debt and covered bonds. The mechanics of the impact are relatively clear, but the methods to assess the price differential between a financial institution's (senior) unsecured debt and covered bonds are yet to be developed.

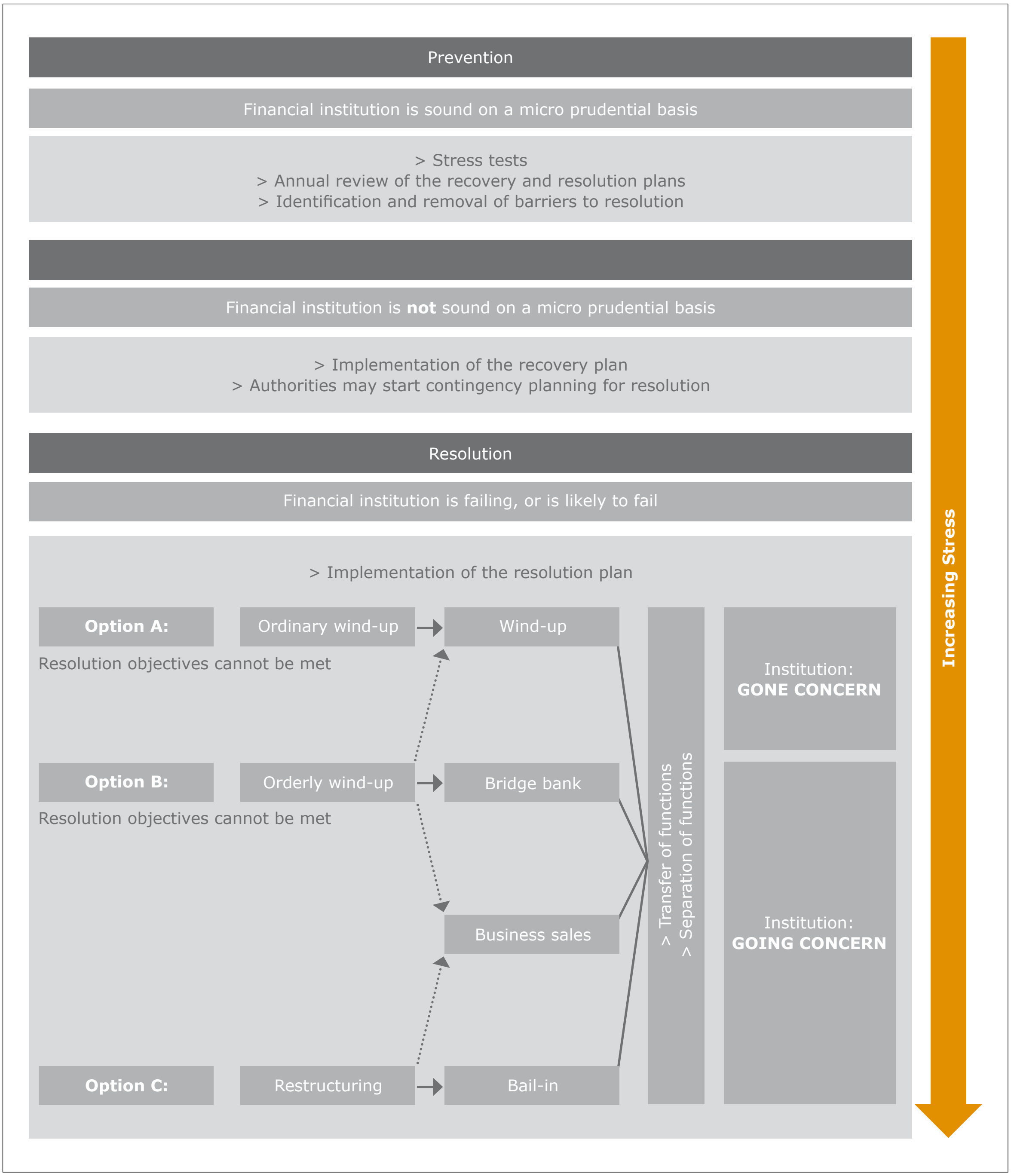
RESOLUTION – SUBORDINATION – IMPAIRMENT

Bill payer: public funds or private funds, or both

Government support for financial institutions has so far meant that the security mechanism inherent in covered bonds has remained untested. In most cases, where a financial institution was failing, or was likely to fail, measures such as nationalisation, orderly wind-up, and the merger with another institution prevented the opening of insolvency proceedings in respect of its assets and covered bond investors from having to rely on the performance of the dedicated collateral for coupon and redemption payments. With resolution regimes being introduced, government support for financial institutions is about to change, and questions arise, for example, with regards to the treatment of the different funding instruments of financial institutions, including covered bonds, in an ordinary wind-up, orderly wind-up, or restructuring with bail-in.

There needs to be **triggers** prompting the implementation of a recovery plan or resolution plan. The EC proposed common parameters for triggering the application of recovery and resolution measures. Early intervention would currently occur if a financial institution is not sound on a micro prudential basis. Resolution measures would only be implemented if the financial institution is failing, or is likely to fail, and there is no other solution that would restore the financial institution within an appropriate timeframe. In addition, the intervention by means of resolution measures has to be justified by reasons of public interest, as has the interference with stakeholders' rights. Early intervention and resolution triggers need to be objective and unambiguous. Unclear triggers, i.e. those leaving room for interpretation or scope for discretion, cause **uncertainty**.

> Figure 1: Prevention, early intervention, and resolution



Prevention
Financial institution is sound on a micro prudential basis
> Stress tests
> Annual review of the recovery and resolution plans
> Identification and removal of barriers to resolution
Financial institution is **not** sound on a micro prudential basis
> Implementation of the recovery plan
> Authorities may start contingency planning for resolution
Resolution
Financial institution is failing, or is likely to fail
> Implementation of the resolution plan
Option A:
Resolution objectives cannot be met
Ordinary wind-up
Wind-up
Option B:
Resolution objectives cannot be met
Orderly wind-up
Bridge bank
Business sales
Option C:
Restructuring
Bail-in
> Transfer of functions
> Separation of functions
Institution:
GONE CONCERN
Institution:
GOING CONCERN
Increasing Stress

Source: European Commission, Credit Suisse

Resolution: gone-concern or going-concern institution

A resolution authority needs to be able to quickly form an opinion on a financial institution facing difficulties due to micro and/or macro prudential stress. Recovery and resolution plans would help the **resolution authorities** to better understand group structures and intra-group dependencies, and to identify critical and non-critical economic functions. They may provide information required by the resolution authorities for swift implementation of early intervention or resolution measures. In addition, they may contribute to ease the risk that a financial institution facing difficulties is either too-big-to-fail or too-complex-to-fail. They may further help financial institutions to streamline operations and foster more integrated approaches to risk management.

> **Recovery plans:** The objective of a recovery plan is to enable an institution that is not sound on a micro prudential basis to avoid failure.

> **Resolution plans:** The objective of a resolution plan is to provide a roadmap to resolve a failing or likely-to-fail financial institution.

The objective in an ordinary wind-up is to maximise the recovery value to the stakeholders of the **gone-concern** institution. The objective of an orderly wind-up or a restructuring with bail-in is to allow for continuation of a financial institution's critical economic functions and financial stability, while exposing selected stakeholders of this financial institution to losses and avoiding their protection through the provision of public funds. Non-critical economic functions of a financial institution subject to an orderly wind-up or a restructuring with bail-in are likely to be wound up in an orderly fashion. In theory, a financial institution subject to a restructuring with bail-in would continue operating as **going-concern**. Bail-in is likely to be accompanied by significant restructuring.

Resolution: asset-backed versus unsecured position

Since 2008, there have been shifts in the way financial institutions fund themselves. In practice, they have a diverse funding mix, but the following key components can be distinguished: equity, retail and wholesale debt. In the past few years, several institutions have replaced shorter-term wholesale debt, with more "stable" funding sources, such as retail or longer-term wholesale funds. In comparison with "stronger" financial institutions, "weaker" ones (i.e. those with undiversified business models, inferior credit strength, and higher exposure to problematic assets) face challenges to raise unsecured funds in the capital markets on affordable terms. New regulations, heightened unsecured funding costs, and some financial institutions' challenges to launch unsecured debt led to a rise in the use of **asset-backed instruments**.

An increasing use of asset-backed instruments and higher collateralisation requirements mean asset encumbrance is on the rise. **Asset encumbrance** for the benefit of selected creditors is prejudicial to the interests of the other creditors, be it directly via structural subordination and lower recovery rates in an (ordinary) wind-up of the financial institution, or indirectly via pressure on the institution's credit ratings and funding costs. Increased use of asset-backed instruments may also affect an institution's future funding mix, and the availability of different parts of the capital markets for future issuance. Although the risks posed by asset encumbrance for the benefit of selected stakeholders are widely accepted as a threat to the interests of the other stakeholders of a financial institution, the regulators address these risks in different ways, if at all.

The introduction of and debate about resolution regimes are putting more emphasis on the order of priority of allocating losses to the stakeholders of an institution in resolution, and the treatment of bail-in-able and non-bail-in-able instruments, and the treatment of holders of asset-backed instruments. They also result in an increased focus on the amount and quality of **unencumbered assets** on a financial institutions' balance sheet available to unsecured debt holders in an (ordinary) wind-up, the preferential claim of selected creditors against dedicated collateral, the trigger mechanisms within structures and contractual agreements, and the strength of (covered bond) legislation and contractual arrangements. Despite the popularity of asset-backed (funding) instruments, a growing number of market participants starts to question the limits to their use.

According to the European Commission, **bail-in** would apply to a financial institution's unsecured liabilities, but not, for example, to deposits protected by a DGS, and short-term liabilities, i.e. liabilities with a residual maturity of less than one month. Although deposits protected by a DGS would be excluded from bail-in, it is considered that, in order to underpin the effectiveness of bail-in, it would be useful that DGSs are treated pari passu to other creditors that could be subject to a write-down and conversion. According to the EC, EU member states may exclude UCITS 52(4) compliant covered bonds from bail-in. EU member states could also exclude other instruments on a case-by-case basis if needed to ensure the continuation of any critical economic functions of the institution subject to a resolution.

On 6 June 2012, the European Commission published a provisional version of its *proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firm*s. In this provisional version, the Article 38 defining the scope of the bail-in tool is worded as follows:

Article 38: Scope of bail-in tool

1. Member States shall ensure that the bail-in tool may be applied to all liabilities of an institution that are not excluded from the scope of that tool pursuant to paragraph 2.

2. Resolution authorities shall not exercise the write down and conversion powers in relation to the following liabilities:

(a) deposits that are guaranteed in accordance with Directive 94/19/EC;

(b) secured liabilities,

(c) any liability that arises by virtue of the holding by the institution of client assets or client money, or a fiduciary relationship between the institution (as fiduciary) and another person (as beneficiary);

(d) liabilities with an original maturity of less than one month;

(e) a liability to any one of the following:

(i) an employee, in relation to accrued salary, pension benefits or other fixed remuneration, except for variable remuneration of any form;

(ii) a commercial or trade creditor arising from the provision to the institution of goods or services that are essential to the daily functioning of its operations, including IT services, utilities and the rental, servicing and upkeep of premises;

(iii) tax and social security authorities, provided that those liabilities are preferred under the applicable insolvency law.

Points (a) and (b) of paragraph 2 shall not prevent resolution authorities, where appropriate, from exercising those powers in relation to any part of a secured liability or a liability for which collateral has been pledged that exceeds the value of the assets, pledge, lien or collateral against which it is secured. Member States may exempt from this provision covered bonds as defined in Article 22(4) of Council Directive 86/611/EEC38.

Point (c) of paragraph 2 shall not prevent resolution authorities, where appropriate, from exercising those powers in relation to any amount of a deposit that exceeds the coverage under that Directive.

[…]

Please refer to the European Commission website (here[3]) for an updated version of this Proposal.

In an ordinary wind-up, all stakeholders of the gone-concern institution would be exposed to losses. In an orderly wind-up or a restructuring with bail-in, selected stakeholders would be exposed to losses. Accordingly, holders of non-bail-in-able instruments, in particular those related to critical economic functions, may be better off in a restructuring with bail-in than in an ordinary wind-up. Non-bail-in-able instrument holders may be better off in an orderly wind-up, than in an ordinary wind-up, in particular if the restructuring plan for the financial institution subject to an orderly wind-up would arrange for their transfer to a third party with superior credit strength. The resolution authorities retain **discretion** regarding the choice of resolution measures. Resolution measures interfere with the stakeholders' rights, but their **negative impact** differs across measures and type of instrument.

Bail-in-able debt minimum or non-bail-in-able debt limit

In the context of the debate about bail-in, it is being discussed that in order for bail-in to be a credible resolution tool, there must be a sufficient amount of **bail-in-able securities**. The EC said that a minimum amount of bail-in-able securities may be defined as a proportion and for each institution based on the institution's credit risk and funding mix. The national policymakers would retain the discretion of defining the minimum amount of bail-in-able securities. In order to address lingering concerns about **insufficient** bail-in-able securities, consideration may also be given to constrain the use of non-bail-in-able securities or the level of asset encumbrance. Such an approach would likely need to be effected as part of a more holistic way to managing asset-backed funding instruments rather than by singling out covered bonds for disparate treatment.

Although an issuance limit may be aimed at protecting unsecured creditors' interests, it is also in the interest of covered bond investors as the risk of a dilution of the collateral by rising covered bond issuance is lower, the issuer's ability to meet its obligations under the debt programme is higher, and the economic value of a full recourse of the covered bond investors may not lose substance. The extent to which covered bonds have been used in a particular market differs across countries. Policymakers in several European countries may be unable to impose a minimum amount of bail-in-able securities, a maximum amount of non-bail-in-able securities, or an asset encumbrance limit given the role asset-backed instruments play in their markets. Imposing these thresholds may put some covered bond markets and issuers, in particular specialised lenders, under pressure.

[3] http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm

COVERED BOND USE: STABLE, BUT DIFFERENT

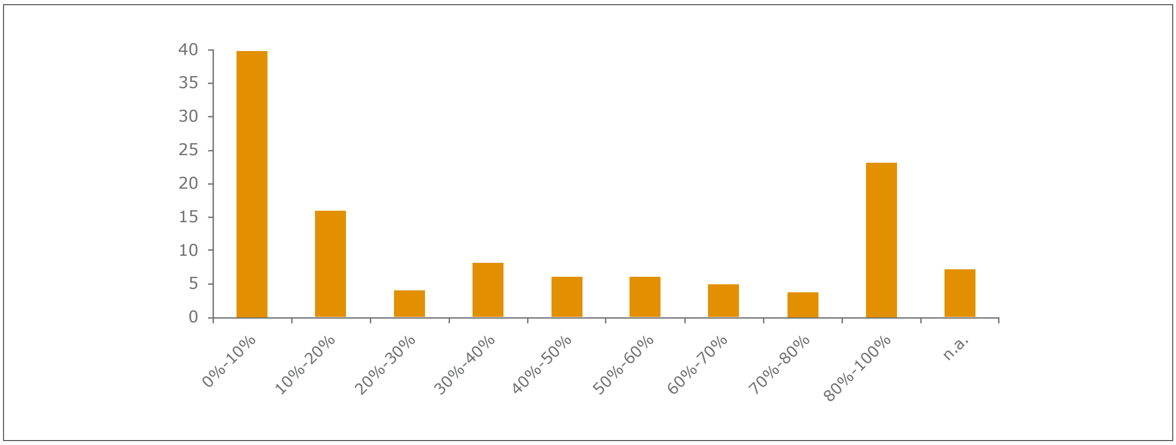
To compare issuers, we are using the total cover pool-to-total assets ratio because asset encumbrance for the benefit of covered bond investors can be tracked, while that related to the other asset-backed instruments used by financial institutions cannot be quantified as necessary data are unavailable. We recognise that covered bonds are only one of a variety of instruments encumbering assets, and that other measures, including an unencumbered assets-to-unsecured debt ratio, would better reflect the risk posed to the unsecured creditors by the use of asset-backed instruments by financial institutions and related asset encumbrance. In addition, both the unencumbered assets-to-unsecured debt ratio and the total cover pool-to-total assets ratio, would not show the quality and the risk profile of the unencumbered assets.

In countries, such as Hungary, Ireland, Luxembourg, and Norway, only specialised lenders can use covered bonds. The special banking principle in some countries was abolished as the respective covered bond market developed. Specialised lenders are often restricted to relatively low margin business mostly funded through covered bonds. The special banking principle typically precludes lenders from taking deposits and therefore avoids structural subordination of depositors, but not of other creditors. The use of covered bonds in a lender's funding mix depends on its business model, and is often higher for specialised lenders. For universal banks, the importance of covered bonds in the funding mix depends on their access to unsecured funds. Institutions with a low loans-to-deposits ratio and a high deposits-to-liabilities ratio are less reliant on capital market funding.

A specialised lender may be part of a banking group and act as the covered bond issuing entity for the holding company and the group, and the other group entities are engaged in deposit-taking activities. As a group entity, a specialised lender is likely to have modest or no asset-origination capacities, and may not be consolidated for resolution purposes in respect of the holding company and other group entities. The investors in covered bonds of a specialised lender often have recourse to the issuer (full recourse structures), but no further recourse to the holding company and to the other group entities. In countries with a special banking principle, the total cover pool-to-total assets ratio may be relatively high. In comparison with universal banks, in a wind-up of a specialised lender, the recovery rate on unsecured securities, and the economic value of a full recourse is likely to be lower.

We distinguish between nine total cover pool-to-total assets ratio ranges, from 0%-10% to 80%-100%. For seven (in Q4 2011) and twelve (in Q2 2011) of the 119 issuers in our analysis, we could not determine the total cover pool to total assets ratio range as data of those issuers were unavailable. In Q4 2011, 34% of issuers fell into the 0%-10% total cover pool-to-total assets ratio range, and 19% of issuers were part of the 80%-100% total cover pool-to-total assets ratio range. We are concerned about the "substitution effect" whereby issuers substitute unsecured with asset-backed funding and its consequences. However, with regards to covered bonds, from Q2 2011 to Q4 2011, most issuers (89) in our analysis remained in the same total cover pool-to-total assets ratio range. In comparison with Q2 2011, in Q4 2011, 8% of issuers were in a higher total cover pool-to-total assets ratio range, and 8% of issuers were in a lower total cover pool-to-total assets ratio range.

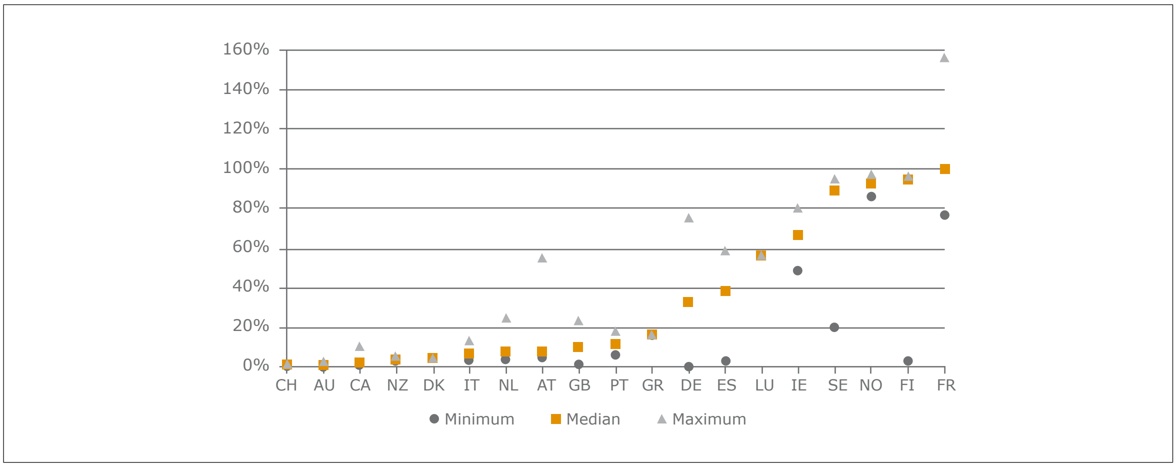
> Figure 2: Total cover pool to total assets ratio ranges (number of issuers)



Source: Corporate data, Fitch, Moody’s, S&P, Credit Suisse

The average and median total cover pool-to-total assets ratios of the issuers with sufficient data disclosure remained at a similar level in Q4 2011 as in Q2 2011 at around 40% and 20%, respectively. In Q4 2011, the maximum and minimum total cover pool-to-total assets ratios of these issuers were 156% and close to zero, respectively. 36 of the 38 issuers in the 50%-60% or in a higher total cover pool-to-total assets ratio range are specialised lenders. Most of these lenders are part of a banking group. The average and median total cover pool-to-total assets ratios remain higher at specialised lenders than at universal banks. In Q4 2011, the average and median total cover pool-to-total assets ratios of the specialised lenders were 88% and 90%, respectively, while the average and median total cover pool-to-total assets ratios of the universal banks were 15% and 10%, respectively.

> Figure 3: Total cover pool to total assets ratio across issuers (by country)



Source: Corporate data, Fitch, Moody’s, S&P, Credit Suisse

From Q2 2011 to Q4 2011, one Canadian, Italian, and UK issuer moved to the 10%-20% from the 0%-10% total cover pool-to-total assets ratio range, one Swedish moved to the 20%-30% from the 10%-20% total cover pool-to-total assets ratio range, two Spanish moved to the 30%-40% from the 20%-30% total cover pool-to-total assets ratio range, one German and Spanish moved to the 50%-60% from the 40%-50% total cover pool-to-total assets ratio range, and one Irish moved to the 80%-100% from the 50%-60% total cover pool-to-total assets ratio range. Specialised lenders from jurisdictions, such as Finland, France, Germany, Ireland, Luxembourg, Norway, and Sweden have relatively high total cover pool-to-total assets ratios, i.e., asset encumbrance for covered bond investors and the implied structural subordination of unsecured creditors is relatively high.

In France, most banking groups have more than one covered bond issuing entity. The total cover pool-to-total assets ratio of the issuers from countries with relatively new covered bond markets, such as Australia and New Zealand, is relatively low. In Q4 2011, Australian and New Zealand issuers fell into the 0%-10% total cover pool-to-total assets ratio range. In comparison with the universal banks from other countries, most universal banks from Spain have high total cover pool-to-total assets ratios as Spanish covered bond investors have a special privilege in a relatively large pool of assets on an issuer's balance sheet, i.e., in comparison with other jurisdictions, asset encumbrance for the benefit of Spanish covered bond investors and the implied structural subordination of unsecured creditors is relatively high. In Q4 2011, the total cover pool-to-total assets ratios of the UK issuers were between 1% and 24%.

1.8 SUB-JUMBO SECTOR

By Anne Caris, Bank of America Merrill Lynch

SUB-JUMBOS VS. JUMBOS: STILL RELEVANT?

The covered bond market has historically been divided into "jumbos" and "sub-jumbos" or so called "Jumboliños". The main difference between the two is size. A jumbo has a required minimum of EUR 1 bn (at issuance or over time through taps), compared with a typical EUR 0.5-1 bn for sub-jumbos. Issuance used to be primarily under the jumbo format, but this is no longer the case. The share of sub-jumbos has been rising over the past few years, a trend which has been confirmed in recent months as market volatility has persisted. This development is visible across markets and not restricted to the EUR-denominated market (see Figure 1). Issuance is also spread across countries and issuers independent of their size. Sub-jumbo issues are no longer confined to the smaller banks only and have similar characteristics to their counterparts, e.g. maturity (see Appendix listing sub-jumbo new issues at end-July 2012).

> Figure 1: New issuance and share of sub-jumbos across covered bond markets

	2011	2012*
€-denominated (local currency bn)	17.5	14.2
% total benchmark issues	10%	18%
US$-denominated (local currency bn)	0	2.6
% total benchmark issues	0%	9%
£-denominated (local currency bn)	2.9	2.6
% total benchmark issues	33%	55%

* As of 25 July 2012. Data is based on fixed rated and publicly placed benchmark issues only.

Source: BofA Merrill Lynch Global Research

MAJOR STRUCTURAL CHANGES

The larger issuance of sub-jumbos is not random but rather the result of a number of important structural changes. It has also been a way of adapting to the current operating environment. Factors that favour sub-jumbos over jumbos include:

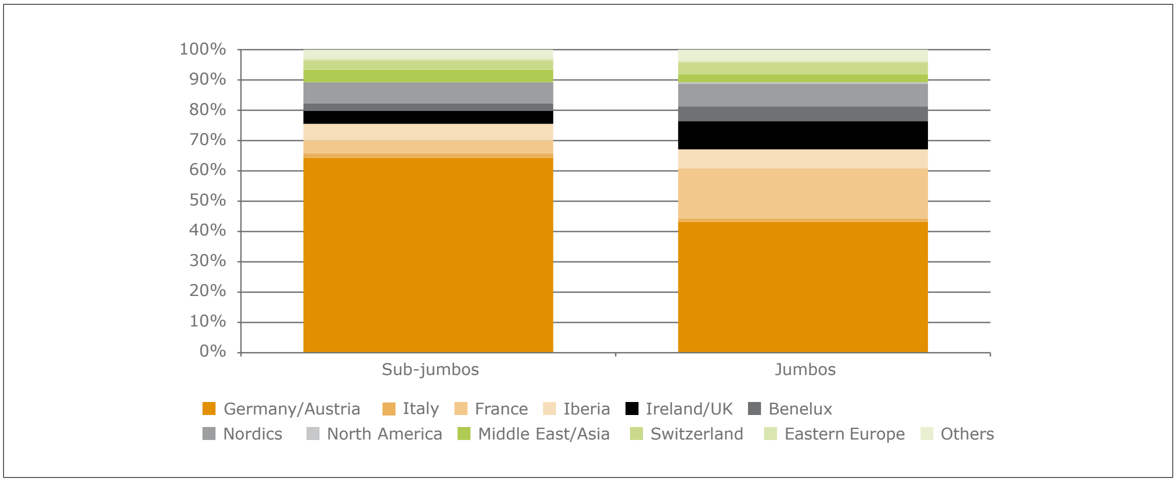
- **New market practices:** Until 2008, a jumbo size was a requirement for liquidity purposes due to committed quoting/trading agreements by market-markers. However, this is no longer the case, as low liquidity, high volatility and banks' balance sheet de-risking have rendered such commitments challenging and hardly applicable. Therefore, jumbo covered bonds no longer guarantee better liquidity, although they might still be preferred by some traditional investors.
- **Widened index eligibility:** The eligibility criteria in covered bond indices used to be based on the jumbo definition, unlike for ABS or senior unsecured bonds, for which the cut-off point has been EUR 500 m. However, on 31 December 2011, Markit iBoxx (an important index for the covered bond market) lowered its eligibility threshold to EUR 500 m. Such a size is now the norm for indices, with EUR 500 m and above considered the "benchmark" covered bond. Sub-jumbos have also been eligible for the two covered bond programmes by the European Central Bank (ECB) and, as such, have not been singled out as not making the grade.

- **Persistent market volatility:** The crisis has disrupted not only the secondary but also the primary market. Execution risks have increased significantly and vary in response to news headlines, which can change rapidly within a few hours. As a result, the frequency of taps has increased, enabling issuers to get a feel for investor appetite and adapt to demand depending on market circumstances. Taps have amounted to 10-15% of new issuance over the past 18 months. The issuance of sub-jumbos is another more widely used avenue today, being easier to place in terms of size, while in some cases stimulating demand. The announcement of small deals can trigger a better response, especially given the current lack of supply versus demand. Volatility is a feature of today's markets and looks here to stay.
- **Lesser funding needs post-LTROs:** The 3-year LTROs launched by the European Central Bank in December 2011 and February 2012 have significantly reduced banks' funding needs. Some names are actually fully funded for the rest of the year. That said, a number of issuers are still keen to access the markets, notably for reputation purposes, and have done so with sub-jumbo covered bonds, which better meet their needs.
- **ALM / diversification:** Issuing less and more frequently has helped to manage asset and liability mismatches between cover assets and covered bonds – increasingly important given the focus on refinancing risks, one of the rating agencies' main current concerns. It is also positive for banks' debt maturity profiles by avoiding major hikes, which can be challenging in the current markets. Spreading maturities is crucial for risk management. Furthermore, some banks have preferred to tap different markets in smaller amounts to play diversification (investor base, currency, etc).
- **New legislation:** The amount of covered bond legislation is increasing globally. Belgium is the latest country to have passed its law and new issuance can be expected by year-end or early next year. Such expansion growth can be expected to lead to further sub-jumbo new issuance, which naturally remains the niche of the smaller banks.

SUB-JUMBOS MARKET PERFORMANCE AS GOOD AS JUMBOS

Sub-jumbos have performed well in the primary market. New issuance in 2012 was successfully allocated and over-subscribed by more than two times – thus showing no difference vs. jumbos. Furthermore, both sizes enjoy a similar investor base (see Figure 2 and Figure 3). The higher participation of German investors in sub-jumbos is due to a domestic bias and reflects the fact that German banks have been the main issuers of such bonds this year. That said, both jumbos and sub-jumbos have attracted a wide range of investors across Europe.

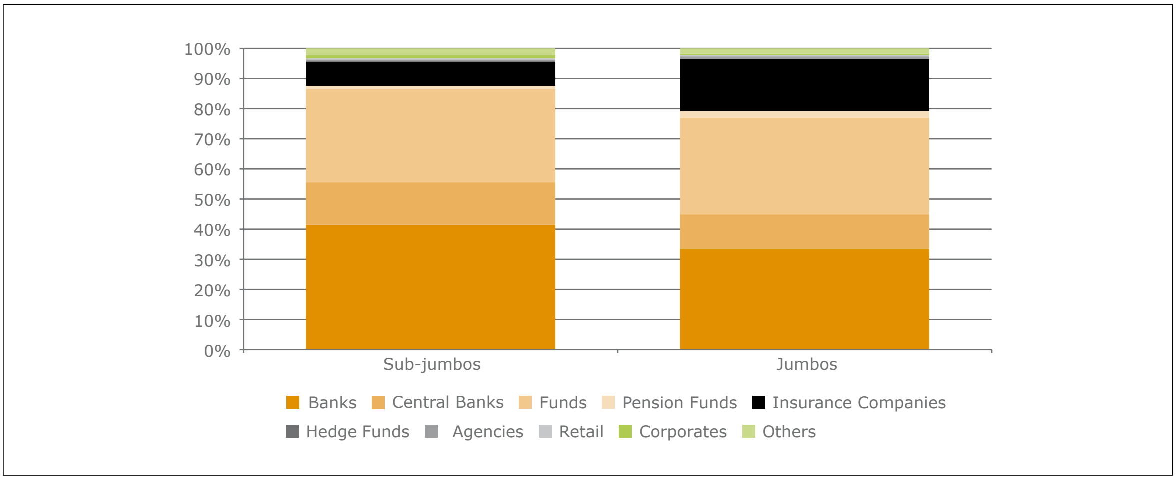
> Figure 2: Allocation of EUR-denominated benchmarks by country



As of end-July 2012; excluding FRNs

Source: BofA Merrill Lynch Global Research, Bond Radar LTD

> Figure 3: Allocation of EUR-denominated benchmarks by investor type

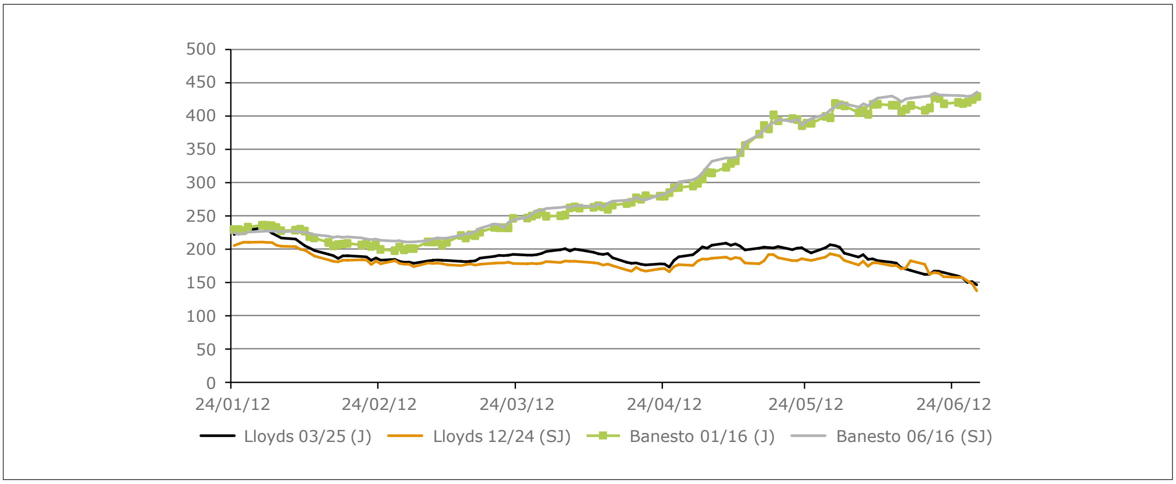


As of end-July 2012; excluding FRNs

Source: BofA Merrill Lynch Global Research, Bond Radar LTD

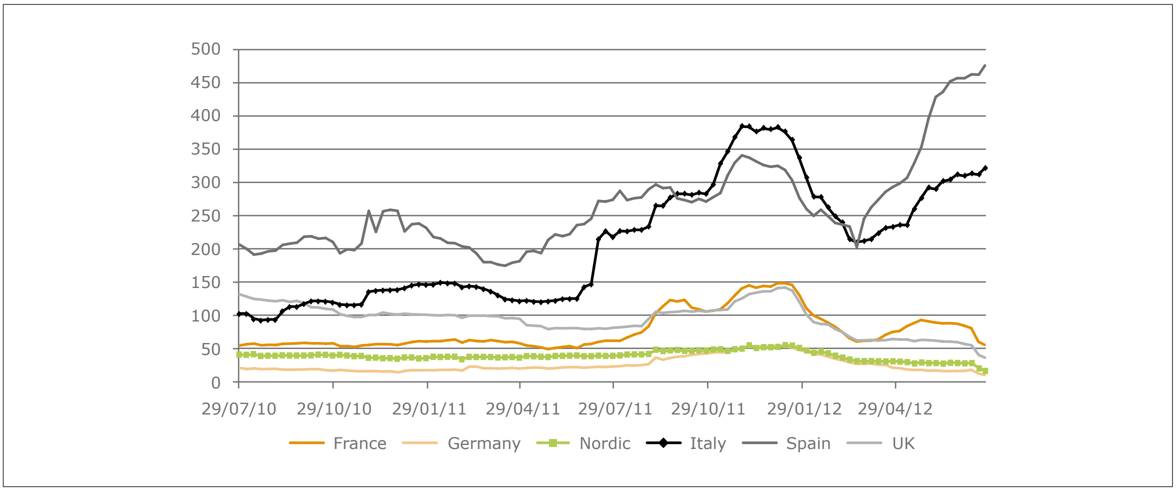
Similarly, there is no clear difference in ASW spread developments between the two sizes in the secondary market. This is well illustrated in Figure 4 and Figure 5 which compares the spread levels for jumbo (J) and sub-jumbo (SJ) covered bonds of similar maturities for two specific issuers (Lloyds in the UK and Banesto in Spain). The data shows little difference between the two bond sizes, thereby demonstrating that size is not a spread driver. Pricing in the covered bond market is still mainly a function of the strength of the legal framework, viability of the issuer, quality of the cover pools, and sovereign/macroeconomic risks underpinning the spread differential, as highlighted in Figure 5. Liquidity is another key driver, especially for smaller and less frequent issuers.

> Figure 4: ASW spreads for EUR-denominated benchmarks (bp)



Source: Bloomberg

> Figure 5: 3-5yr EUR covered bond ASW spreads by country (bp)



Source: BofA Merrill Lynch Global Research

Therefore, the distinction between sub-jumbos and jumbos has diminished in recent years and one might therefore wonder about its relevance. The appellation "benchmark" is now typically used by the market to refer to covered bonds with a minimum size of EUR 500 m which are eligible for indices. While few market practices adhere to the old jumbo definition, it still matters in at least one context: the eligibility criteria for the ECB repo operations, which distinguish between jumbos and non-jumbos to determine "Category II" and "Category III". The two categories have different haircuts, especially for covered bonds rated BBB+ to BBB- (see Figure 6).

> Figure 6: Valuation haircuts applied to eligible marketable assets (%)

Credit Quality	Residual maturity	Category I (central gvt/ bank)		Category II (Jumbo covered/SSAs)		Category III (other covered/ corporate)		Category IV (senior unsec.)**		Category V (ABS)
Step 1 & 2 (AAA to A-)*	years	fixed coupon	zero coupon	fixed coupon	zero coupon	fixed coupon	zero coupon	fixed coupon	zero coupon	Fixed or zero coupon
	0-1	0.5	0.5	1.0	1.0	1.5	1.5	6.5	6.5	16.0
	1-3	1.5	1.5	2.5	2.5	3.0	3.0	8.5	9.0	
	3-5	2.5	3.0	3.5	4.0	5.0	5.5	11.0	11.5	
	5-7	3.0	3.5	4.5	5.0	6.5	7.0	12.5	13.0	
	7-10	4.0	4.5	5.5	6.5	8.5	9.0	14.0	15.5	
	>10	5.5	8.5	7.5	12.0	11.0	16.5	17.0	22.5	
Step 3 (BBB+ to BBB-)	years	fixed coupon	zero coupon	fixed coupon	zero coupon	fixed coupon	zero coupon	fixed coupon	zero coupon	Fixed or zero coupon
	0-1	5.5	5.5	6.0	6.0	8.0	8.0	15.0	15.0	Not eligible
	1-3	6.5	6.5	10.5	11.5	18.0	19.5	27.5	29.5	
	3-5	7.5	8.0	15.5	17.0	25.5	28.0	36.5	39.5	
	5-7	8.0	8.5	18.0	20.5	28.0	31.5	38.5	43.0	
	7-10	9.0	9.5	19.5	22.5	29.0	33.5	39.0	44.5	
	>10	10.0	13.5	20.0	29.0	29.5	38.0	39.5	46.0	

Source: ECB

* Assets in this liquidity category that are given a theoretical value (in accordance with Section 6.5 of the "General Documentation") will be subject to an additional valuation markdown of 5%.

** Unlike covered bonds, self-issued unsecured senior debt is not eligible for ECB repo operations.

APPENDIX: LIST OF SUB-JUMBOS ISSUED IN 2012

> Figure 7: Sub-jumbo new issuance across markets (as of end-July 2012)

Bloomberg ticker	Name	Country	Maturity date	Maturity at launch (years)	Coupon	Size (local currency bn)	Spread at issuance
€-denominated market							
AARB	Aareal Bank	Germany	01-Feb-16	4	2.00	0.5	ASW+58
HYPORE	Depfa Deutsche Pfandbriefbank	Germany	18-Jan-16	4	2.25	0.5	ASW+75
TERBOL	Terra Boligkreditt	Nordic	25-Jan-17	5	2.25	0.5	ASW+73
BNZ	Bank of New Zealand	New Zealand	07-May-15	3	2.38	0.5	ASW+113
BANEST	Banesto	Spain	17-Jun-16	4	3.75	0.5	ASW+235
BKIASM	Bankia	Spain	28-Feb-14	2	4.00	0.5	ASW+290
DB	Deutsche Bank	Germany	01-Mar-19	7	2.13	0.5	ASW+22
INGDIB	ING-Diba	Germany	13-Mar-19	7	2.00	0.5	ASW+17
WLBANK	WL Bank	Germany	29-Mar-22	10	2.50	0.5	ASW+26
HSHN	HSH Nordbank	Germany	05-Apr-17	5	1.88	0.5	ASW+33
BACA	Unicredit Bank Austria	Austria	25-Apr-19	7	2.63	0.5	ASW+88
NDOLB	Hypo Noe Gruppe Bank	Austria	09-May-22	10	3.00	0.5	ASW+88
NYKRE	Nykredit Realkredit	Nordic	01-Jun-17	5	3.25	0.5	ASW+200
LBBW	Landesbank Baden-Wuerttemberg	Germany	01-Jun-18	6	1.38	0.5	ASW+7
PBBGR	Deutsche Pfandbriefbank	Germany	03-Jun-19	7	2.13	0.5	ASW+60
HSHN	HSH Nordbank	Germany	06-Jun-16	4	1.13	0.5	ASW+18
DB	Deutsche Bank	Germany	08-Jun-22	10	1.75	0.5	ASW+12
AARB	Aareal Bank	Germany	19-Jun-17	5	1.38	0.5	ASW+20
DHY	Deutsche Hypotheken-bank	Germany	20-Jun-17	5	1.25	0.5	ASW+9
ASBBNK	ASB Finance	New Zealand	10-Jul-17	5	1.88	0.5	ASW+68
PBBGR	Deutsche Pfandbriefbank	Germany	04-Jul-17	5	1.63	0.5	ASW+38
BYLAN	Bayerische Landesbank	Germany	11-Jul-22	10	2.00	0.5	ASW+17
NDB	Norddeutsche Landesbank	Germany	17-Jul-17	5	1.63	0.5	ASW+55
NDB	Norddeutsche Landesbank	Germany	05-Dec-19	7	1.50	0.5	ASW+9
POPSM	Banco Popular	Spain	30-Mar-17	5	4.13	0.6	ASW+255
TERBOL	Terra Boligkreditt	Nordic	19-Jun-19	7	2.00	0.65	ASW+55

Bloomberg ticker	Name	Country	Maturity date	Maturity at launch (years)	Coupon	Size (local currency bn)	Spread at issuance
US$-denominated market							
NACN	National Bank of Canada	Canada	19/10/16	5	2.20	0.6	ASW+67
MUNHYP	Muenchener Hypothekenbank	Germany	13/07/15	3	1.13	0.5	ASW+63
WSTP	Westpac Banking Corp	Australia	17/05/15	3	0.00	0.5	3m$L+80
£-denominated market							
BARC	Barclays	UK	20-Jan-15	3	0.000	0.75	3mL+150
NWIDE	Nationwide	UK	23-Jan-15	3	0.000	0.65	3mL+160
NAB	National Australia Bank	Australia	27-Jan-15	3	0.000	0.50	3mL+145
COVBS	Coventry Building Society	UK	10-Feb-15	3	0.000	0.50	3mL+165
ABBEY	Santander UK	UK	16-Feb-29	17	5.250	0.75	G+245
ABBEY	Santander UK	UK	16-Feb-15	3	0.000	0.75	3mL+160
BARC	Barcalys	UK	20-Jan-15	3	0.000	0.70	3mL+135
LEED	Leeds Building Society	UK	20-Mar-15	3	0.000	0.25	3mL+50
CLYDES	Clydesdale Bank	UK	08-Jun-26	14	4.625	0.70	G+270
CLYDES	Clydesdale Bank	UK	08-Jun-26	14	0.000	0.40	3mL+170

Source: BofA Merrill Lynch Global Research, Bond rRadar LTD

1.9 THE US DOLLAR MARKET

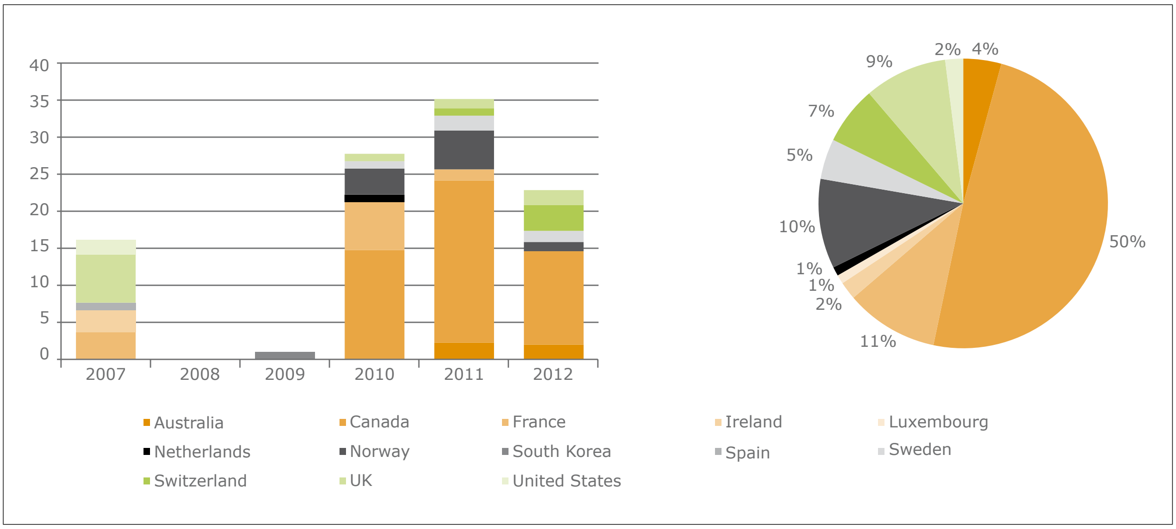
By Anne Caris and Rondeep Barua, Bank of America Merrill Lynch

A GROWING MARKET

The US$ covered bond market has experienced material expansion in recent years: it has grown tenfold since 2005, reaching c.US$100bn at end-May 2012[1], which represents c.10% of the €-denominated outstanding benchmark market and c.3.5% of the total covered bond market. Issuance by Canadian banks has been a key growth driver since 2010: banks in Canada currently account for 50% of the outstanding US$ covered bond market (see Figures 1 and 2). The entrance of the Australian banks following the implementation of their covered bond legislation in 4Q11 further boosted market volumes. New covered bond benchmark issues in US$ accounted for 18% of the total at end-May 2012, compared with 13% at YE2011 and 9% at YE2010.

> Figure 1: US$-denominated benchmark issuance by country end-May 12 (US$bn)[1]

> Figure 2: Outstanding US$-denominated benchmark by country (%)



Source: BofA Merrill Lynch Global Research; [1] Excluding FRNs

Source: BofA Merrill Lynch Global Research

FEW SIGNS OF THE EURO DEBT CRISIS

Unlike its € counterpart, the US$ covered bond market saw no breakdown in the pattern of activity during 2011 due to the Eurozone crisis. Issuance was consistent throughout the year (see Figure 3). However, the composition of issuers changed during 2H11 with the dominance of non-European names. The start of 2012 was buoyant, with US$25bn of benchmark issues at end-May 2012 (equivalent to 70% of 2011).

> Who are the US$ issuers? Initially, the US$ covered bond market was a funding alternative to the largest European covered bond issuers for diversification purposes (FX, investor base, etc). Since

[1] Data is based on outstanding fixed rate benchmark issues with a minimum size of US$500 million.

summer 2011, when the Eurozone sovereign crisis escalated, it has been open to the core/strongest European banks only. This is unlikely to change until market concerns regarding the Eurozone subside. Other issuers are the largest banks in Canada and Australia. Covered bonds have typically given them access to a new investor base and a competitive funding source. That said, in both countries covered bond issuance is limited by law to avoid overreliance on the product[2].

> What are the key characteristics of US$ covered bonds? They are typically 3- or 5-year fixed rate bonds of a "jumbo" size, although the term remains limited to the €-denominated market. Therefore, the terminology "benchmark" is used instead to highlight similar criteria e.g., regarding size and/or liquidity. US$ covered bonds can be issued under a specific US$ programme but are backed by the same cover assets as covered bonds in € or other foreign currency (typically residential mortgages). They must also meet the same legal requirements. The average maturity slightly lengthened in 2012, with 4.6 years on average at end-May compared with 4.2 years in 2011. It nonetheless remains lower than in the €-market, with 6.7 years on average in 2012 at end-May. The average size also increased to US$1.8bn versus US$1.5bn in 2011. This compares with an average of €1.1bn in the €-market.

> What are the future growth drivers? The US$ covered bond market seems to be set up for expansion. Key growth drivers include:

a) The implementation of new covered bond legislation in more countries should help broaden the US$ market. New Zealand and Belgium are expected to implement their covered bond legal frameworks by YE2012. It is a work in progress in other countries (eg, Japan, Chile, Brazil, Singapore). For new legislation in non-European countries, the US$ market might be a more natural home than the €-market. Covered bond legislation is also being contemplated in the US and would naturally have the most impact on that market.

b) The SEC registration for covered bonds by Royal Bank of Canada opens the door to a wider investor base and thus can be expected to facilitate further increase in issuance. Prior to this new step, US$ covered bonds were offered under Rule 144A, meaning they could be sold to Qualified Institutional Buyers only under specific restrictions. This new avenue is quite important and can be expected to be followed by other issuers, as some of the 144A investors were close to reaching their allocation limit for the product.

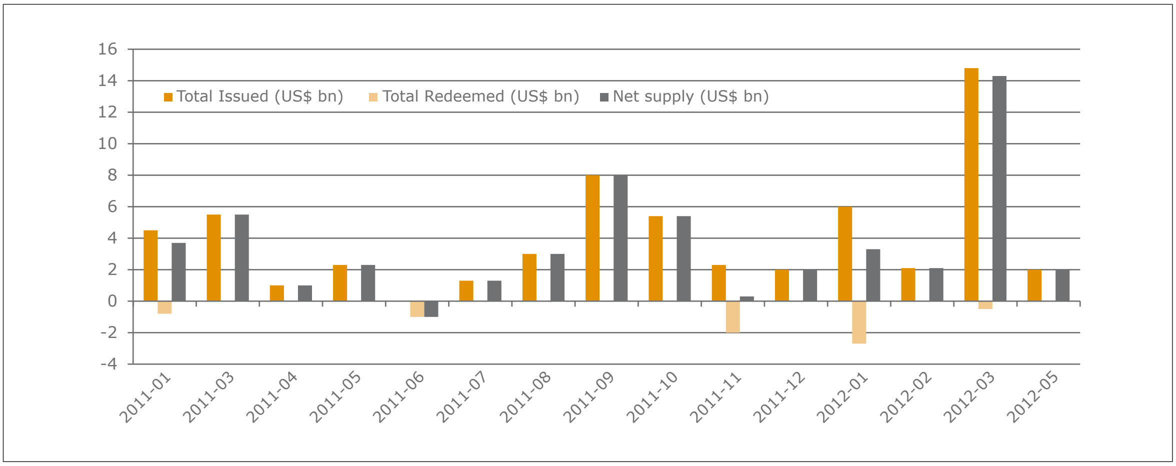
c) Covered bonds typically trade at a spread discount to senior unsecured debt so that they are a natural competitive funding source for banks – even more so for strong issuers in a healthy macroeconomic environment. Management can be expected to alternate between the two products, which supplement each other unless new regulations, e.g., regarding bail-in, change the endgame for investors. However, as we highlighted in our report The Cost of Asset Encumbrance, when comparing pricing, it is important to take into account all-in funding costs.

Our model simulations show that when calculating the all-in cost of different bank funding options by factoring in the cost of their execution and management in addition to their headline spreads, e.g., swap costs or required over-collateralisation in the case of covered bonds, the

[2] Outstanding covered bonds cannot exceed 4% and 8% of banks' total assets in Canada and Australia, respectively.

latter are not always the most competitive funding source in some countries. Furthermore, higher covered bond usage can lead to wider unsecured bank spreads and to a negative feedback loop (higher risk premium for senior unsecured debt due to asset encumbrance leads to more covered bond issuance and more asset encumbrance).

> FIGURE 3: US$-DENOMINATED BENCHMARK ISSUANCE GROSS VS. NET END-MAY 2012 [1]



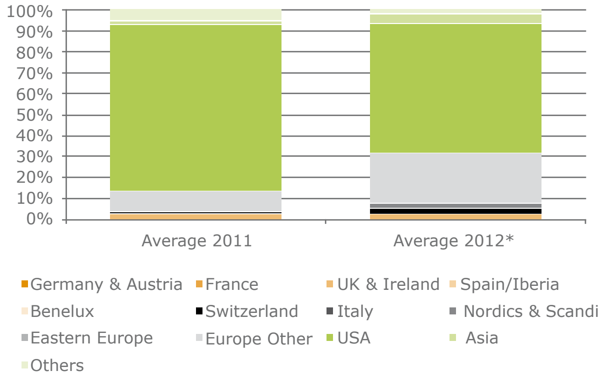
Source: BofA Merrill Lynch Global Research; [1] Including taps; excluding FRNs

SHIFT IN INVESTOR BASE BUT REMAINS US-BIASED

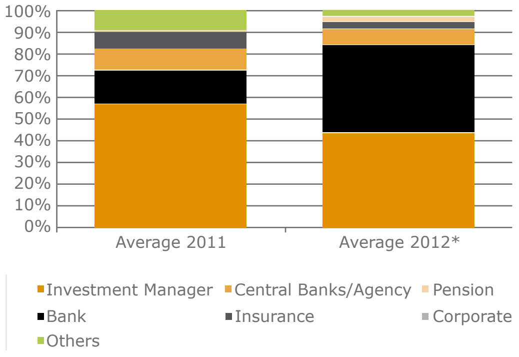
Regarding the allocation of new issuance, the majority of active investors in the US$ covered bond market have understandably been domestic (see Figure 4). However, the share of US investors fell to 62% at end-May 2012, from 80% in 2011 on average. This can partly be explained by the lack of supply in the European market after the ECB 3-year LTROs, which has forced investors to become active across international markets. In addition, the US$ market can offer yield pick-up for investors, versus its € counterpart, partly due to a sustained European stigma since the summer 2011, including for core issuers. Like in the €-market, Asian investors have been present but to a limited extent and on a selective basis, focusing on specific names.

New issuance allocation by investor type tends to differ in the US$ market from the €-denominated market (see Figure 5). Asset managers are particularly dominant in the US, accounting for more than 50% (c.60% in 2011 on average), versus one-third typically in the €-market. That said, there has been a shift in 2012, with banks accounting for 40% of new issuance i.e., at similar shares to what we typically see in the €-denominated covered bond market. Nonetheless, the take-up by life insurance companies remains low overall (below 10%), unlike in Europe where it represents c.15-20%. New SEC registration can be expected to widen the investor base going forward, putting US$ covered bond issuers on an equal footing with UCITS issuers in Europe. It is also worth noting that US$ covered bonds are eligible at the discount window with the US Fed subject to a minimum rating of BBB.

> Figure 4: Breakdown of US$ covered bond investors by country



> Figure 5: Breakdown of US$ covered bond investors by type

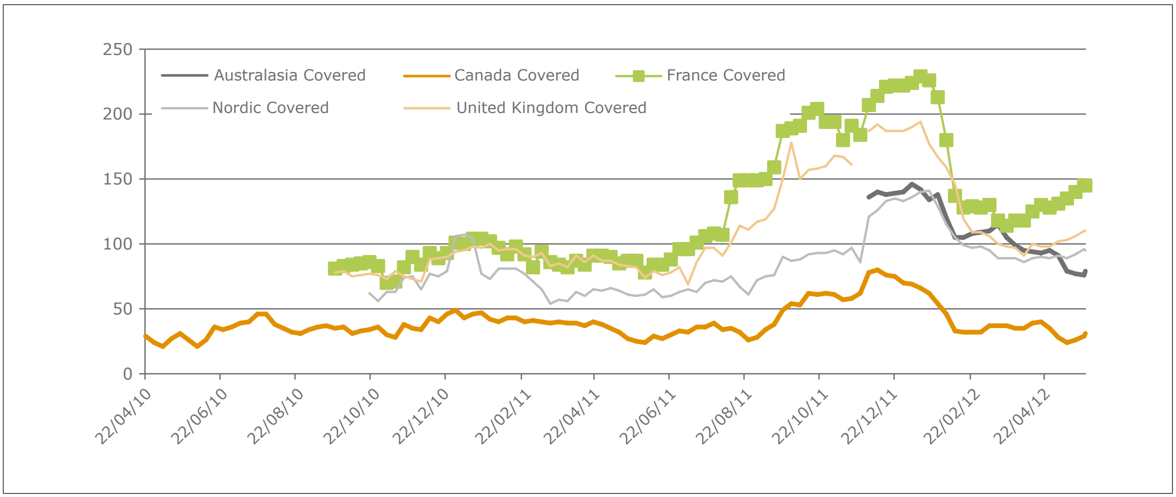


Source: BofA Merrill Lynch Global Research; * at end-May 2012

A TIERED MARKET, LIKE IN EUROPE

The US$ covered bond market is characterised by non-negligible differences in ASW spread levels across countries and issuers. Such differentiation has been even more pronounced since summer 2011 when concerns regarding the Eurozone started to escalate (see Figure 6). Like its €-peer, the US$ secondary market can be split into two tiers: core versus non-core issuers. The former category has benefited from stable and tight spread levels overall, while the latter has shown more volatile and wider spread levels. Countries/issuers belonging to these two tiers differ, nonetheless, across the two markets. In Europe, core issuers consist mainly of the following countries: the Nordics, Germany, the Netherlands, the UK and Switzerland. Non-core issuers have been from peripheral countries (Spain, Italy, Portugal, Greece, Ireland). Countries like France have been fluctuating between the core and non-core groups. In the US$ market, core issuers comprise Canadian banks, whereas all Europeans seem to belong to the second group. Australian banks are in between, although on their way to the core category based on their fundamentals. This segregation of the market can be expected to last, depending on the resolution of the current banking and sovereign issues in Europe.

> Figure 6: 3-5 year US$ covered bond ASW spread averages by country (bp)



Source: BofA Merrill Lynch Global Research

SPREAD DRIVERS REMAIN MOSTLY MACRO...

The development of covered bond ASW spreads has mainly been a function of headlines/events at a macro level. News at the issuer level are also priced but has carried less weight generally in recent months. Figures 14 to 28 in the Appendix show how spreads have moved for covered bonds, bank senior unsecured bonds and sovereign bonds across the term structure. Darker lines represent more recent data, with the darkest orange lines representing the latest data as of May 2012. We note the following:

> Canada has benefited from flight-to-quality with spreads tightening across debt instruments between January and May 2012. The targeted exclusion of insured mortgages as eligible assets under the new covered bond legislation has also led to increased investor demand. Once the law is implemented, new issuance backed by these assets will no longer be possible, so the asset class will become scarcer. It is also worth noting that the issuance limit (covered bonds cannot exceed 4% of banks' total assets) also puts a cap on the total amount of Canadian covered bonds.

> Similar to Canada, Australia has been viewed as a defensive investment alternative, being a non-European country. Furthermore, its banks have limited direct exposures to Europe. However, spreads (sovereign in the first instance) have been sensitive to news regarding economic softening in China. The premium paid on covered bonds when Australian banks launched their first issues is no longer warranted. Investors have a better understanding of product, while technical factors (namely a significant lack of supply versus demand) have also been favourable to Australian issuers.

> European issuers have typically faced higher spread volatility although the degree varies across countries according to the risks at sovereign and/or bank level, which ultimately impact covered bonds given the linkage.

a) In France, spreads widened due to the elections in May and the new political direction taken by the freshly elected Socialist government in a challenging macroeconomic environment. French banks, which have been on their way to rehabilitation, also need to show further progress regarding their deleveraging and ability to manage risks in peripheral countries – causing covered bond spreads to widen as well.

b) In the UK, government bonds have benefited from flight to quality as investors have favoured the sterling versus the euro. That said, banks have faced a double-dip recession while still being actively restructured, underpinning spread volatility in both bank and covered bonds in response to headlines.

c) The Nordics have been somewhat in a different league. Although not immune from current developments in Europe (notably given their open economy), they are not part of the Eurozone (except for Finland) and their exposure to the European peripheral countries is limited. As such, spreads across debt instruments have shown some stability, reinforced by technical factors such as a strong investor base.

... BUT PREMIUM ACROSS DEBT INSTRUMENTS ARE NOT UNIFORM

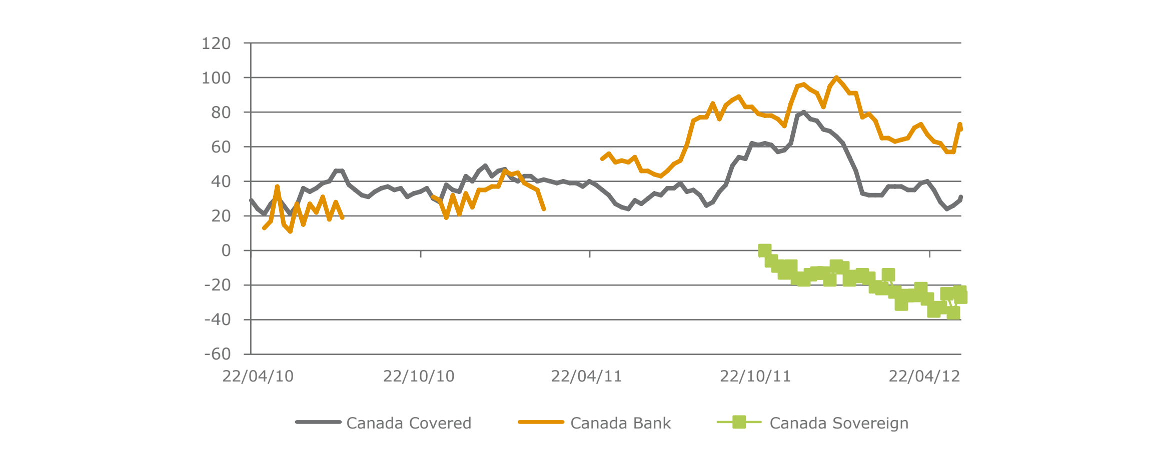
In the US$ covered bond market, all issuing countries show a consistent spread ranking, with senior unsecured bank bonds trading wider than covered bonds and covered bonds wider than sovereign bonds. This is not always the case in the €-market where in Portugal, for example, covered bonds have traded inside sovereign bonds. Covered bonds can be seen as offering better protection due to their preferential rights on specific cover assets but also their immunity from bail-in or PSI risks[3]. Nonetheless, the spread differential between bank and covered bonds can vary significantly. The premium for issuing senior unsecured bank bonds is more important for European issuers than non-European, averaging 100bp in the Nordics, 150bp in the UK and 200bp in France (see Figure 7 to Figure 11). In contrast, such premiums average 50bp in both Canada and Australia.

Such differences can be explained by the active discussions taking place in Europe regarding bail-in as governments aim to share the burden of bank failures with investors, rather than taxpayers alone. The spread differential between bank and covered bonds can be expected to vary in the future. Key drivers include: the implementation of bail-in, the creditworthiness of each issuer and, increasingly for covered bonds, the quality of cover assets and the transparency of the reporting. This pricing difference could offer some yield pick-up versus covered bonds since the risks of bail-in only matter in an insolvency scenario.

From an issuer perspective, covered bonds tend to be a competitive source of funding due to their lower spread levels, but it is important to take into account also secondary costs (swaps, required over-collateralisation, etc.) to understand their full cost, which can vary from one country or issuer to another, as previously mentioned.

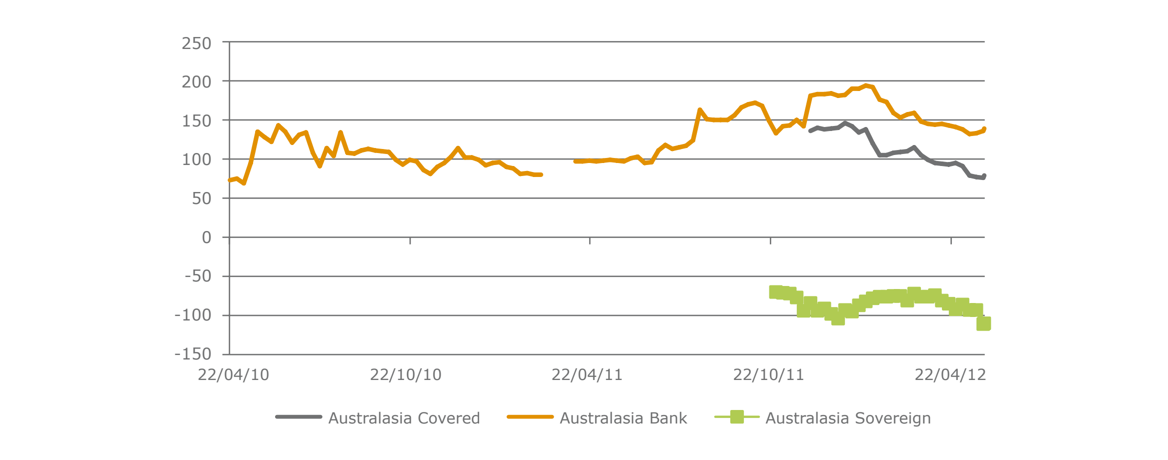
[3] With respect to bail-in, the current EU directive proposal mentions that covered bond holders would be affected in a second stance only ie, in case of insufficiency of the cover pools when ranking pari passu with senior unsecured debt holders.

> Figure 7: ASW spreads in Canada (bp)



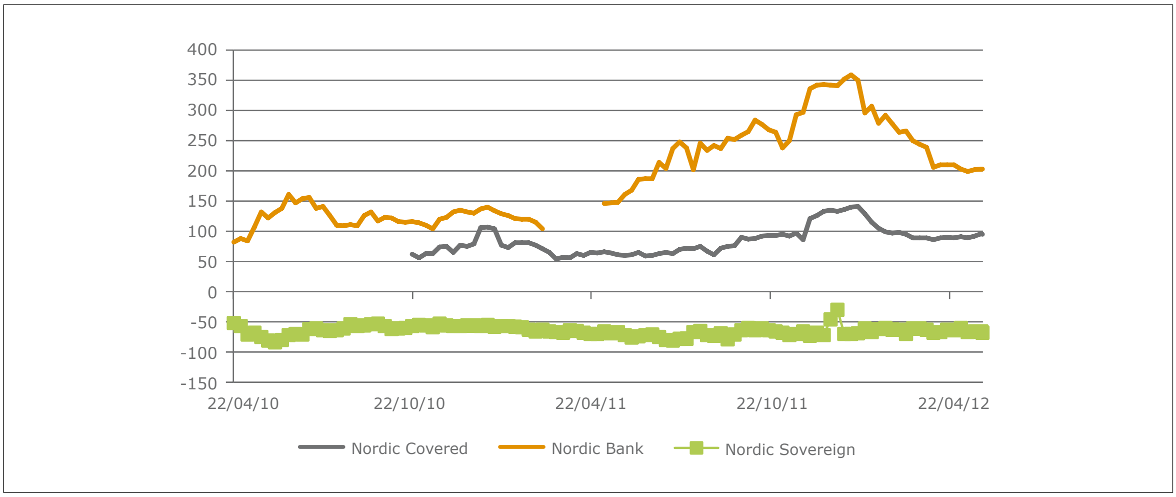
Source: BofA Merrill Lynch Global Research

> Figure 8: ASW spreads in Australia (bp)



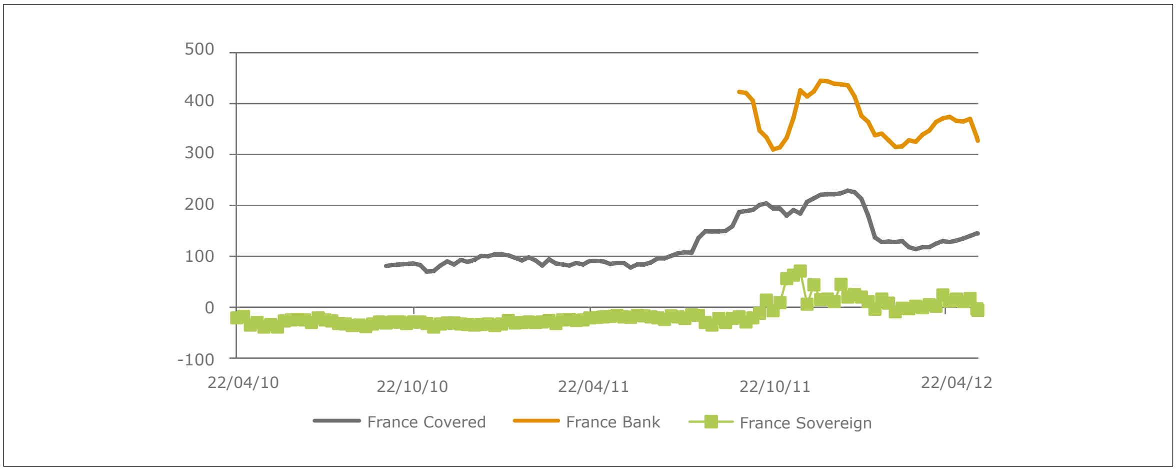
Source: BofA Merrill Lynch Global Research

> Figure 9: ASW spreads in Nordics (bp)



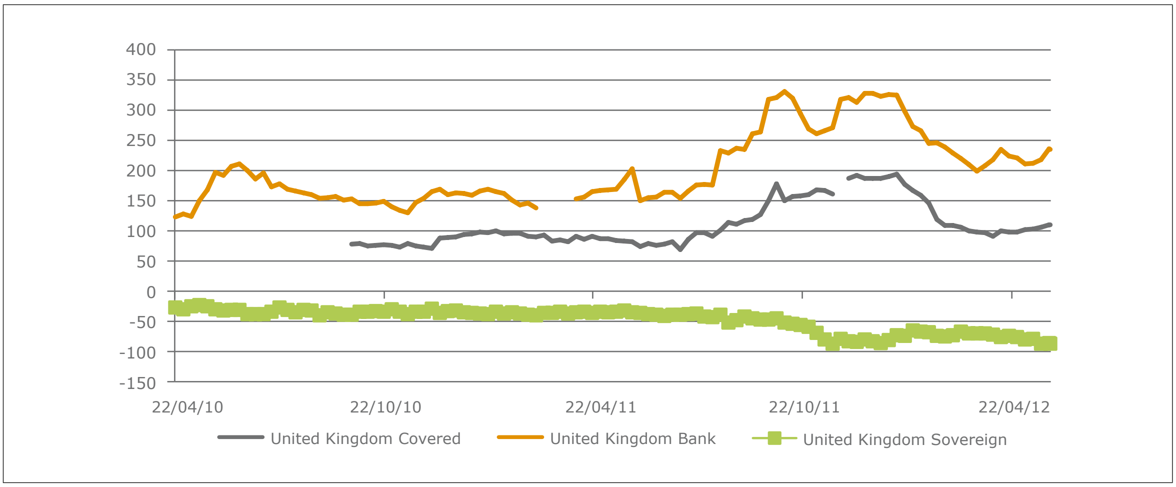
Source: BofA Merrill Lynch Global Research

> Figure 10: ASW spreads in France (bp)



Source: BofA Merrill Lynch Global Research

> Figure 11: ASW spreads in UK (bp)



Source: BofA Merrill Lynch Global Research

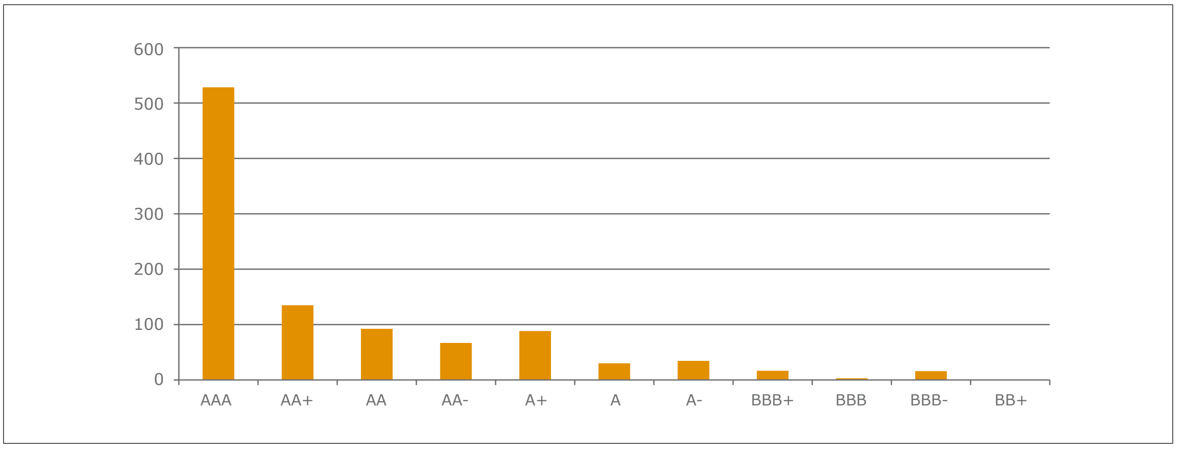
MAJOR RATING DIFFERENCES BETWEEN THE US$ AND € MARKETS

Rating downgrades have made headline news in the last 18 months in Europe, impacting sovereigns, banks and covered bonds given their linkage. As a result, the €-denominated covered bond market is no longer an AAA rated market unlike its US$ counterpart (see Figure 12 and Figure 13). All European markets have been affected although peripheral countries (Portugal, Ireland, Greece, Spain and Italy) were naturally the most harmed. Unlike in the past, we have seen multiple downgrades in a short period of time and/or downgrades of multiple notches, which has been historically rare. Drivers in most cases consisted of:

- A rating downgrade at the sovereign level, the latter representing a rating ceiling or cap to non-sovereign obligors, except in a few circumstances (e.g., the existence of a formal guarantee from an entity domiciled in a higher-rated country).
- A reduced level of systemic support factored into the issuer rating based on expected lower willingness (e.g., in the case of bail-in regimes) or ability (e.g., weakening economies or EC conditions) to offer such support.
- In few cases (although increasingly) lesser support of the cover pools as the issuer is no longer willing and/or able to provide extra over-collateralisation to mitigate higher refinancing risks for example.
- Changes in the methodologies of rating agencies in terms of sovereign caps, bank ratings or covered bond ratings. These have been multiple and occurred at different times across agencies.

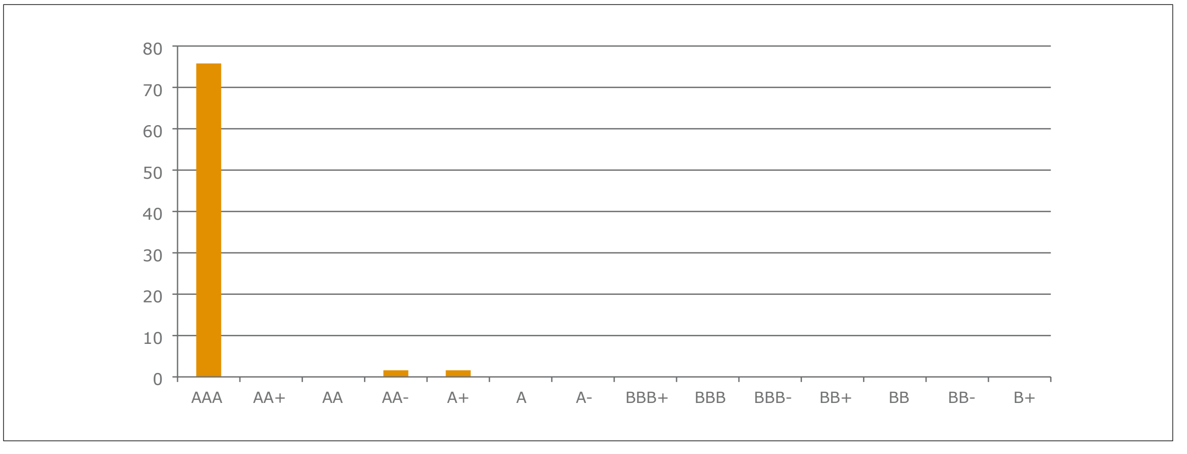
The US$ market has been more or less immune so far due to the sustained sound fundamentals of its key participants. Few US$ covered bonds are not rated AAA. However, rating pressures cannot be excluded in the future as a range of European issuers currently show limited leeway between the bank and covered bond ratings. Non-European banks have also faced rating pressures although current issuers remain highly rated and in most cases are able to support their cover pool by adding extra over-collateralisation for example. Regarding covered bond ratings, it is important to keep in mind the linkage between sovereign, bank and covered bond ratings translating into higher rating volatility versus other asset class e.g., RMBS.

> FIGURE 12: €-DENOMINATED BENCHMARK RATING DISTRIBUTION END-MAY 2012 (€BN) [1]



Source: BofA Merrill Lynch Global Research; [1] Excluding FRNs

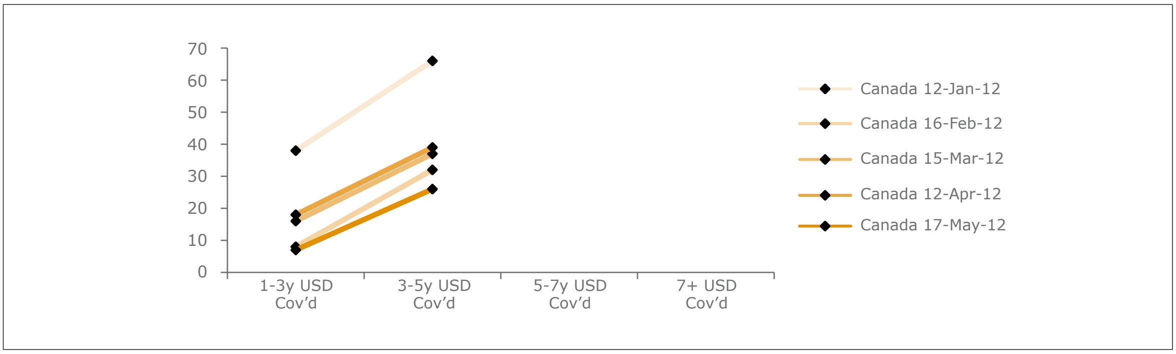
> FIGURE 13: US$-DENOMINATED BENCHMARK RATING DISTRIBUTION END-MAY 2012 (€BN) [1]



Source: BofA Merrill Lynch Global Research; [1] Excluding FRNs

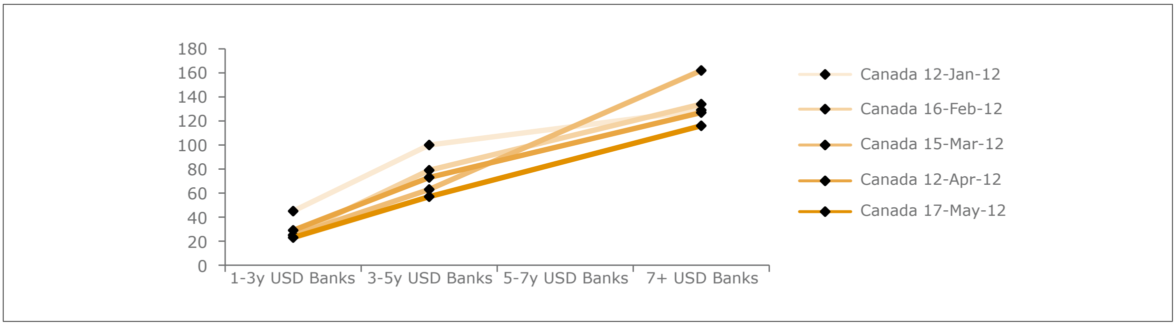
APPENDIX: US$ ASW SPREADS BY DEBT INSTRUMENT (COVERED BOND, BANK UNSECURED, SOVEREIGN) ACROSS MATURITIES AND COUNTRIES

> FIGURE 14: CANADA COVERED BOND ASW SPREADS (BP)



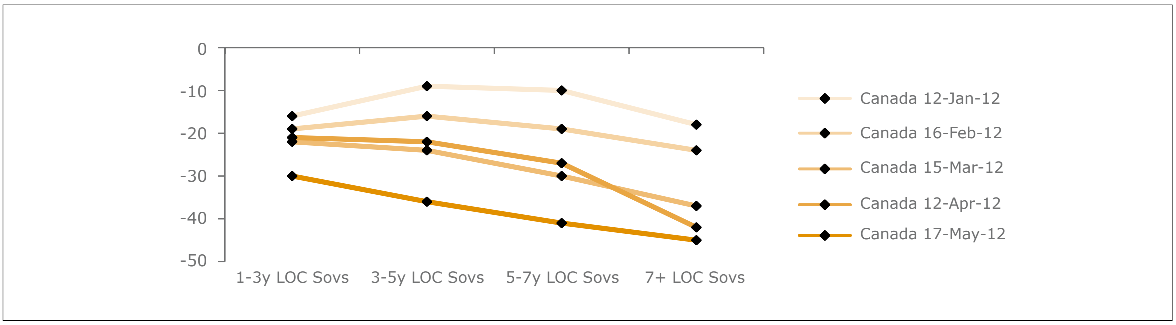
Source: BofA Merrill Lynch Global Research

> FIGURE 15: CANADA BANK ASW SPREADS (BP)



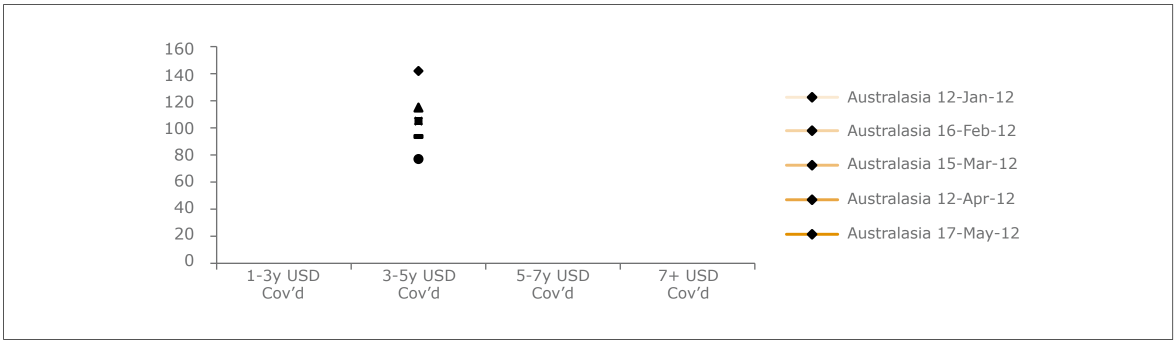
Source: BofA Merrill Lynch Global Research

> FIGURE 16: CANADA SOVEREIGN ASW SPREADS (BP)



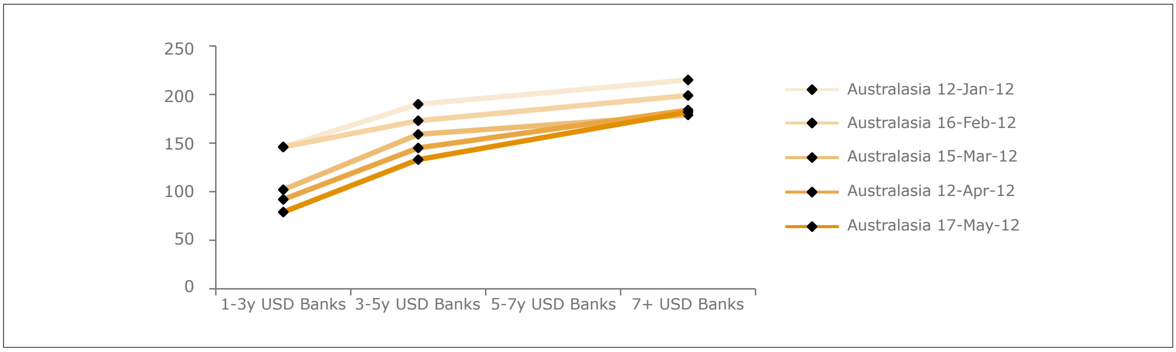
Source: BofA Merrill Lynch Global Research

> FIGURE 17: AUSTRALIA COVERED BOND ASW SPREADS (BP)



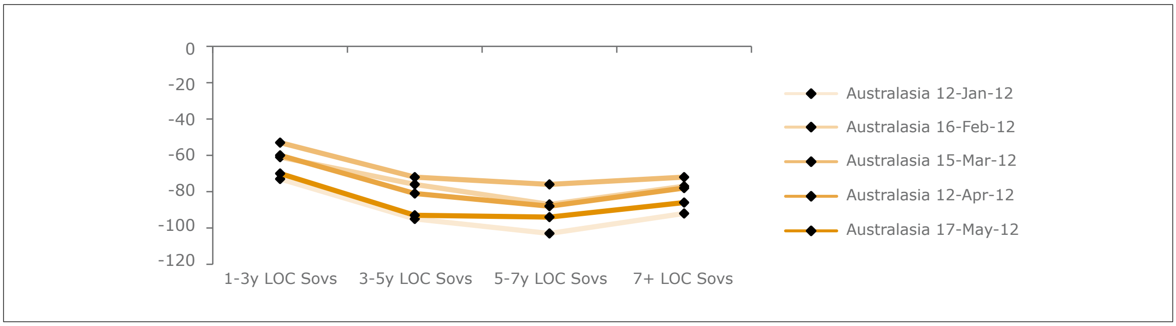
Source: BofA Merrill Lynch Global Research

> FIGURE 18: AUSTRALIA BANK ASW SPREADS (BP)



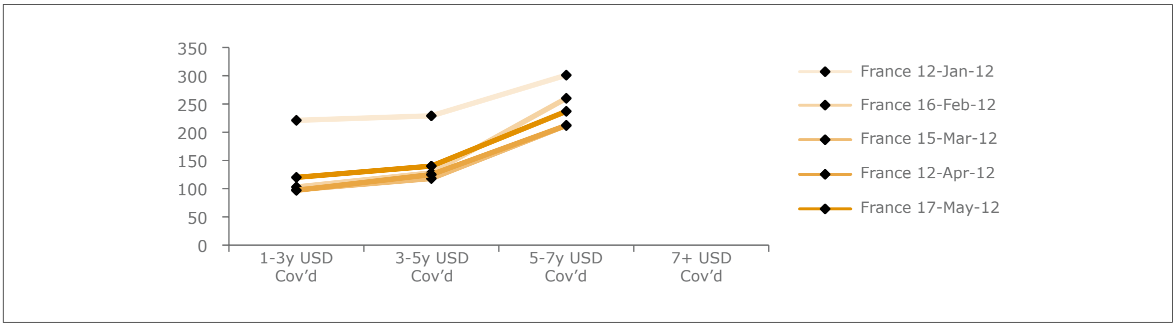
Source: BofA Merrill Lynch Global Research

> FIGURE 19: AUSTRALIA SOVEREIGN ASW SPREADS (BP)



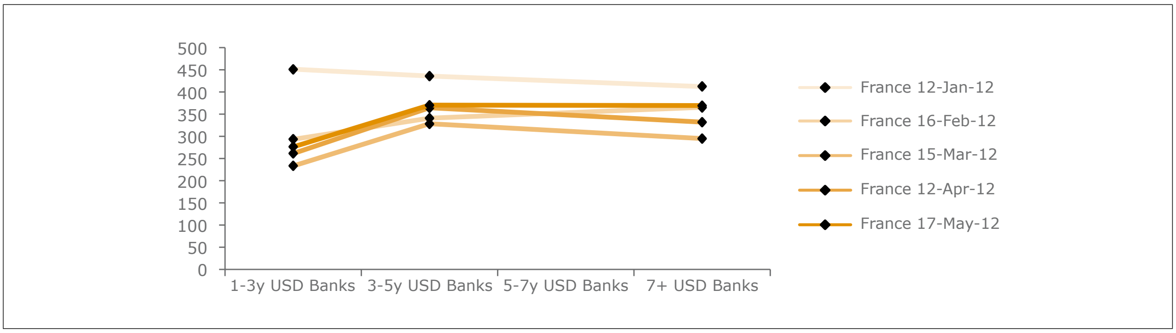
Source: BofA Merrill Lynch Global Research

> Figure 20: France covered bond ASW spreads (bp)



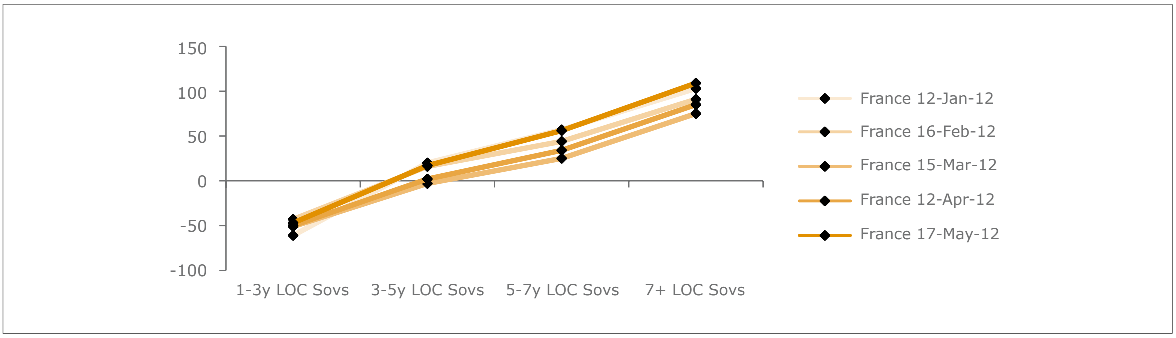
Source: BofA Merrill Lynch Global Research

> Figure 21: France bank ASW spreads (bp)



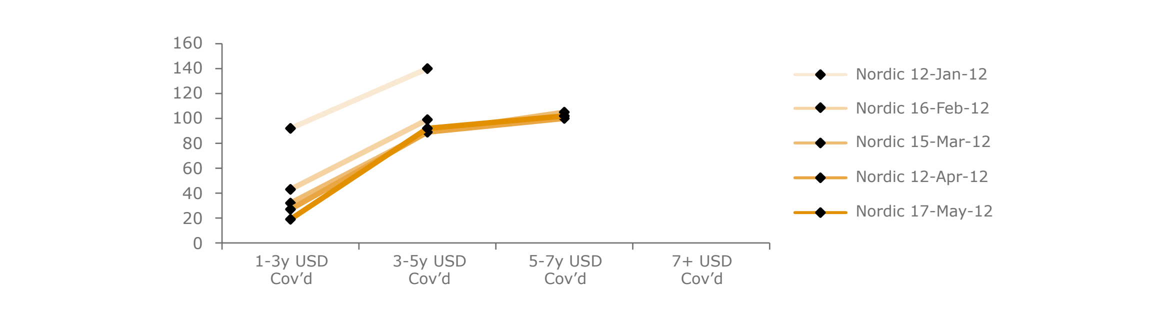
Source: BofA Merrill Lynch Global Research

> Figure 22: France sovereign ASW spreads (bp)



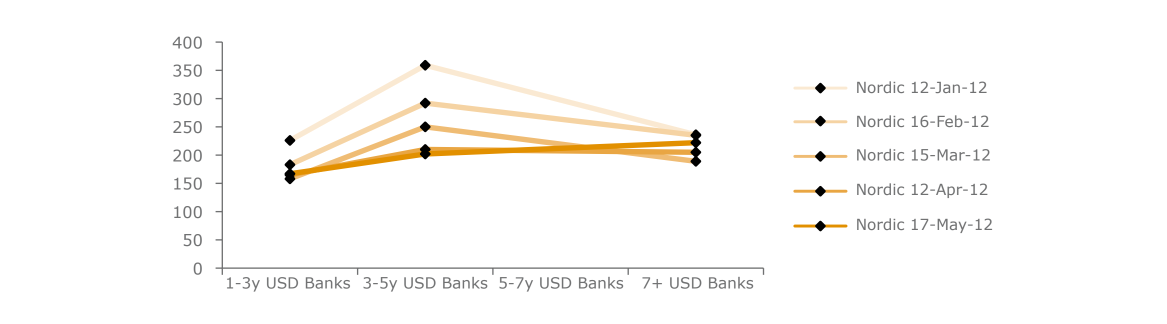
Source: BofA Merrill Lynch Global Research

> Figure 23: Nordics covered bond ASW spreads (bp)



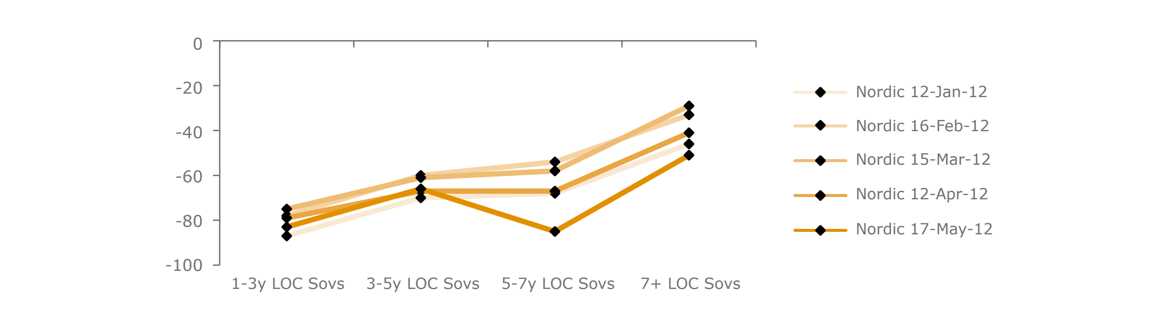
Source: BofA Merrill Lynch Global Research

> Figure 24: Nordics bank ASW spreads (bp)



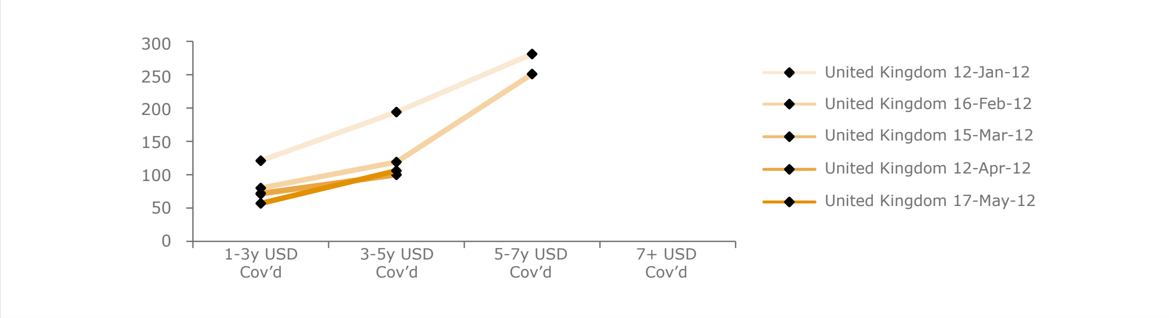
Source: BofA Merrill Lynch Global Research

> Figure 25: Nordics sovereign ASW spreads (bp)



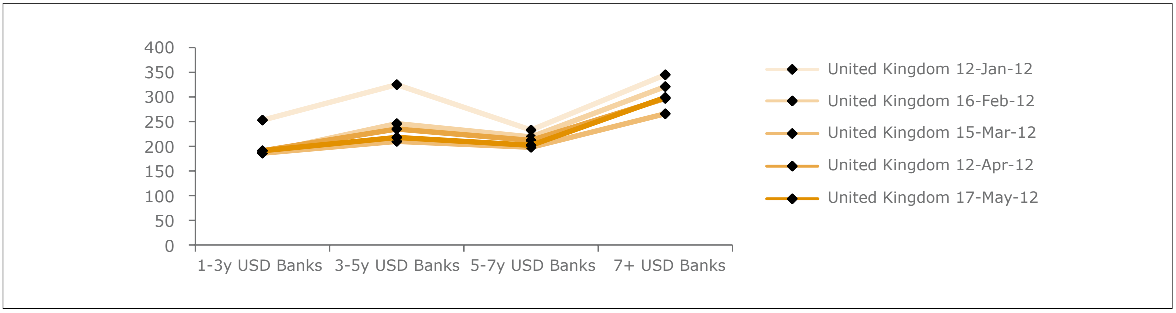
Source: BofA Merrill Lynch Global Research

> FIGURE 26: UK COVERED BOND ASW SPREADS (BP)



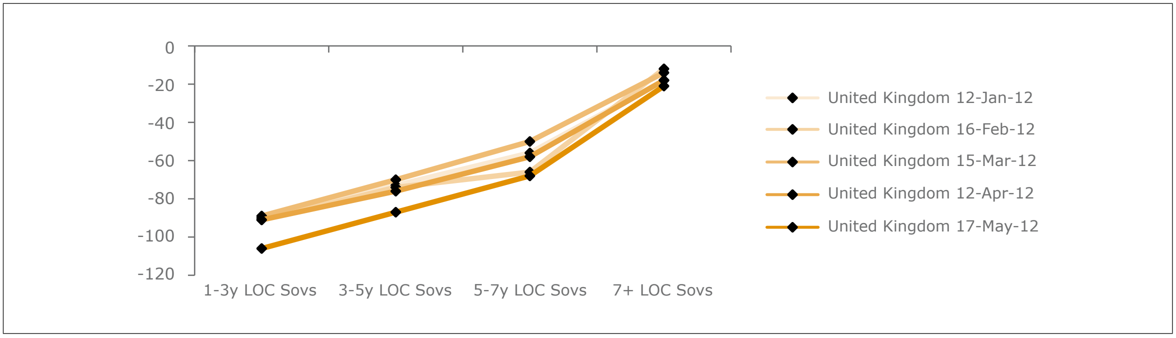
Source: BofA Merrill Lynch Global Research

> FIGURE 27: UK BANK ASW SPREADS (BP)



Source: BofA Merrill Lynch Global Research

> FIGURE 28: UK SOVEREIGN ASW SPREADS (BP)



Source: BofA Merrill Lynch Global Research

1.10 DERIVATIVES IN COVER POOLS

By Michael Schulz, NordLB

Derivatives help financial institutions in managing their cash flow; they help to absorb risks resulting from changes in the market and consequently prevent additional fluctuations in valuations. In addition to simple derivatives such as interest and currency swaps, complex derivative structures also play a major role in banks' day-to-day operations nowadays. However, these complex derivative products are of no relevance in managing cover pool risks and, in most cases, are even prohibited by law, while plain vanilla derivatives are permitted in most countries. The primary aim is to ensure that cash flows, which affect asset liability management among other things, can be managed. The assumptions of rating agencies, which impose different requirements in some cases on the use of derivatives in cover funds, play an important role here.

Attention is increasingly focused on the risk of not servicing payment obligations on time. This is particularly true of the period after an issuer of covered bonds has announced that it is insolvent and that consequently the cash flows can only be financed from the cover pool. Many of the rating agencies' rules focus precisely on this point, meaning that when using derivatives, contractually agreed payments by counterparties are very important. As a rule, the methodologies stipulate that if there is a relevant use of derivatives in the cover pool, the rating of the covered bond will be heavily dependent on the rating of the counterparty/counterparties. Possible consequences in the rating process may therefore include downgrades in the covered bond rating or capping the rating at the level of the counterparty rating. For a long time, investors have viewed the requirements, which are very detailed in some cases, and information for derivatives in cover pools as merely peripheral. However, it is primarily the smouldering crisis of confidence among financial market players that is causing a sea change. Today, it is no longer only the issuers of covered bonds and rating agencies that follow the international rules governing derivatives attentively. Investors are also keenly interested in recognising and analysing possible risks.

At present, the volume of outstanding covered bonds encompasses more than EUR 2.6 trillion. The volume of benchmark issues (EUR >500m) considered by most participants increased further this year and recently exceeded the EUR 1.0 trillion threshold. Without going into the conceptual differentiation of covered bonds at this point, regulatory changes mean that a further increase in total volume must be expected. However, in relation to the cover assets behind these bonds, the market values of the swaps contained therein are low. The netted market value of all derivatives in relation to the cover assets is in low single digit percentages, for instance. Account must also be taken of the fact that while swaps are arguably used to hedge interest and currency risks at all financial institutions, derivatives are not included in cover pools across the board. The reasons behind this differ considerably in some cases in relation to the issuers involved and with regard to the different countries. While only very few issuers in Germany have derivatives in cover, for example, this is virtually standard practice at all covered bond issuers in France and Luxembourg.

NEWS FROM REGULATORS

Above all the financial crisis, triggered by the bankruptcy of the US bank Lehman Brothers, called the supervisory authorities' attention to improving the provisions governing the derivatives market. Primarily over the counter (OTC) trading in derivatives was affected by this. The initial ideas for regulation were formulated as early as September 2009. In Pittsburgh, the heads of state and heads of government in the G20 agreed that trade in standardised OTC derivatives could only take place at stock exchanges or via electronic trading platforms in future. These transactions were also to be processed solely via a central counterparty by the end of 2012 at the latest. The establishment of a transaction register for OTC derivatives contracts was also envisaged to increase market transparency. In this connection, the increase in the capital requirements for derivatives that do not comply with the requirements should act as an "incentive" for implementing the proposals.

The requirements have been made more specific since the first moves in Pittsburgh. At the end of March this year, the EU Parliament adopted the European Market Infrastructure Regulation (EMIR) following trialogue discussions between the European Commission, the EU Parliament and the Council. At the time this article was being prepared, the EU supervisory authorities, the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) were involved in consultations on a range of issues including risk reduction techniques as well as capital requirements for Central Clearing Counterparties (CCPs). The aim is for the European supervisory authorities to conclude their consultations in the third quarter of 2012 meaning that a provisional framework can be presented to the European Commission by 30 September 2012. Enactment of the ordinance is scheduled for the end of 2012.

Essentially, EMIR encompasses more stringent regulation of OTC derivatives contracts. The aim here is primarily to increase market transparency and, at the same time, to reduce the risk of defaults. Initially, it envisages identifying classes of derivatives that will be subject to a clearing obligation in future and must therefore be transacted via a central counterparty. The expectation is that in the first step this will affect plain vanilla derivatives such as interest and currency swaps, which among other things play a major role in hedging transactions in covered bond cover assets. However, the European Securities and Markets Authority (ESMA) and the European Commission have not yet specified which classes of derivatives must be transacted via a CCP. According to recital 12 of EMIR "In determining the subjection to the clearing obligation of classes of derivatives, ESMA shall take into account the specific nature of OTC derivatives which are concluded with covered bond issuers or with cover pools for covered bonds."

The current drafts envisage bilaterally cleared derivatives requiring bilateral collateralisation, which would constitute a major hurdle for covered bond issuers in particular. In the case of CCP cleared derivatives, the margins set by the central clearer would have to be deposited, which would be a problem for many cover pools or is even forbidden by law. Today, swap agreements for cover pool assets are designed in such a way that the issuing bank does not have to provide direct collateral. This is justified most notably by the fact that a counterparty to a derivative transaction has a claim to realisation equal to all other creditors from the cover pool.

The different ordinances will, among other things, envisage a process which identifies the classes of derivatives for which a clearing obligation is to apply in future. Anybody that is subject to this clearing obligation must transact these classes of derivatives via a central counterparty. The question of whether a class of derivatives must necessarily be transacted via a CCP will play an important role in the decision-making process. Even if the European securities supervisory authority ESMA and the European Commission still have to bring about a decision, it can be said today that it is not appropriate to include derivatives for covered bonds.

Since the publication of the European Commission's Proposal, the ECBC undertook and coordinated a lobbying campaign to include amendments requesting that (i) derivatives in a covered bond cover pool be permitted to continue to be cleared bilaterally rather than through a central clearing counterparty and (ii) unilateral collateral posting used for covered bonds be recognised as an appropriate exchange of collateral. The amendments were approved by the European Parliament (EP) in 2011 and were then discussed with the European Council during the trialogue discussions at the end of January 2012. As they were supported by most Member States, the amendment was finally approved. In recitals 16[1] and 24[2], European regulators have considered that two covered bond specificities should be taken into account by the European supervisory authorities when establishing the draft technical implementation measures. At the time of drafting, the ECBC had already published responses to three consultation papers, in March, April and July 2012, on the draft technical implementation measures proposed by the European supervisory authorities (http://ecbc.hypo.org/).

A VIEW FROM A RATING AGENCY PERSPECTIVE

The rating agencies Moody's, Fitch and Standard & Poor's attach individual and, to some extent, different conditions to derivatives in cover pools. At the same time, attention is focused consistently on hedging disruptions to payments resulting from interest and currency risks, should the issuer become insolvent. For this purpose, the contractually involved counterparties to the derivative transactions need to be able to make the payments they have promised even after the issuer becomes insolvent. Underlying this is not only the existence of the counterparty but also a consistently required minimum rating, which can cause difficulties in periods when banks' ratings are deteriorating. At the same time, whether the use of derivatives is advantageous for issuers and how significant these advantages ultimately are can be very different. In some cases, a swap included in the cover pool may have no impact on the rating or even have a negative impact. While Moody's last adjusted its rating approach for covered bonds in March 2008, both S&P and Fitch have made changes to their counterparty criteria in the recent past. S&P announced its new criteria on 31 May this year following controversial discussions about the upcoming changes last year. In March this year, Fitch started a consultation period for the changes it wishes to make to its counterparty criteria. The consultation period ended in April 2012. Publication of the final criteria is expected shortly

Moody's gives varying degrees of credit for the protection provided by swaps. The assessed level of protection is swap specific and varies from a very limited to a good level of protection depending on (i) the credit strengths of the issuer, (ii) the swap counterparty and (iii) the form of the swap documentation. To date there is no swap agreement analysed by Moody's that achieves complete protection against risk. In addition to the individual valuation of the derivative agreement to establish the expected loss, the results of the analysis may also be considered for the timely payment indicator (TPI) assessment. In valuing derivatives, attention is focused on the probability of the swaps surviving when the issuer defaults, payment is disrupted in the case of the covered bonds or a swap counterparty becomes insolvent. The options available to the cover pool administrator following the issuer's default are also assessed. According to Moody's, the derivatives must satisfy various requirements to ensure that a derivative retains

[1] "*In determining which classes of OTC derivative contracts are to be subject to the clearing obligation, ESMA should take into account the specific nature of OTC derivative contracts which are concluded with covered bond issuers or with cover pools for covered bonds.*" Recital 16 (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF)

[2] "*When developing draft regulatory technical standards to specify the arrangements required for the accurate and appropriate exchange of collateral to manage risks associated with uncleared trades, ESMA should take due account of impediments faced by covered bond issuers or cover pools in providing collateral in a number of Union jurisdictions. ESMA should also take into account the fact that preferential claims given to covered bond issuers counterparties on the covered bond issuer's assets provides equivalent protection against counterparty credit risk.*" Recital 24 (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF)

its full value and the desired target rating and/or a reduction in the overcollateralization requirements are/is achieved. Among others, these include the preclusion of the derivatives' premature maturity or a unilateral cancellation of the contract by the derivative counterparties. These must be excluded both in the event of the issuer's insolvency and in the event of delays in payment or limited with the help of delaying regulations (e.g. grace periods). This also applies in the case of a temporary or final insolvency arising from the cover pool. Consequently, all swap contracts must remain extant following a secondary insolvency via the cover pool. As a rule, an administrator assumes responsibility for servicing the payment obligations to covered bond creditors following the issuer's insolvency. However, according to Moody's, this may not have any negative consequences for the derivatives contracts included in the cover pool. The assessment of the swap counterparty constitutes a key component of the swap valuation. Among other things, the question behind this is whether the swap will survive the insolvency of the derivative counterparty? Therefore, in the event of the counterparty rating being downgraded below a specific threshold, the posting of collateral and regulations governing the replacement of the counterparty are required. These rating triggers, as they are known, relate not only to the long-term rating but also to the short-term rating. Since none of the swap agreements analysed by Moody's so far covers all risks, the degree of protection ultimately decides on the amount of overcollateralization required for a desired target rating. The higher the risk cover, the more positive the impact of the swap on the overcollateralization requirement. If an issuer uses swaps, which were concluded within the banking group (internal swaps), Moody's assumes that there is a greater probability of the swap being cancelled if the issuer is insolvent than for external swap counterparties.

The particular criteria for the analysis of counterparty risks in covered bonds applied by the rating agency Fitch are based on the general criteria for structured finance products, but also take account of the dual recourse nature of covered bonds and consequently also the rating of the issuer. A revised version of Fitch`s covered bond counterparty is expected in due course. At the moment 74 of the covered bond programmes rated by Fitch contained derivatives in the cover pool.

At Fitch, attention is focused on the risk of the counterparty defaulting when valuing swaps in covered bond cover pools. The agency makes an exception if the issuer has a long-term rating of at least AA- and a short-term rating of F1+. In this case it waives stress-testing the interest and currency positions and focuses solely on the creditworthiness of the issuer in the mitigation of open interest and currency positions. Various criteria must be satisfied for a derivative to be viewed as protective for the covered bondholders. These include, for example, replacement rules should the rating of the derivative counterparty fall below a specific level. According to Fitch, this regulation is important in ensuring that in the case of any deterioration in the counterparty's rating, any hedging of existing risks resulting from interest and currency effects remains covered. For the covered bond to be awarded a rating of AA- or higher, the derivative counterparty must have at least a long-term rating of A and a short-term rating of F1 or, if the rating is lower (up to BBB-/F3), provide collateral to mitigate the counterparty default risk.

Derivative agreements, which are concluded with internal counterparties and consequently with banks that are related to the issuer, undergo a particular valuation. Here, Fitch sees no additional protection for investors from the recourse to both, the issuer and the counterparty as the insolvency of the issuer and the insolvency of the partner to the derivative constitute the same event. There is a closer link between the issuer rating and the covered bond rating with both ambiguous replacement rules and with internal swaps. This is effected primarily by means of the discontinuity factor used to date (this will probably be replaced by discontinuity caps, "D-caps"), which allows an uplift vis-à-vis the issuer rating.

If a derivative fails to satisfy the criteria put forward by Fitch or only satisfies them in part, the valuation will depend on the programme's structure, on the assessment of how easily the counterparty can be replaced in the case of any deterioration in its rating and how heavily dependent the programme is on one counterparty. If the results of the analysis are positive, the covered bond can be given a rating above the issuer and counterparty rating. However, should there be a considerable degree of dependence and should the replacement of the counterparty be questionable, the rating of the covered bond may be set at the level of the lowest counterparty rating or it may be analysed without the derivatives.

S&P has struggled to complete the changes to the counterparty criteria put up for discussion in March 2011 in the "Request for Comment (RfC): Covered Bonds Counterparty and Supporting Obligations Methodology and Assumptions" and to publish new rules. It took more than a year until the paper entitled "Counterparty Risk Framework Methodology and Assumptions" was finally published on 31 May 2012. In a report from mid-2011, S&P referred to the fact that 50 of the covered bond programmes rated by it contained derivatives in the cover pool. While the average number of derivative counterparties was four, there was at least one programme that included 35 counterparties. The counterparties' average rating was A.

The fact that both the number of the derivatives counterparties engaged and the average rating of these counterparties is important to S&P in assessing derivative risks with counterparties that are not related to the issuer (external swaps, as they are known) became clear not least at the presentation of the RfC. The criteria now published are geared to a three-stage process. Firstly, the counterparty concentration is determined before the counterparties' weighted rating and the reduction in the maximum rating uplift (in accordance with ALMM criteria) are established. However, the adjustment to the maximum uplift is waived if the derivative obligations do not exceed 5% of the outstanding covered bonds. Stage 1 of the rating process contains two groups. A distinction is made here if there is a counterparty concentration of more than 25%. The reason for this is that at least four different derivative counterparties must be involved in the event of an equally weighted allocation. In last year's RfC, the limit was at least 10 counterparties and a concentration of 30%. The rating of the counterparty, the value of the derivatives and the residual term of the derivatives are included in the calculation of the weighted counterparty ratings in stage 2. Compared with the RfC from 2011, the rating ranges (AAA to A- and BBB+ to BBB-) have been changed here meaning that even a weighted counterparty rating of A- allows a more accurate assessment now. In the third stage, issuer ratings are classified into two rating ranges. These are based on the distinction in stage 2, whereby the maximum achievable covered rating is no longer adjusted rather the classification relates to the maximum rating uplift in accordance with the ALMM classification. The ability to replace the derivative counterparty should the counterparty's rating fall below a specific rating is a matter of importance for S&P. If this is guaranteed and backed-up by the use of different counterparties that are unrelated to the issuer, covered bonds can continue to receive first class ratings. The same is true of the assessment of derivative risks involving counterparties that are related to the issuer. However, the Structured Finance Counterparty Risk Framework, which was also published on 31 May and is largely based on the Replacement Framework, applies here. In the Covered Bond Counterparty Criteria, S&P stressed that 50% of the covered bond programmes it rates are threatened by a downgrade. However, it remains to be seen whether there will actually be a wave of downgrades of this order of magnitude. Issuers may make adjustments that must be finally implemented by January 2013.

HIGH HURDLES HAVE TO BE OVERCOME

In a world of constantly changing requirements for financial market players and their financial instruments, derivatives are also in the spotlight at present. With the European supervisory authorities' plan to bring about more stringent regulation of the derivatives market with the help of EMIR, covered bond issuers, in particular, are threatened with disproportionate punishment. The requirements for the use of a central counterparty (CCP) and bilateral collateralisation of cover pool derivatives, presents major challenges for all issuers when including these financial instruments in the cover pool. The master agreements currently concluded by issuers generally include unilateral collateralisation for derivatives in the cover pool. This approach is based on the fact that a covered bond cover pool cannot provide any collateral. However, that is precisely what the regulatory authorities are demanding, which is why unilateral collateralisation could lead to a greater RWA burden. At present, only a few issuers are adopting the course of indirect bilateral collateralisation with the help of separately negotiated collateral. On the other hand, the counterparty to a derivative has the same ranking in comparison with covered bond creditors in the event of the assets being realised, which makes bilateral collateralisation unnecessary. The Basel III regulations are also causing problems. The capital requirements contained therein also target derivatives, which will not only fuel costs for market players. Individual counterparties have already selectively withdrawn from the market.

Rating agencies and their methodologies play an increasingly important role for derivatives in cover pools and, in the process, are becoming central to the management decisions that have to be taken. The rating criteria envisage a strong focus on the rating of the counterparty/counterparties. This is based on the principle that the possibility of timely payments depends on the rating of the counterparty if the issuer is insolvent. However, a vicious circle rapidly emerges in a period of deteriorating bank ratings, which will have negative consequences for covered bond issuers as a result of falling counterparty ratings. If a counterparty's rating falls below a specific threshold set by the rating agencies, the counterparty must either be replaced or collateral must be provided to achieve the desired covered bond rating. In this manner funding costs may increase in two respects. Both the counterparty risk and the collateral to be provided tie up a great deal of capital. Among other factors, the substantial capital commitment is a reason for the current market situation. Not only has the number of counterparties fallen perceptibly recently, issuers' costs have also increased further. The sustained rating migration in the banking sector and the risk associated therewith that counterparties could slide below a specific rating threshold is also playing a part.

The rating agencies' requirements concerning the documentation of swap agreements constitute an additional challenge. Even if, according to Moody's, the derivatives included in the programmes considered by the agency cover a majority of the existing risks, there is no swap agreement at present that achieves complete protection against risk. Among other things, the reason for this is significant requirements regarding the replacement of counterparties. Derivative counterparties are also less and less willing to implement the content demanded by the rating agencies in their documentation.

All things considered, it should be noted that the need for derivatives in cover pools is affirmed by both issuers and by investors. On the other hand, rating agencies have exacting requirements for derivatives in cover pools, which have opposite consequences in some cases across the agencies. For instance, S&P demands a considerable degree of diversification among counterparties to derivatives, whereas Fitch punishes too much complexity with higher D-factors. On the other hand, regulatory requirements are ensuring that banks are less and less willing to enter into a swap agreement as a counterparty. As a result, we have found ourselves in a vicious circle.

1.11 TIMELY PAYMENT AND THE ROLE OF SOFT-BULLET STRUCTURES

By Franz Rudolf, Unicredit, Florian Hillenbrand, Unicredit
and Heiko Langer, BNP Paribas

In the years before the crisis, timely payment of covered bonds was something that was taken for granted. However, with the crisis evolving, investors and rating agencies alike have placed the issue of timely payment center stage. This was driven by the question of what will happen when the issuer defaults and how can the remaining part of the issuer cope with the needed liquidity to continuously pay interest and repay the covered bond on the maturity date. Thoughts on topics such as what is the legal nature of the remaining bank, what sources of funding are available, how long will it take to liquidate assets and what haircuts on the assets for sale have to be applied, have become increasingly important. This has impacted the modeling by rating agencies for probability of default and expected losses, with consequences for overcollateralization levels and/or ratings. It has also led to legal framework adjustments (e.g. in the German Pfandbrief Act, the French, Swedish and Finnish legal frameworks) and has evoked reaction from issuers introducing new structures such as pass-through-structures for covered bonds. We will discuss these aspects as well as the consequences for the covered bond market.

DISCOVERING LIQUIDITY RISK

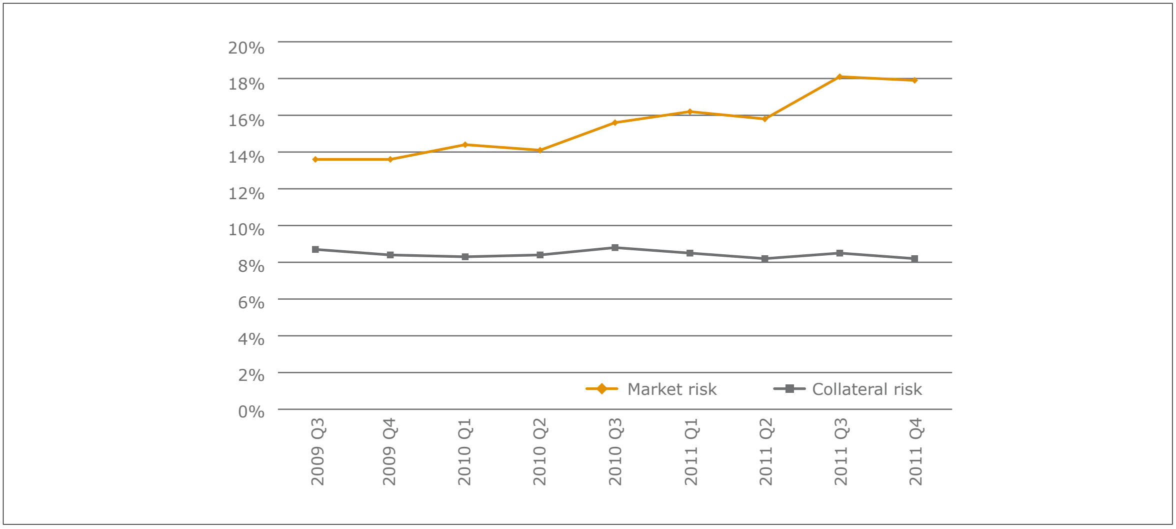
Increasing focus on liquidity risk

Although liquidity risk has always been inherent in covered bonds, it has only received greater attention from market participants and rating agencies in recent years as the global financial crisis intensified. The fact that liquidity risk exists in covered bonds stems from there usually being a mismatch of cash flows between cover pool and covered bonds. As long as the issuer is able to refinance maturing covered bonds and manage mismatches through its treasury operations, liquidity risk does not affect covered bondholders. The fact that liquidity risk (such as credit risk) is borne by the issuing bank can be seen as one reason why markets have increasingly focused on it as the financial crisis intensified. Decreasing financial strength of banks in connection with reduced probability of government support means that covered bondholders are more likely to be exposed to liquidity risk in the future.

Growing impact of liquidity risk on covered bond ratings

Rating agencies have played a crucial part in increasing market focus on liquidity risk. Through ongoing changes and adjustments of rating methodologies, the impact of cash flow mismatches on covered bond ratings has increased noticeably in recent years. At the same time, assumptions about market liquidity in a post-bankruptcy scenario and prices achievable through liquidation of cover assets have both changed significantly. Severe market distortions in a systemic crisis and the collapse of the securitization market, which had been regarded as a viable source of liquidity for cover pools before the crisis, have caused rating agencies to apply bigger haircuts in their liquidation scenarios. As a result, covered bond ratings have become increasingly affected by liquidity risk. This also means that issuers have to provide additional overcollateralization to compensate for liquidity risk. One example of the increase in the relative importance of liquidity risk compared to credit risk within covered bonds is the increase in market risk reported by Moody’s in its quarterly “Monitoring Overview”. Although various types of risk are included within market risk, liquidity risk (or “re-financing risk”) is the main component. As the chart below shows, market risk has increased noticeably in recent years, while collateral risk remained largely stable.

> Figure 1: Simple Average Historical Cover Pool Losses: Mortgage-Backed Covered Bonds



Source: Moody's

Ways to mitigate liquidity risk

Increased market focus and higher overcollateralization requirements from rating agencies have led issuers and regulators to focus more on mitigating factors for liquidity risk. Liquidity risk can be addressed internally, either via the asset side (cover pool) or the liability side (covered bonds). In addition, liquidity risk can also be addressed externally through central bank liquidity or liquidity lines.

ASSET SIDE

Inclusion of liquid cover assets

Including liquid assets, such as high-quality government bonds or central bank deposits, in the cover pool can create a liquidity buffer that can be used in a post-bankruptcy scenario. Should a maturity mismatch occur, the administrator of the pool could liquidate the liquid assets first to repay maturing covered bonds and thus avoid potential haircuts that could arise from the sale of mortgage assets. Most covered bond frameworks allow for the inclusion of so-called "replacement assets", which are usually more liquid than ordinary assets. However, most frameworks and the CRD limit the use of replacement assets to a certain percentage (10-20%) of outstanding covered bonds.

For issuers, the inclusion of liquid assets in the cover pool can be relatively costly, as the achievable yield may be significantly lower than the yield on ordinary cover assets and even implies the topic of negative carry. For covered bondholders, liquid assets provide a certain protection against liquidity risk. The fact that their use is limited in many cases, suggests that the liquidity buffer is insufficient to cover the full liquidity risk of the pool. In addition, the early use of liquid assets to repay maturing covered bonds after an issuer's insolvency could lead to subordination of holders of covered bonds with longer maturities, who may no longer benefit from the liquidity buffer. On the other hand, liquidity in the pool should improve over time as more and more assets amortize.

Pre-Maturity Test

A Pre-Maturity Test in conjunction with a hard-bullet covered bond ensures that enough liquidity is available to repay covered bonds maturing within a certain rolling time frame (usually six or twelve months). If the rating of the issuer falls below a certain level, the issuer has to provide cash equivalent to the amount of covered bonds maturing within the next six or twelve months. The cash is held in a special segregated account.

For issuers, the Pre-Maturity Test means that they can achieve a higher rating uplift for their covered bonds over their senior unsecured rating. A downgrade below the specified rating limit results in additional costs for the issuer since he has to pre-fund upcoming maturities on a six or a twelve-month horizon. For covered bondholders, the pre-maturity test means that no cover assets have to be liquidated within the first months after the issuer's insolvency, which reduces the risk of a fire sale of cover assets and therefore decreases the likelihood of over-indebtedness due to asset sales below par.

LIABILITY SIDE

Staggering of covered bond maturities

Liquidity risk can be reduced by avoiding concentration of large volume maturities on the covered bond side. This means that the issuing entity uses a relatively wide range of maturities with relatively small bond sizes in its funding strategy. In case of an issuer's insolvency, refinancing requirements of the pool will be more evenly distributed across a time line. This increases the probability that at least part of the upcoming covered bond maturities can be covered by cash accumulating in the pool through regular payments from the asset side. The need to liquidate smaller parts of the portfolio at a given time may increase prices achievable on asset sales.

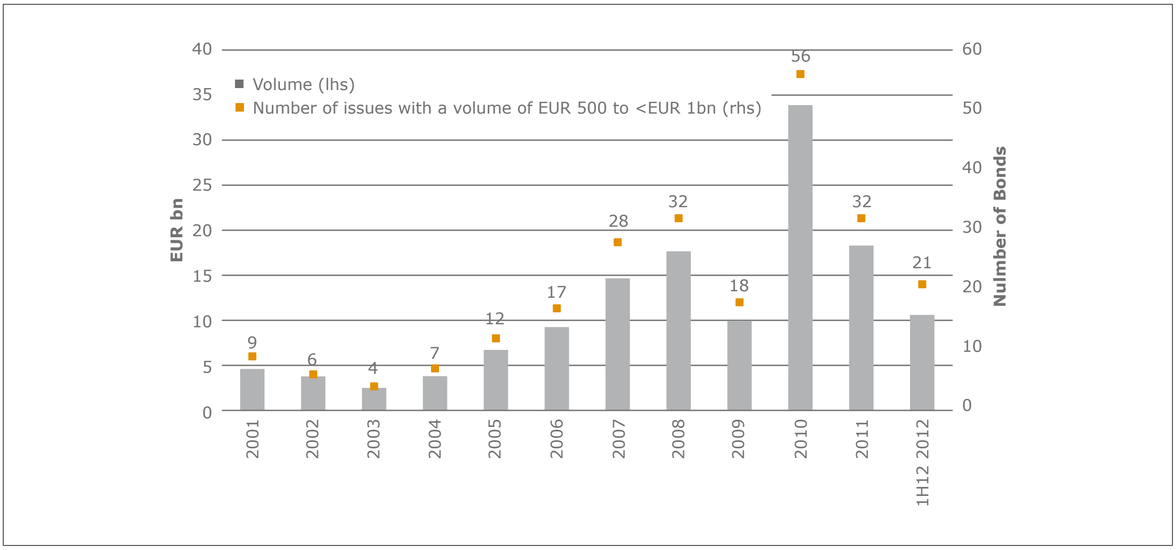
There has been a trend towards smaller sized benchmark issuance (see chart below), which helped issuers to distribute maturities more evenly. However, especially new issuers that have just joined the covered bond market will find it difficult to evenly distribute covered bond maturities. The typical market practice of using larger-sized benchmark transactions to raise the profile of the issuer in the market and to reach larger institutional investors conflicts with the idea of using smaller-sized bonds to avoid concentration of maturities. For certain issuers it may also be difficult, or unattractive financially, to issue covered bonds with longer-dated maturities. In general, the choice of maturity and issuance size is often driven by investor demand, which limits an issuer's flexibility with respect to building its curve.

Soft-bullet covered bonds

Soft-bullet covered bonds are designed to change the repayment structure in a post-bankruptcy scenario. The main difference is that soft-bullet covered bonds provide for a mere extension of the bullet repayment by a pre-arranged time period. The extension depends on certain conditions and only occurs at the time when covered bonds reach their "scheduled" maturity (please see below for details). The extension period provides additional time to liquidate parts of the cover pool or to generate additional cash through asset amortization.

Issuers of soft-bullet covered bonds can benefit from lower overcollateralization requirements for their covered bond programs – comparable to hard-bullet covered bonds. Investors face a certain extension risk, however they might benefit from higher recovery expectations as fire sales of assets may be avoided in certain cases through maturity extension. Soft-bullet covered bonds are widely used and can show significant differences regarding documentation (see below for details).

> FIGURE 2: NUMBER OF COVERED BONDS ISSUED WITH AN ISSUANCE VOLUME OF EUR 500MN TO <EUR 1BN



Source: UniCredit Research

Transformation into pass-through securities upon the issuer's insolvency

Cash-flow mismatches between cover pool and outstanding covered bonds can be eliminated by changing the repayment schedule of covered bonds from a bullet repayment to an amortizing repayment that matches the cash flows generated by the cover pool. The change in repayment structure would occur only upon default of the issuer, i.e. the issuer would still be responsible for managing and funding any cash-flow mismatches as long as he is solvent. For the covered bondholder, liquidity risk would largely be replaced with extension risk. Extension risk would be higher for holders of covered bonds with shorter maturities. In addition, covered bondholders that have engaged in an asset swap when purchasing the bond, may face costs for re-hedging or closing out the existing asset swap. For issuers, the main advantage would lie in significantly lower overcollateralization requirements for their covered bond programs as well as increased flexibility regarding the maturity profile of their covered bond curves.

So far, covered bonds that turn into pass-through securities have been issued only for repo activities with central banks. Investor appetite and potential pricing of such structures thus remains untested. Investors with a structured finance background may find such structures more acceptable than traditional covered bond investors who are used to bullet repayment. However, structured finance investors may also demand a noticeably higher yield for pass-through covered bonds than for bullet repayment covered bonds.

EXTERNAL LIQUIDITY

Access to central bank liquidity

Access to central bank liquidity in a post-bankruptcy scenario can be achieved via repo transactions with the central bank, either by using cover pool assets as collateral or using own issued covered bonds as collateral. Using central bank liquidity could help to avoid selling cover assets at significant discounts to repay maturing covered bonds.

Access to central bank liquidity can be difficult if the segregated entity holding the cover assets no longer meets the criteria to engage in repo transactions with the central bank. A bank which is in winding-up proceedings or reorganization will automatically be exempt from the ECB's minimum reserve requirements and thus is no longer able to engage in repo transactions with the ECB. If the entity is an SPV, i.e. not a regulated bank, access to central bank liquidity may not be possible in a post-bankruptcy scenario nor will it be possible for the SPV to issue new covered bonds. As a result, central bank liquidity may only be accessible if the issuer is a specialized subsidiary with a banking license, and is not affected by the insolvency of the parent institution (e.g. in case of French Obligations Foncieres or Obligations de Financement de l'Habitat); or in cases where the segregated pool itself can have a banking license (e.g. for German Pfandbriefe). Further constraints could occur if the cover assets or the self-issued covered bonds do not meet the eligibility criteria (e.g. minimum rating) that the central bank requires for repo collateral, or they do not qualify directly as collateral due to their asset nature, e.g. residential mortgage loans.

Third-party liquidity lines

Access to pre-arranged third-party liquidity lines can be used to make payments to covered bondholders in a post-bankruptcy scenario. So far, liquidity lines have only been used to cover interest payments on covered bonds for a certain period. Recoveries from a potential liquidation of the cover pool or from asset amortization are first used to repay any drawdowns of the liquidity line. Mismatches that would affect the repayment of the covered bonds are not covered by the liquidity line.

In the current market environment, liquidity lines that would cover not only interest payments but also notional payments of covered bonds, would be rather uneconomical for issuers due to the high costs involved. Liquidity lines that cover certain interest payments would be a plus for investors but they do not address the much larger risk of maturity mismatches, which is also reflected in the fact that Spanish multi-issuer Cédulas also provide a three-year maturity extension (soft-bullet), despite the existence of an external liquidity line.

PASSING ON RISK

Why is liquidity in a cover pool so important? Taking the investors' view on the topic, an investor prices – at the time of the covered bond purchase – the maturity of the bond, and he may also enter into related swap contracts. Hence, his assessment – among other criteria – is strongly based on the reliability to receive coupon payments and the principal exactly on the promised date. In order to assure this timely payment, issuers have chosen the one or the other instrument to increase the probability of timely payment (as discussed above). One common feature in this respect is the use of soft-bullet structures. Soft-bullet structures allow for the (automatic) extension of the final maturity of the unpaid amount by a pre-defined period of time (usually 12 months). However, the preconditions for this extension vary across countries and programs. In the following, we shed some light on the specifics of different "extension languages" as well as on the question whether soft-bullet structures are priced differently compared to hard-bullet structure.

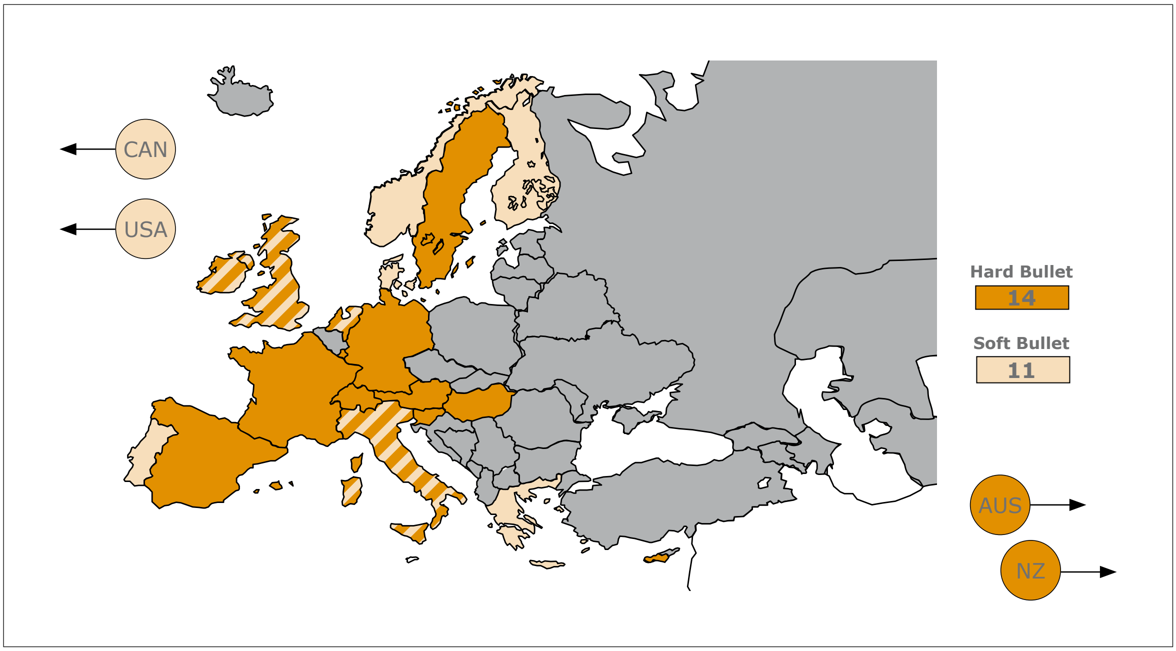
Why soft-bullet structures?

Timely payment on bullet bonds becomes key following an issuer event of default. Besides a certain amount of liquidity held in cover pools, e.g. highly liquid substitution collateral, and access to central bank facilities, the key challenge is to raise liquidity against the ordinary collateral in the cover pool in a timely manner. This can be achieved by the administrator of the pool either by selling (parts of) the cover pool or borrowing against the cover pool. Especially the sale of (parts of) the collateral depends on: 1. the time it takes to find a buyer and 2. the amount of money he receives in relation to the nominal (haircut). Generally speaking, the less time the administrator has to sell collateral, the higher the haircuts. Thus, giving the administrator sufficient time to execute a collateral sale in an orderly manner is crucial to the recovery values of covered bonds. This can be achieved through 1. minimum liquidity provisions, e.g. 180-day liquidity provisions as is the case in Germany or France or pre-maturity tests in hard-bullet structures; or 2. the extension of the maturity date (soft-bullet structures). In the first case, the administrator can concentrate on raising the liquidity necessary in month seven and beyond as, for example, sufficient liquidity for the first six months is given (if stipulated by law or contractual agreements). In the case of soft-bullet structures, the administrator can extend the maturity of the covered bonds by the predefined time period, e.g. 12 months, thus preventing a fire sale. This increases the probability of timely payment (on the extended maturity date) and limits the extent of haircuts. By using soft-bullet structures, other mechanisms to increase the probability of timely payment can be avoided or minimized, i.e. the level of overcollateralization (which is costly), and the rating can be lifted, as rating agencies give credit to features like soft-bullet structures. While both aim at the timeliness of payments, in the first case (hard-bullet payments) sole responsibility to ensure sufficient liquidity at time of interest or principal payment lies with the issuer. In the latter case (soft-bullet structures), timeliness of payment is achieved by involving the investor and extending the maturity of his investment.

Soft-bullet provisions allow for the postponement of bond redemption for a certain period of time. It ranges from 12 months, which is also the most common soft-bullet extension period for single-issuer soft-bullet structures, to 24 months or 36 months in the case of Spanish structures, and extends to ten years or even beyond in the case of covered bonds issued for the purpose of delivery to repurchase programs. During the extension period, the bonds usually pay the reoffer spread over a pre-defined Euribor rate plus the original reoffer spread. The key issue is who is empowered to make use of the extension: the issuer or the cover pool administrator? Linked to this condition is the question whether the failure to pay from the side of the issuer alone is sufficient for the extension or whether it is the combination of an issuer failure to pay plus a failure to pay from the side of the cover pool. Regarding the former, when the issuer failure to pay is sufficient, one might argue that this might facilitate opportunistic behavior to abuse the extension as an option. The issuer might then – in order to prevent a default and a segregation event – extend the bonds without direct consequences for the default situation of the issuer. In the latter case, a segregation event (i.e. the default of the issuer) has to be triggered in order to qualify for the extension, which in itself excludes opportunistic abuse. Issuers using soft-bullet structures are commonly found in Canada, Denmark, Finland, Greece, Italy, Norway, and in the US. Some issuers in the UK, Ireland, the Netherlands, and Portugal also use soft bullets.

General soft-bullet language reads as follows: *If an Extended Final Maturity Date is specified as applicable in the Final Terms for a Series of Ordinary Notes and the* ***Issuer has failed to pay the Final Redemption Amount*** *on the Maturity Date specified in the Final Terms, then* ***payment of the unpaid amount by the Issuer shall be deferred*** *until the Extended Final Maturity Date, provided that any amount representing the Final Redemption Amount due and remaining unpaid on the Maturity Date may be paid by the Issuer on any Interest Payment Date occurring thereafter up to (and including) the relevant Extended Final Maturity Date*. This leaves the decision about whether or not to pay largely in the hands of the issuer. This general soft-bullet language can be found in Norway, Finland, Denmark, Ireland and Portugal.

> Figure 3: Which Redemption Structure Applies: Hard Bullet or Soft Bullet?



Source: UniCredit Research

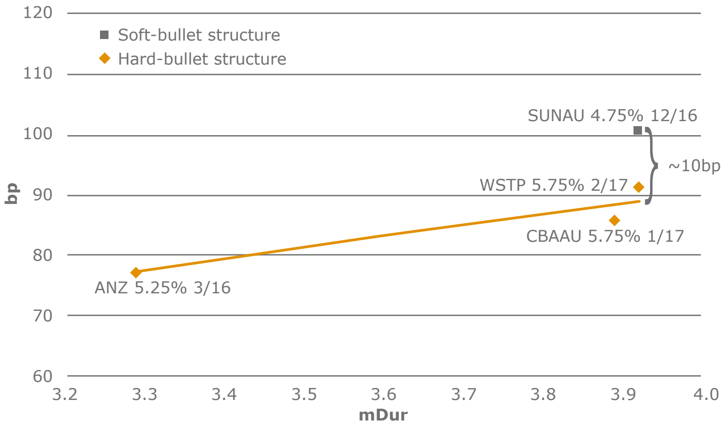
The more specific soft-bullet language, which can be found in Italy, the UK, Greece and the Netherlands, reads as follows: ***If the Issuer fails to pay the Final Redemption Amount*** *of the relevant Series of Covered Bonds on the relevant Maturity Date (subject to applicable grace periods)* ***and if the Guaranteed Amounts equal to the Final Redemption Amount of the relevant Series of Covered Bonds are not paid in full by the Guarantor*** *on or before the Extension Determination Date (for example, because following the service of an Issuer Default Notice on the Issuer and the Guarantor, the Guarantor has or will have insufficient moneys available in accordance with the Guarantee Priority of Payments to pay in full the Guaranteed Amounts corresponding to the Final Redemption Amount of the relevant Series of Covered Bonds), then* ***payment of the unpaid amount pursuant to the Covered Bond Guarantee shall be automatically deferred*** *and shall become due and payable one year later, on the Extended Maturity Date (subject to any applicable grace period).* This empowers the administrator to extend the maturity of the covered bond.

So the question remains: are investors pricing hard-bullet structures and soft-bullet structures differently? Moreover, might there even be a differentiation between the different soft-bullet wordings?

With respect to the latter, the answer is relatively simple: No, there is no verifiable price difference between the two soft-bullet wordings. One reason is that for a single issuer, usually only one of the above wordings applies and a comparison between different names or even countries contains many other factors that make it impossible to extract the possible single effect of wording (and there is no example of which we are aware within a single name). However, investors do pay attention to details and ask for additional information regarding the specific structure and the specific wording. The topic becomes less relevant for Finnish or Irish covered bonds, as some issuers either use hard-bullet structures anyway, or in the case of soft-bullet structures, the issuer is a specialized financial institution. Therefore the issue of who is in charge of extending the maturity at a particular stage, becomes comparable to the situation with a specific language and the segregation of the cover pool following issuer default (funding besides covered bonds is managed by a subordinated loan from the parent company).

With respect to the question of whether there is a differentiation between hard-bullet and soft-bullet structures, the answer is more complex. First of all, only the final terms of a covered bond can reveal whether it is a soft or a hard-bullet structure (especially as the use of hard/soft-bullet structures is not consistent among issuers in countries where soft-bullet is generally allowed). And even for the same issuer, there can be the use of soft-bullet as well as hard-bullet structures (e.g. Barclays). The first example examines issuers within the same jurisdiction, where some issuers use hard-bullet structures, and one is using a soft-bullet structure: Australia. The first four issuers of Australian covered bonds (ANZ, CBA, NAB, Westpac) use all hard-bullet structures so far. The fifth issuer, however, uses a soft-bullet structure (Suncorp-Metway). The chart below shows that there is a spread differential of around 10bp between the SUNAU 4.75% 12/16 and the WSTP 5.75% 2/17. At first glance, this might appear to be attributable to the different bullet structure. However, it is instead a matter of issuer rating (single-A vs. double-A rating, although the covered bonds are all rated AAA) and issuer specifics, such as balance sheet size (SUNAU total assets AUD 96bn vs. WSTP AUD 670bn), for example. Hence, the bullet structure is not the driver of the price difference. The soft-bullet structure was chosen to achieve a AAA rating for its covered bonds despite having a lower issuer rating. So Suncorp-Metway basically had two options to achieve a AAA rating for the covered bonds: 1. provide higher overcollateralization (which is costly), or 2. choose the more "rating beneficial" soft-bullet structure. Hence, the bullet structure is not the price determining factor, but rather a reflection of rating methodology and asset-liability matching considerations, among other things.

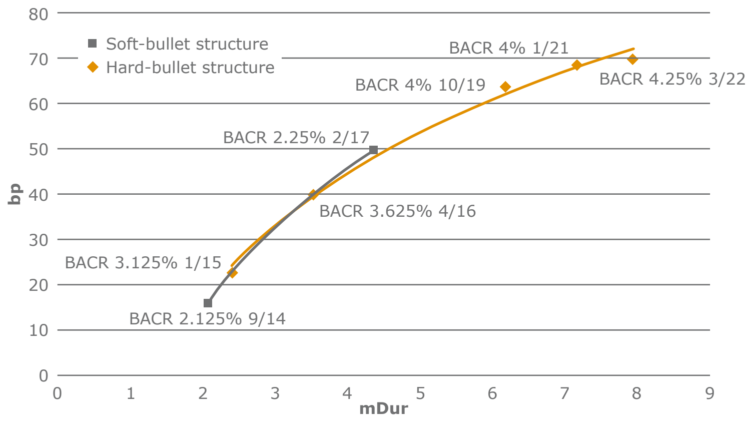
> Figure 4: Hard vs. Soft-Bullet Structures – The Example of Australia



Source: UniCredit Research

The second example used to pinpoint price differences more accurately is Barclays, which previously issued hard-bullet covered bonds and then changed to soft-bullet structures in 2011. Barclays perfectly illustrates that there is no noticeable price differentiation for the two different bullet structures. All covered bonds in the chart below are issued by the same entity, Barclays, and all have mortgages as underlying collateral, all have a AAA rating, and the only difference is a 12-month extension period in case of issuer default (soft-bullet) or no extension period at all (hard-bullet). The two curves are perfectly matching. In fact, this paradox could be explained in two ways: either investors are not aware of the soft-bullet feature or simply do not care, or they do care and do price in a possible extension. The latter explanation, however, implies that the likelihood that investors assign to a segregation event, in combination with an extension (please note that a default of the issuer does not necessarily lead to an extension of the covered bond), is too little to be statistically significant. In other words, from today's point of view, a clear answer to the question of whether or not it is priced in cannot be given. The only theoretical way to do this would be to see an issuer that simultaneously has hard and soft-bullets outstanding showing a massive deterioration in unsecured credit quality, such that an investor recognizing the extension risk starts to increase the likelihood thereof.

> Figure 5: Hard vs. Soft-Bullet Structures – The Example of Barclays



Source: UniCredit Research

1.12 THE INVESTOR’S PERSPECTIVE

By Ralf Burmeister, DB Advisors

Market participants can surely complain about a lot of things in recent months when it comes to capital markets in general. But lack of excitement will probably not be found amongst the complaints. With regard to covered bonds, it is fair to say that they were part of the general volatility as well as a market being blessed with individual issues.

As it is difficult to put a certain weighting or ranking to the importance of various events since the publication of the last ECBC Fact Book, it appears appropriate to comment on undisputedly relevant topics in order to line out future developments, without being in a position to define which of them are the most important ones:

RATING CHANGES

In a certain way, rating changes have been boring as for the vast majority, investors had to cope with downgrades. A very few notable exceptions (to our knowledge) have been mergers, in which the weaker and smaller player might have been given an upgrade due to the inclusion into a larger and stronger banking group. But in general, it was just a question of how many notches the ratings were lowered.

What was almost impossible to prepare for was the degree of randomness in rating decisions, as the market had to cope with a bunch of changes in the rating methodologies. While the legitimate desire of all rating agencies to adopt their individual approaches to new realities has to be acknowledged, the number and frequency of changes in the corresponding rating methodology was not really helpful as it has become increasingly difficult to compare ratings over a longer time horizon.

Nevertheless, it is also important to state that rating agencies in general have made a decent step ahead in providing more information and more transparency in intermediate steps on their way to their final ratings for covered bonds. What is also quite encouraging for investors in covered bonds is the fact that only a fraction of the downgrades observed (approx. 10-15% of all rating actions) were due to deteriorating credit quality of the underlying collateral. The vast majority of downgrades for covered bonds were triggered through sovereign rating downgrades as well as downgrades on the level of the bank i.e. the issuer.

The reason behind a particular negative rating action is irrelevant e.g. for the average portfolio rating which in turn might be part of individual investment guidelines. But it is fair to say that the rating actions do not necessarily point towards an intrinsic problem in the covered bond space. As this market is surely connected to a high degree obviously to the banking market as well as to the sovereign credit quality, it simply cannot decouple itself from spillover effects from these sources.

It is rarely the policy of investors to determine the underlying quality of their investments purely by external ratings. But it is important to mention that external ratings do have a major effect when it comes to e.g. index membership of certain bonds and therefore, on the determination of the investment universe. The Basel Committee states as of early June 2012 that investment decisions shouldn’t rely to such a large extend on ratings. In turn, there are a lot of non-bank institutional investors that have to rely on external rating due to their supervisory standards.

So even in situations where investors are willing to relax their investment guidelines in order to cope with current rating migration, this process is rather slow and time consuming. The argument also holds true for mutual fund vehicles, where a change in the investment guidelines can be observed from time to time, but surely not on a quarterly basis. Accordingly, there is a real danger that negative rating actions exclude at least temporarily parts of the investor community from certain market segments, notwithstanding very attractive risk adjusted yields of the bonds concerned in the meantime. Not to mention that in such an environment of rising spreads and lower ratings it becomes increasingly as well as understandably difficult to argue for a reopening of risk limits which were closed down due to rating considerations.

TRANSPARENCY

A lot in the market has been discussed about the topic of transparency. While there are two main initiatives under way in the field of covered bonds in order to increase transparency, namely the ECBC Label Initiative as well as the template provided by the Covered Bond Investor Council (CBIC), it is important to highlight that there are limits to transparency and that more information especially on the composition of cover assets is surely a good thing to have, but that there are more reasons than just deteriorating credit quality of underlying cover assets that might turn a specific covered bond into a burdensome investment.

The law of diminishing returns also applies to the publication of ever more data on the cover pool so it is fair to ask whether the vast majority of the covered bond investor community has the resources and capacities to handle e.g. loan-by-loan data and to extract some value added from this kind of information. Accordingly, as covered bonds are secured bank bonds it is more important to look closer at the issuer and the corresponding business model.

While arguably the level of transparency provided by issuers differs significantly and surely improvements can be made here, the investor base is also looking forward to receiving more information on the bank and on the holdings of derivatives in particular in order to properly access counterparty risk, cash flows in a stressed scenario for the issuers and possibly additional collateral requirements for the issuer (not necessarily the derivatives concerning the cover pool!) in case of e.g. downgrades.

TRADABILITY

It is not only a phenomenon to be observed in the covered bond market that trading and positioning a portfolio has become increasingly difficult in the last 12 months. This can also be observed in other asset classes, even in the European sovereign bond space. What is quite encouraging though is the fact that the primary market for covered bond has worked and continues to do so and that at least those investors being active in private placements and non-benchmark issues still are able to acquire paper: The very active market in USD in early 2012 is also in our view a vote of confidence for that product.

But again, covered bonds cannot decouple themselves from other markets and besides many other effects, one effect of the Long Term Refinancing Operation (LTRO) surely has been an increased difficulty to execute trades on both sides of the market, i.e. markets have become more choppy and pro-cyclical. What was also quite a new market feature is the emergence of tender offers for covered bonds, which also had consequences for future tradability of the bonds concerned. Hence, it is fair to say that the secondary market is still the more critical part of the game and that the possibility to exit a particular investment even in times of stress has become a major ex ante investment decision.

It is again understandable that banks as major provider for secondary market liquidity are hit by various regulatory initiatives, forcing them to shrink balance sheets as well as trading book positions. Nevertheless, it cannot be overemphasized that a decent share of the investor base in the market will not accept current trading environment indefinitely and might therefore shift out of covered bonds in their strategic asset allocation. If therefore CDS on covered bonds become an instrument which at least encourages brokers to take on more positions in the covered bond market, then the introduction of these instruments is to be welcomed.

RISK PERCEPTION AND REGULATION

Besides the risks already mentioned like rating migration and tradability risks, it is obvious that the state of domicile of the covered bond issuer is probably the most prominent risk these days. As the current market surely does not trade exclusively on fundamentals, investors clearly have to analyze the systemic risk as well as the interconnectedness of the financial sector before making investment decisions.

Besides looking at cover pool data, special covered bond legislation and business models of issuers, all aspects of support, may it be for individual issuers as well as for individual states, have to be analyzed as well. Therefore, it is unavoidable to incorporate a bit more political analysis in the ongoing investment decisions – which has not been that necessary just a few years ago.

Another expression for political risk may well be regulatory risk as regulation is the reaction of the public sector to certain outcomes on financial markets. As we have seen one of the sharpest crises for decades, it is obvious as well as understandable that there is a broad range of initiatives and legal steps in order to close loopholes and avoid future shortcomings – which is absolutely legitimate.

The question being asked by investors simply is, whether the answer to the crisis from the public authorities is really holistic – i.e. that all second and third round effects of upcoming regulation are being considered. While fully agreeing to the goals set out by regulatory bodies to create a more stable and less risky financial sector it is fair to ask the question of how to make sensible investment decisions over a long-term horizon of sometimes several years when the rules under which the investment has to be treated are in constant flux.

One very prominent as well as crucial initiative in the field of regulation in our view is the introduction of a resolution regime. At a first glance, it is good to see, that covered bonds are excluded from any kind of upcoming resolution regime on EU level. But the financial world is very interconnected so the question arises, how issuers will continue to fund the overcollateralization of covered bonds under a resolution regime – can they access e.g. deposits or could they be possibly forced to lower overcollateralization levels? Will this lead in turn to problems for covered bond issuers and will restrict their funding possibilities in the unsecured as well as in the secured funding space?

This is just one example of how good, prudent and holistic re-regulation of the financial sector should be implemented – think about second and third round effects which in total might be larger than the first round effect and would therefore not contribute to the overall aim of more stable financial markets. Obviously this is neither an easy task, nor a task that can be achieved quickly as it is surely time-consuming to develop such cross-checking procedures for regulation. But for the sake of the common goal of safer financial markets it should be given a try as the current status of drafting various pieces of regulation individually and accessing their possible market impact well after the implementation and not necessarily beforehand in a truly holistic way (at least, this is the current perception amongst investors) leaves room for improvement.

In the meantime, investors will continue to monitor more closely individual issuers and scrutinize their complete funding structure as well as weighing all kind of support mechanisms possibly backing either underlying cover assets, the covered bonds themselves or the issuers. The regulatory preference of the covered bond compared to other asset classes is surely an incentive to stay in that market. On the other hand, it cannot be an excuse to escape to complacency and to stop searching for risks and downside potential in an overall sound asset class.

ANNEX: THE COVERED BOND INVESTOR COUNCIL

By Nathalie Aubry-Stacey, International Capital Market Association

The ICMA Covered Bond Investor Council (CBIC) has been focusing during the last two years on strengthening the covered bond product, through better transparency. In fact, one point of the CBIC's mission statement makes a reference to its intent to promote "*the high quality, simplicity and transparency of the product*". The CBIC represents long-standing investors – who believe that only the most secure assets should be used in cover pools, and keeping covered bonds a simple and strong product. With this statement in mind, enhancing transparency and facilitating better comparison between covered bond programs has been a natural priority work stream for the CBIC. The Council anticipates that the ongoing and increasing financial market uncertainty will continue to make it necessary for all covered bond issuers to prioritise the ongoing work of improving transparency to the highest possible standards.

The CBIC European transparency standard that has been open to consultation in the past year is part of a process to achieve high transparency standards throughout Europe in the long run but not an ”all or nothing” list in the short-term. The template comprises qualitative and quantitative information requests to fulfil investors' transparency and information needs. The information required has been agreed by investors independently from the data requested by rating agencies, and used in their own analytical models. The CBIC believes that enhanced transparency of the cover pool would help transparency in the pricing process of covered bonds vis-à-vis senior debt. Moreover the ”key concepts” section of the template provides valuable information behind the figures presented by issuers – and we welcome national associations' efforts to agree on national definitions.

Another aim of the project is easier access to information for all investors, big and small. By standardising information requests from investors through the CBIC template, the transparency template harmonises their requirements thereby providing issuers with clarity when designing their IT and systems specifications. Therefore only issuers using the CBIC template will be allowed to post on the dedicated CBIC webpage – to ensure standardisation and comparability of the data received.

Finally, the CBIC expects that increased transparency will also broaden the covered bond investor base. Increased transparency will be a minimum requirement to meet new investors' demands for information, notably those coming with a credit analytical tradition, but also provide smaller investors with better information that they may not be able to access otherwise. Investors should feel free to refer to the template in bilateral meetings with issuers and use the information provided – or not – as a basis for deeper discussions.

Since the launch of the project the CBIC has received generally positive feedback from a wide range of actors, as well as support from a number of important investors in the covered bond market (available on CBIC webpage www.icmagroup.org/CBIC). The ECB explained that the CBIC transparency initiative was of "*utmost importance*" and believed that the CBIC's work should help inform industry efforts to establish a covered bond label. Several of the responses highlighted a need for greater clarity and standardisation of definitions and concepts included in the CBIC's template. A second round of consultation addressed these requests – from both issuers and investors - each question has been considered by CBIC members and is available on the CBIC European transparency standard webpage. One national association, the Norwegian FNO, has already published its national template designed on the CBIC template. We understand that others are also working on their own template.

The CBIC noted the ECBC’s own labelling initiative that includes a transparency list. In its feedback statement the CBIC highlighted that the assessment of the quality of labelled covered bond programmes will in fact rest upon the data requirements included in the different national templates, and also the ability of national associations to agree upon common definitions of key concepts. The ECBC minimum transparency requirements are seen as a positive starting point and as part of a progression towards the CBIC transparency template. The CBIC would also encourage ECBC members to focus specifically on the standardisation of the reporting at European level – along the lines indicated in the CBIC template - to help investors to easily compare information.

CHAPTER 2 - GENERIC SECTION

2.1 OVERVIEW OF COVERED BONDS

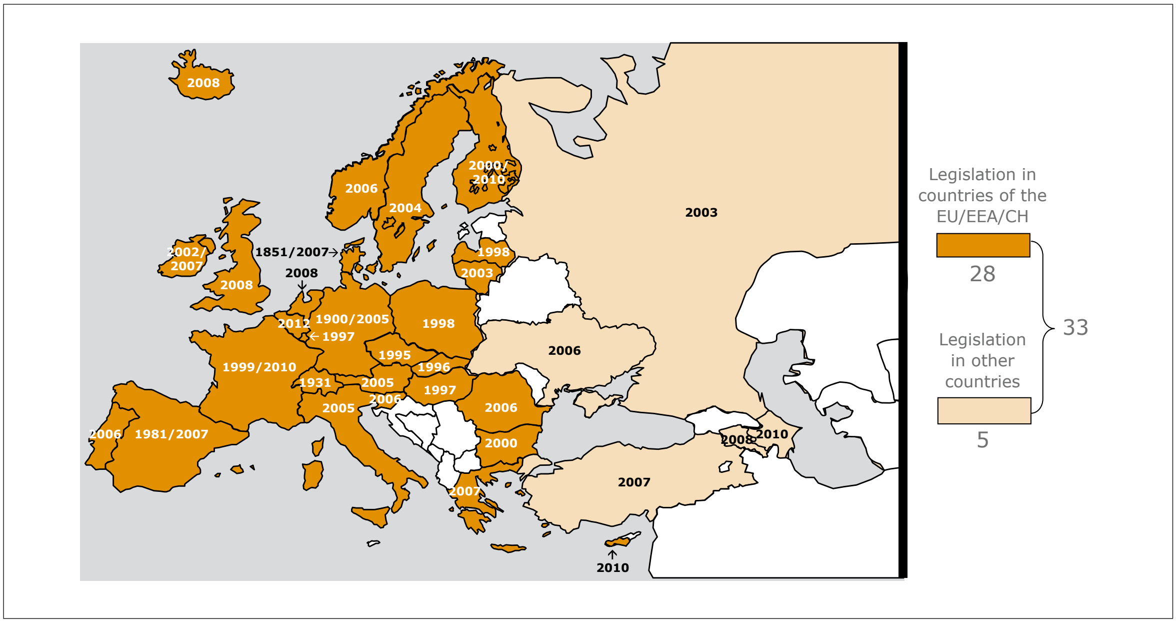
By Ralf Grossmann, Société Générale CIB
and Otmar Stöcker, Association of German Pfandbrief Banks

2.1.1 INTRODUCTION

Over the past decade, the covered bond market has developed into the most important segment of privately issued bonds on Europe's capital markets, with volume outstanding at the end of 2011 amounting to EUR 2.68 trillion[1]. Covered bonds were one of the first non state-guaranteed funding instruments of credit institutions to resume issuance activity after the Lehman default. It is generally accepted that the covered bond market should play a pivotal role in bank wholesale funding as it provides lenders with a cost-efficient instrument to raise long-term funding for mortgage or public-sector loans and offer investors the (non state-guaranteed) top-quality credit exposure on credit institutions. The high importance of covered bonds for the financial system is also demonstrated by the privileges these instruments enjoy in various areas of EU financial market regulation.

Today, there are active covered bond markets in over 25 different European jurisdictions and there is a strong expectation that the covered bond market will continue to grow, especially as national legislators across Europe have adopted modern covered bond regulations and numerous countries inside and outside Europe are either in the process of adopting a covered bond legislation or have already done so, such as Australia, Belgium, Canada, Japan, New Zealand, Romania, South Korea, or US.

> Figure 1: Covered bond legislation in Europe (as of August 2012)


2008
2006
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2012
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1931
2005
1997
2006
2005
2006
2006
1981/2007
2000
2007
2007
2008
2010
2010
Legislation in countries of the EU/EEA/CH
28
Legislation in other countries
5
33

Source: vdp

[1] Source: EMF/ECBC. http://ecbc.hypo.org/Content/default.asp?PageID=519

As well as the introduction of new covered bond legislations, there has been a continuous evolution of existing legislation, underlining the commitment of issuers, investors and regulators to further reinforce the quality of the asset class and take on board best practice.

In this Fact Book, you will find more information on all covered bond markets in Europe, including recent regulatory changes in the different covered bond systems.

2.1.2 HISTORY

The covered bond is a pan-European product par excellence. Its roots lay in ancient Greek mortgages and Italian and Dutch bonds. Decisive milestones in its development were laid in Prussia (1770), Denmark (1797), Poland (1825) and France (1852). The issuers ranged from public law "Landschaften" to private mortgage banks. The aim was first to finance agriculture and later concentrated more on housing and commercial real estate.

The creation and the expansion of covered bond systems in their different structures and features are a perfect example of a fruitful and effective exchange of ideas across all European borders. It is very impressive to see how the huge benefit of experience and exchange of international know how contributed to create the covered bonds in Europe during more than 240 years. In the 19th century, nearly every European country had a covered bond system. Their success influenced each other. Covered bonds also played an important role in stabilising financial systems at the end of the 19th century, a time of high bankruptcies of companies and banks.

Since the mid 20th century, the inter-bank market developed and, with it, a growing retail deposit base provided funding for mortgage loans. As a result, covered bonds in many European countries lost their outstanding importance. Some countries did not use their covered bond systems any more or even abolished them. This was the case in Western Europe and especially in Central and Eastern Europe, where private banking and capital market instruments did not comply with communist theories.

The situation changed when the first German Pfandbrief in benchmark format (Jumbo) was issued in 1995. The bond was issued in order to meet liquidity needs of investors and to provide increased funding for public sector loans. Since then, the Jumbo market has expanded strongly. The introduction of the Euro meant that investors could no longer diversify regarding currencies, but intensified their search for liquid products. Banks needed to look for new funding sources via high credit-quality liquid bonds to attract international capital investors. Therefore, banks in Western countries revitalised their covered bond systems to create a competitive capital market instrument.

At the end of the 20th century Central and Eastern European countries reintroduced real estate finance techniques. Covered bonds were an important element of this process to fund the growing number of mortgage loans, due to the booming housing markets. The financial crisis further strengthened the importance of covered bonds as the most resilient wholesale term-funding instrument for credit institutions. As a consequence, we find covered bond systems in nearly all European countries and in the funding toolbox of an increasing number of credit institutions.

2.1.3 THE PURPOSE OF COVERED BONDS

From the issuer's perspective the purpose of covered bonds is basically to use a pool of high quality assets, being separated from other assets of the issuer in order to achieve the following benefits:

Cheap funding in absolute and relative terms and longer term funding

One of the key motivations for the introduction of a high quality funding tool such as covered bonds is the fact that it has always been difficult to measure the creditworthiness of a bank. Therefore, it is obvious to use a well-defined funding channel for specific assets through a system, whose credit quality is delinked as much as possible from the issuing entity. It has to be said that the rating of covered bonds is not completely de-linked from the issuer rating. Nevertheless, covered bonds generally do offer a good degree of protection against rating downgrades of the long term rating of the issuing bank.

Investors tend to invest larger volumes into covered bonds

Investors take particular comfort in covered bonds due to their being backed by legally sound mechanism, offering higher recoveries and more transparency than a senior unsecured bank bond. The regulation around covered bonds (e.g. UCITS and / or Solvency II) reflects exactly this safety of covered bonds and, in turn, encourages institutional investors to engage themselves on a larger scale in this highly regulated market.

Market accessibility

Thanks to the high protection offered to its bond holders, covered bonds are one of the most resilient funding instruments during financial crisis, often offering issuers better wholesale capital market access than other bank debt instruments. However, one has to keep in mind that the performance of covered bonds remains connected to the performance of government bonds of the corresponding state of domicile, in particular, where the latter gets under stress.

2.1.4 THE MACRO-ECONOMIC BENEFITS OF COVERED BONDS

Evidently, funding conditions of the banking sector have important macro-economic repercussions through credit supply and allocation. Conditions of mortgage credit supply impact the property market and, therefore, have important long-term effects on consumption and investment behaviour. In that context, covered bonds as an instrument bringing safety, reliable credit supply and continuously low credit spreads for borrowers to the mortgage markets are to be welcomed per se. Likewise, public sector covered bonds have undoubtedly reduced the funding costs of public sector borrowers. Moreover, homogenous funding instruments for banks lead to higher information efficiency increasing transparency as regards the pricing of loans (e.g. refer to the Danish mortgage bond system).

Covered bonds have also an important role to play in the context of financial stability. The moral hazard problems surrounding MBS products, one of the key factors for the 2008 financial crisis, is mitigated by using covered bonds, as the issuer still retains the credit risk of the underlying loans. This advantage of covered bonds was also highlighted by the ECB in its Financial Integration Report (April 2010). Moreover, covered bonds make banks less susceptible to market turmoil decreasing the reliance on senior unsecured funding and interbank markets.

The ECB has acknowledged the prominent role of covered bonds and stated in January 2011: "A smoothly functioning covered bond market is highly important in the context of financial stability."[2] It is a declared goal of upcoming new banking regulation that certain banks should adapt their business models and,

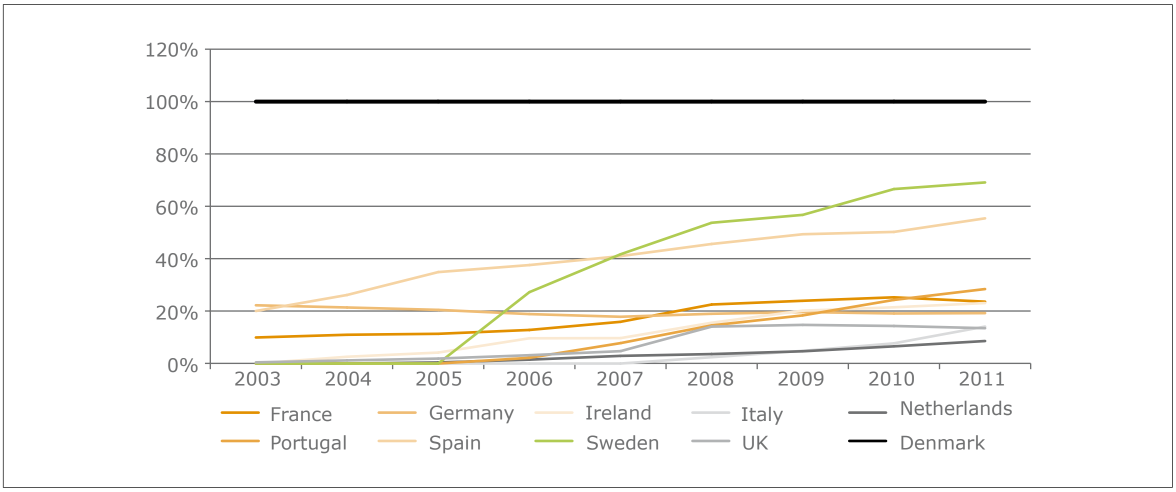
[2] See: The impact of the Eurosystem's covered bond purchase Programme on the primary and secondary Markets; Occasional Paper series, No 122 /January 2011, page 9.

accordingly, their funding mix. Therefore, it can be expected that covered bonds will increasingly be used worldwide by bank treasuries for their funding optimisation processes, as also other regulatory bodies expressed their positive view on this way of secured funding.

However, it should be taken into account that the issue of asset encumbrance has been raised by many market participants and politicians meanwhile. The amount of assets of a bank, which are reserved for special creditors and therefore would not be part of an insolvency estate of this bank, is analysed more and more. This is not an issue of covered bonds only, but also of collateral for central bank funding, repo transactions and for derivative partners. Special concerns are on the side of those investors, who are investing into senior unsecured bank bonds and who are facing risks of bail-in regulation from EC level. There is no perfect solution, which could satisfy all conflicting needs. Therefore, it is of fundamental importance that there is an European-wide understanding that covered bonds - regarding their cover assets - need priority including exemption from bail-in regulation.

The positive effects of covered bonds outlined in this section are clearly dependent on the extent of use of covered bonds within a particular country compared to the size of the domestic mortgage market and the alternative funding tools for banks (and their price) besides just covered bonds. The following chart provides data on the size of the covered bond market in most jurisdictions relative to the volume of residential loans outstanding. Most of the countries have experienced continuous growth of covered bonds as part of banks' real estate funding over the last few years with the steepest increase between 2007 and 2008 (for a more detailed breakdown of the underlying data, see the tables below)

> Figure 2: Mortgage backed covered bonds as % of residential mortgage loans

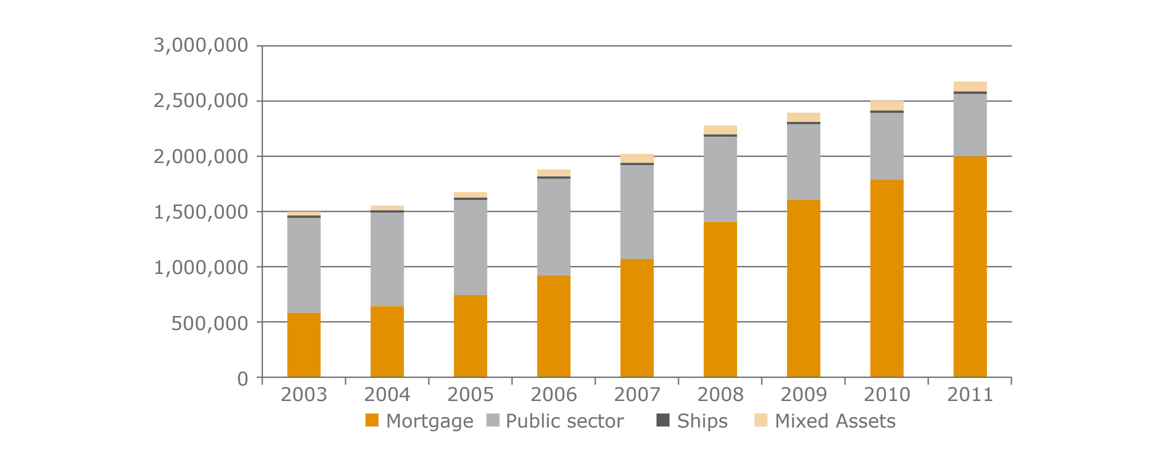


Source: EMF/ECBC

2.1.5 MORTGAGE – PUBLIC SECTOR - SHIP

The major categories of cover assets are mortgage loans, public sector loans and ship loans. The range of eligible cover assets is defined by a country's covered bond system. Covered bonds backed by mortgage loans exist in all countries with covered bond systems. Covered bonds to fund public sector lending (to national, regional and local authorities) are relevant in a limited number of European countries (Austria, France, Germany, Ireland, Italy, Luxembourg, Poland, Portugal, Spain and UK). Covered bonds backed by ship loans are rarer but can be found in Denmark and Germany.

> FIGURE 3:TOTAL OUTSTANDING COVERED BONDS BY UNDERLYING ASSETS, 2003 TO 2011



Source: EMF/ECBC - Covered bonds outstanding at the end of 2011.

2.1.6 COMPARATIVE COVERED BOND FRAMEWORK DATABASE

The ECBC Technical Issues Working Group conducted a comparative analysis, based on a questionnaire, with the responses to 36 frameworks presented in an on-line database at www.ecbc.eu. The questionnaire and the comparative overview are divided into 9 sections covering the essential features of covered bond systems. In addition, links are provided to the covered bond section of all issuers' websites, as well as covered bond legislation in English. Here, we highlight some of the results of that comparative overview.

Structure of the issuer

In all of the countries that participated in our comparative analysis, the covered bond issuers are regulated institutions. A classification of covered bond systems by type of issuer results in the following four categories:

> Universal credit institutions

> Universal credit institutions with a special license

> Specialised credit institutions

> Special purpose entities

Framework

In most European countries, the issuance of covered bonds is regulated by specific covered bond legislation. In some countries contractual arrangements are applied. Both types of framework set the rules for important features such as eligible assets, specific asset valuation rules, assets-liability-management guidelines and transparency requirements.

Identification of the legal framework for bankruptcy of the issuer of covered bonds is of particular importance. The legal basis in case of bankruptcy of the covered bond issuer is provided either by the general insolvency law or by a specific legal framework superseding the general insolvency law.

Cover assets

The eligible cover assets in existing European covered bond systems range from exposures to public sector entities, mortgage and housing loans, exposures to credit institutions, senior MBS issued by securitisation entities to ship and aircraft loans. Some covered bond systems distinguish between regular cover assets (usually mortgage, housing, public sector, ship loans and senior MBS) and substitution assets, where the latter is often subject to quantitative restrictions.

The geographical scope for cover assets ranges from the domestic area only, over EEA countries up to OECD countries. A feature that gained importance is the existence of regular covered bond specific disclosure requirements to the public. Existing covered bond systems offer a broad range of different solutions. One can find disclosure requirements regulated by law, by contract, on a voluntary basis, or no regulation at all.

Valuation of mortgage cover pool & LTV criteria

Most countries have legal provisions or at least generally accepted principles for property valuation. In most cases the property valuation is based on a mortgage lending or prudent market value. LTV limits for single assets are similar as well, e.g. ranging for residential mortgage loans from 60% to 80%. In some countries, there are additional LTV limits on a portfolio basis.

Asset-liability guidelines

Asset-liability guidelines exist in most of the covered bond systems, but large differences in technical details and the degree of explicit regulation (e.g. by law, by supervisor, issuer’s by-laws, contractual provisions or business policy) make a detailed comparison rather difficult. One often applied rule is the ‘cover-principle’, which requires that the outstanding covered bonds must at all times be secured by cover assets of at least equal nominal amount and yielding at least equal interest. Some covered bond systems have implicitly or even explicitly introduced additional net-present value asset/liability matching rules.

Similar, mandatory over-collateralisation (on a nominal or net-present value basis) plays an important role as a risk mitigation tool in some covered bond systems. Derivatives constitute an increasingly important class of risk mitigating instruments in covered bond asset-liability management. In numerous covered bond systems, derivatives are explicitly allowed in the cover pool for hedging purposes.

Cover pool monitor & banking supervision

Compliance with Article 52(4) UCITS Directive has already led to some standardisation in cover pool monitoring and banking supervision. Most covered bond systems have established an external, independent cover pool monitor who must have appropriate qualifications. Moreover, in most countries national banking supervisors (and in some cases, financial market regulators) exercise special supervision of covered bonds in order to fulfil Article 52(4) UCITS.

Segregation of assets & bankruptcy remoteness

European covered bond systems use different techniques to protect covered bondholders against claims from other creditors in case of insolvency of the issuer. Most systems establish by law or by contract the segregation of covered bonds and cover pools from the general insolvency estate. In other covered bond systems, the protection of covered bondholders is achieved through a preferential claim within the general insolvency estate.

One important widespread common characteristic is that covered bonds in Europe do not automatically accelerate if the issuer becomes insolvent. Numerous covered bond systems have provisions that allow derivatives to become part of the cover pool with the purpose to hedge interest rate or currency mismatches. Derivative counterparties can rank pari passu or subordinated to covered bondholders. In covered bond systems, covered bondholders have recourse to the issuer's insolvency estate upon a cover pool default (pari passu with unsecured creditors or even superior to them).

Risk weighting & compliance with European legislation

From our sample, most fulfil the criteria of Article 52(4) UCITS. In many countries, the covered bond legislation completely falls within the criteria of Annex VI, Part 1, Para. 68 (a) to (f) of the CRD (2006/48/EC). There are proposals to amend the legislation on the way in several countries. In the other countries, the CRD criteria are not fulfilled or not applicable. Moreover, in most of the participating countries in our survey, covered bonds are eligible in repo transactions with the national central bank and special investment regulations for covered bonds are in place.

2.1.7 SUCCESS OF THE INSTRUMENT

The covered bond is one of the key components of European capital markets. The amount of outstanding mortgage covered bonds is equivalent to around 20% of outstanding residential mortgage loans in the EU. The volume outstanding at the end of 2011 amounted to 2.68 trillion EUR (covered bonds covered by mortgage loans, public-sector loans and ship loans), which represents an increase of 5% year on year. The five largest issuing countries in 2011 were Denmark, France, Spain, Germany and Sweden respectively.

Covered bonds play an important role in the financial system and thereby contribute to the efficient allocation of capital and ultimately economic development and prosperity.

> Figure 4: Volume outstanding CB in Europe end of 2011 in EUR million

	Public Sector	Mortgage	Ships	Mixed Assets	Total
Australia	0	2,142	0	0	2,142
Austria	27,223	12,547	0	0	39,770
Canada	0	38,610	0	0	38,610
Cyprus	0	5,200	0	0	5,200
Czech Republic	0	8,546	0	0	8,546
Denmark	0	345,529	5,999	0	351,528
Finland	0	18,758	0	0	18,758
France	77,835	198,395	0	89,768	365,998
Germany	355,673	223,676	6,641	0	585,990
Greece	0	19,750	0	0	19,750
Hungary	0	5,175	0	0	5,175
Ireland	31,760	30,007	0	0	61,767
Italy	12,999	50,768	0	0	63,767
Latvia	0	37	0	0	37
Luxembourg	26,700	0	0	0	26,700
Netherlands	0	54,243	0	0	54,243
New Zealand	0	3,656	0	0	3,656
Norway	3,759	91,852	0	0	95,611
Poland	112	527	0	0	639
Portugal	1,400	32,283	0	0	33,683
Slovakia	0	3,768	0	0	3,768
Spain	32,657	369,208	0	0	401,865
Sweden	0	208,894	0	0	208,894
Switzerland	0	71,881	0	0	71,881
United Kingdom	3,656	194,783	0	0	198,439
United States	0	9,546	0	0	9,546
EU-27	**570,015**	**1,782,093**	**12,640**	**89,768**	**2,454,516**
Total	**573,774**	**1,999,780**	**12,640**	**89,768**	**2,675,962**

Source: EMF/ECBC

Notes:

In **Denmark**, numbers have been revised in the 2010 edition of the ECBC Fact Book. The main revision is due to the refinancing activity of interest reset loans based on bullet bonds at the end of the year, both the new bonds issued for refinancing and the bonds they are replacing have up until the 2009 edition been included in ultimo figures. As of the 2010 this double count has been excluded in the data to give an appropriate figure for the total outstanding.

In **France**, the column "mixed assets" refers to the covered bonds of Compagnie de Financement Foncier, where the mortgage and public sector assets are put in the same pool and as such, no specific asset is linked to a specific bond issue.

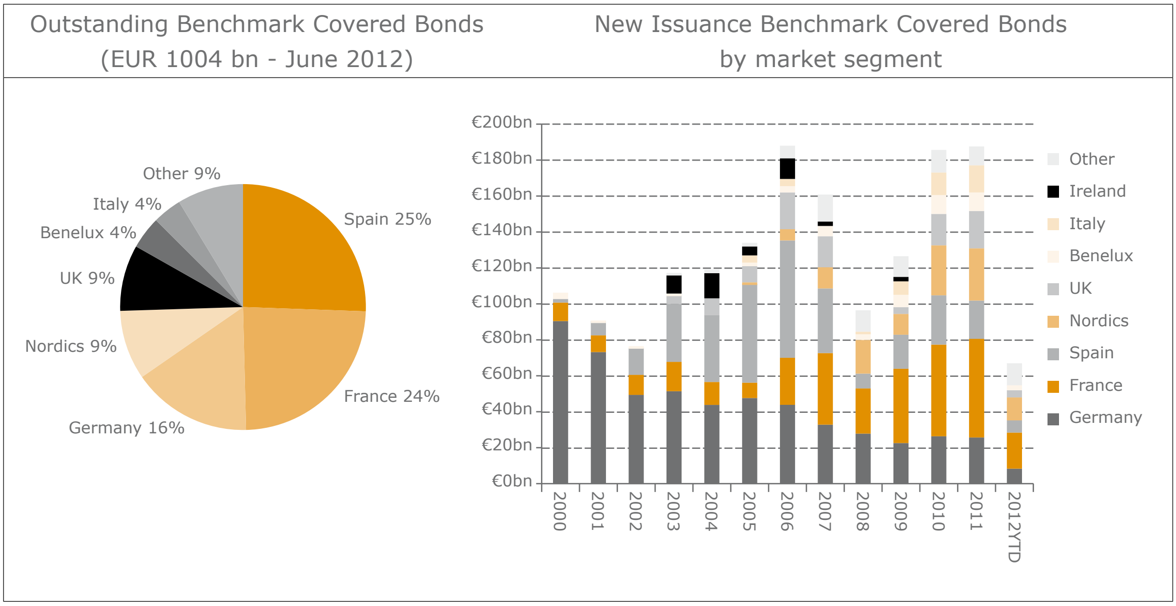
In **Spain**, the data on the table only includes the volume of issuances/outstanding listed in the national market through AIAF. Covered bonds listed outside AIAF (e.g. US, London, Luxemburg, etc.) are not included in the Statistics.

2.1.8 BENCHMARK COVERED BONDS

The Benchmark covered bond market constitutes the most liquid segment of the covered bond market. A Benchmark-format covered bond is a Euro-denominated, bullet maturity, fixed annual coupon bond with a defined minimum outstanding volume (nowadays min EUR 500m). In order to enhance secondary market liquidity, investment banks involved in bringing benchmark covered bonds to the market are committed to quote two-way prices to investors. Due to persisting high market volatility in fixed-income markets, bid-offer spreads in covered bonds may fluctuate significantly with negative impact on secondary market trading activity and unsatisfactory post-trade price transparency. The ECBC is actively contributing to an industry-driven solution to improve post-trade transparency with the ultimate goal to enhance secondary market liquidity.

Benchmark covered bonds are primarily issued with maturities between 5 and 10 years, but shorter maturities of minimum 2 years and long maturities of 15, 20 years and longer play a role as well. In 2012 year-to-date, Benchmark covered bonds with maturities of 10Y account for 27% (22% in 2011) and maturities over 10Y represent 7% of total supply (7% in 2011). The current total outstanding volume of the benchmark covered bond market is approximately EUR 1000 bn (approx. 12% of liquid euro-denominated bonds). Thus, the benchmark covered bond market is the second largest bond market in Europe after Government bond markets.

> FIGURE 5: BENCHMARK COVERED BOND SUPPLY



Outstanding Benchmark Covered Bonds (EUR 1004 bn - June 2012)

New Issuance Benchmark Covered Bonds by market segment

Source: Market data, SG CIB

Note: Other comprises Austria, Portugal, Switzerland, Greece, US and Canada

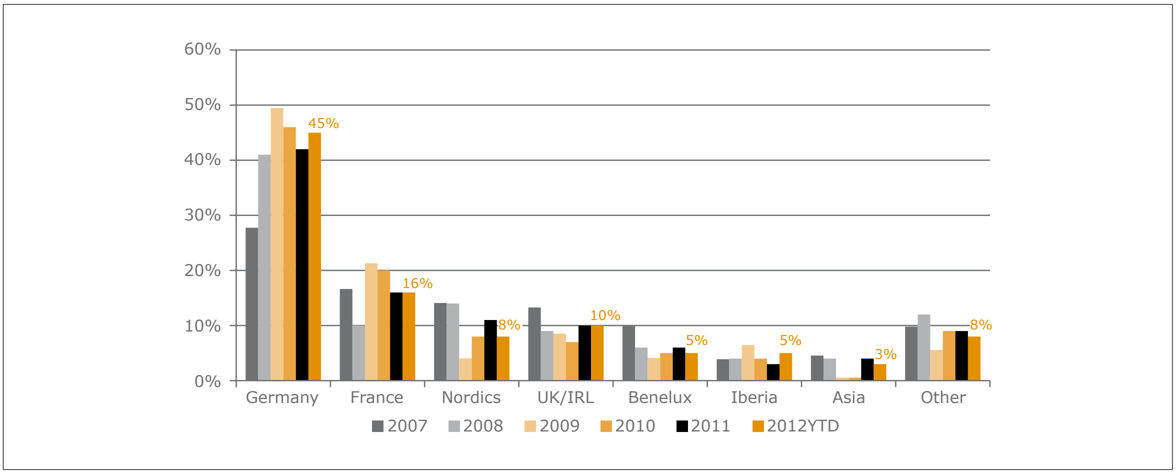
2.1.9 WHO INVESTS IN COVERED BONDS?

Covered bonds are attractive financial investments because they offer excellent credit quality, secondary market liquidity, international diversification and a large choice of maturities. Moreover, covered bonds enjoy privileged treatment in different areas of EU financial market regulation.

From a credit risks perspective, covered bonds are placed between government bond markets and unsecured financial resp. corporate bond markets. Due to the strong bondholder protection and the nature of the cover assets, covered bonds are not completely correlated with government bonds or with financial/corporate bonds. As a result, they offer interesting diversification opportunities to investors.

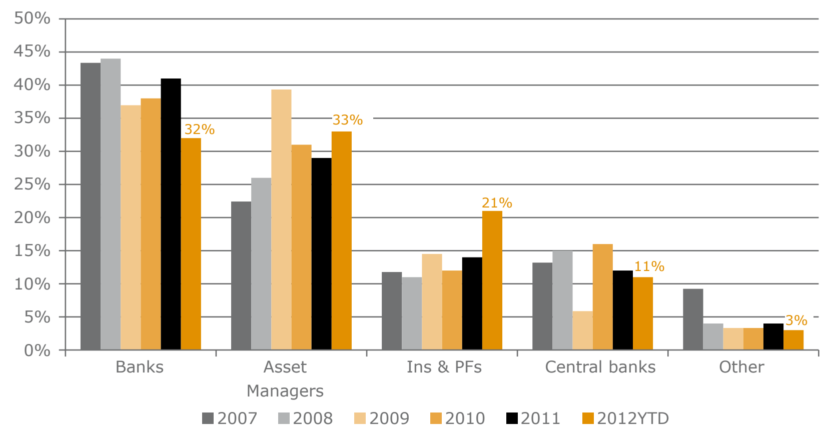
The investors of covered bonds range from small private investors to large institutional investors, the latter dominating the covered bond market. The main groups of institutional covered bond investors are credit institutions, investment funds, pension funds, insurance companies and central banks. In terms of geographical distribution, demand for Benchmark covered bonds becomes increasingly international with Germany, Scandinavia, France, Spain, Ireland, the Netherlands and UK being the major investor areas.

> Figure 6: Benchmark covered bond primary market placement by country / geographical area (averages 2012)



Source: ECBC, SG CIB

> FIGURE 7: BENCHMARK COVERED BOND PRIMARY MARKET PLACEMENT BY TYPE OF INVESTOR (AVERAGES 2012)



2.2 REGULATORY ISSUES

2.2.1 MIFID: THE PERILS OF UNINTENDED CONSEQUENCES

By Richard Kemmish, ECBC Market Related Issues Working Group Chairman

With all of the other regulatory changes crossing your desk, at once complex, evolving and above all significant, you could easily be excused for overlooking one of the less glamorous and less discussed regulations: MiFID, the Markets in Financial Instruments Directive. But that would be a mistake.

MiFID, or more accurately MiFIR (see below), has laudable enough objectives: increasing competition and investor protection in the market for financial services. But the covered bond community has raised several very real concerns about the way that European Commission intends to achieve these objectives. Truly, the devil is in the detail. And within the complex, impenetrable detail that is MiFIR there are several rules likely to have unintended – and adverse – consequences on the way in which we trade covered bonds.

Other parts of the fixed income markets have raised similar concerns to ours but there is a feeling on covered bond trading desks that we will be one of the areas hardest hit by the directive's shortfalls. We know the vital importance of secondary market liquidity to the unique value proposition that is covered bonds, and our aspiration to a high level of liquidity (arguably an artificially high level). And we trade them by phone, which causes even more problems.

MIFID, MIFID-2 AND MIFIR

MiFID-1, came into force in 2004 with full implementation 3 years later. Its main focus was the equity markets where it was seen to introduce some helpful transparency and fairness rules. And therein is the seed of the current problem. The equity and bond markets are very different and an inappropriate application of rules that were appropriate for equities could be counterproductive, particularly in the bond market.

But, in October 2011, the European Commission published the next development; MiFID-2 and MiFIR, which would apply much more broadly, including to the vast majority of the covered bond market. The D in MiFID stands of course for "Directive" but, in fact, most of the new proposals are contained in MIFIR; R is for "Regulation". The distinction is important, a Directive under EU law must be implemented by Member States and can be adapted for local specificities. A Regulation, in contrast, applies to everyone in the EU immediately, with limited room for local interpretation.

So, what's the problem?

MiFID contains many provisions, only a few of which are potential problems for the way we trade covered bonds. The key problems raised by members of the ECBC's Market Related Issues Working Group in a consultation process were the following:

> **Inability of some counterparties to participate**

There are several forums allowed by MiFID on which bonds can be traded, for example regulated markets or Multi-lateral Trading Facilities (MTF). Whereas the rules for MTFs would have been relevant in the past, for our current purposes the relevant rules are those which govern so called Systematic Internalisers (SI), essentially market makers.

But to be a market maker is not the same as being an SI. It's much more onerous than that and only the largest trading houses in the market have achieved this status so far. As the covered bond market, more than its peers, relies for its liquidity on small and medium or regionally focussed traders and end investors – none of whom are likely to qualify as SIs – we have the most to lose. Worst case, these smaller operators will be forced to route their orders via the large SIs, which hardly helps MiFID increase competition for financial services.

> **Pre-trade price transparency**

Article 17 of MiFID requires that if an SI makes a price available to one customer they have to make it available to all. And when the trade is below a certain size they have to make that information public "in a manner which is easily accessible to other market participants."

Sounds fair enough – in theory we shouldn't have a situation where some investors get better prices than others. But in covered bond land investors have high expectations, they expect to be able to trade large, "market moving" positions often on old bonds at only small discounts to the mid market price. Maybe these expectations are unrealistic but the only way that they can ever be achieved is if the market maker providing the price has confidence that the entire market isn't aware of the trade and its level. Full "pre-trade price transparency" is hardly conducive to that.

> **Post-trade price transparency**

Reporting the prices at which bonds can be traded is one thing, reporting the price at which they have been traded is another. But it raises similar problems, market makers being unwilling to transact uber-tickets if the whole market is aware of the trade. Covered bond market makers have often argued that informational asymmetry is the quid pro quo for them being prepared to trade in ticket sizes that are not justified by the 'natural' liquidity of the product.

With this however, there is room for a compromise. For example trades above a 'significant size' threshold could be subject to a reporting delay. Clearly there are practical problems, a significant size in one bond is different from a significant size in another, and what is the appropriate delay?

> **Trading format**

In the past, covered bonds were traded on multi-lateral trade facilities, maybe they will be again, and certainly several of the operators of these facilities are working on "MiFID-friendly" upgrades. But until the day that market makers are comfortable with the new wave MTFs, the overwhelming majority of trades will continue to be bilateral, usually over the phone.

In addition to the commercial problems of pre-trade price transparency there is a very real and very practical problem of how a market maker is going to notify all of their customers of every price that they show when those customers aren't in the habit of looking at screens for their covered bond prices.

> **Disruption to existing (functioning) reporting regimes**

In addition to these general concerns, one small but important issue raised by a member of the Working Group is that even though post-trade price transparency might not work in the euro market it does work in Denmark. It is, of course, impossible to generalise from Denmark to the rest of Europe but the transition to a "one-size fits all" reporting regime would undoubtedly disrupt the existing highly transparent market there.

What next?

In theory MiFID should go live by 2014 with full implementation by 2017, but timelines are there to be broken. Until it is implemented there are three main areas where we can expect developments.

The ECBC through its Market Issues Working Group has, in common with many other industry bodies, submitted comments on the proposals. Whether these will be taken on board is unclear. But we are not alone - other industry bodies have raised very similar concerns.

The European Securities & Markets Authority (ESMA) will be working on the draft technical standards to support the Directive/Regulation. These will provide a calibration of those areas where there is a scope for compromise, such as the delayed reporting for larger trades. Again, the ECBC will look to engage with ESMA to ensure that these technical standards are appropriate.

And the trading patterns of covered bonds will continue to evolve. The providers of trading platforms are upgrading their products both to conform to the new MiFID regime and to meet the needs of covered bond market makers in these volatile times.

2.2.2 SOLVENCY II UPDATE – BIG WINNER OF MOST RECENT PROPOSAL IS THE AA COVERED BOND SECTOR…

By Florian Eichert, Crédit Agricole CIB
and ECBC Statistics & Data Working Group Chairman

Despite having been discussed for a long time already, according to the Financial Times(FT) weekly review of the fund industry, about 37% of respondents to a recent Ernst & Young study still rated their understanding of Solvency II as poor. And considering the complexity of it this doesn't come as a major surprise.

The latest document on Solvency II is a draft version by the European Commission that was handed out to a limited number of people in October 2011. Below we want to give everyone a heads-up on this latest proposal as capital charges have been adjusted for covered bonds compared to the numbers from QIS 5.

Capital charges in the spread risk module

The spread risk module is one of the biggest drivers of capital charges under Solvency II. In QIS 5 there were two problems for covered bonds:

> Covered bonds only received beneficial treatment as long as they were rated AAA. A downgrade to AA+ meant they were treated like senior unsecured exposure with capital charges almost doubling.

> There was a linear relationship between duration and capital charges making it less attractive for insurance companies to invest at the long end.

The most recent Solvency II proposal addresses both problems:

> A separate category for AA+ to AA- rated covered bonds has been created, which has a 0.9% capital charge per year of duration.

> The linear relationship between duration and capital charge is broken up after five years with capital charges for covered bonds going up by 0.5% for every year of duration after that.

The big winners in the new proposal are AA rated covered bonds. Their capital charge, especially for the longer dated maturities, drops considerably. First of all the starting point is not 1.1% anymore, as was the case under QIS 5, but 0.9% and the subsequent increases after year five are significantly smaller. For a 10 year AA rated covered bond the capital charge is about 4% less at 7%.

To compensate for the improved AA rated covered bonds treatment, the capital charge for AAA rated covered bonds has gone up slightly from 0.6% to 0.7%. The aggregate effect after taking into account the different duration treatment is minimal though.

All of these changes have a number of consequences on relative capital charges, and therefore on required spread differences between covered bonds and other products.

Figure 1: overview of capital charges for covered bonds other asset classes (%) per year of duration under the current proposal vs the QIS 5 results (as indicated in brackets)

Product	Up to 5 years	5 to 10 years	1	2	3	4	5	6	7	8	9	10
AAA covered	0.7%* dur.	3.5% + 0.5%* (dur. -5)	0.7 (0.6)	1.4 (1.2)	2.1 (1.8)	2.8 (2.4)	3.5 (3.0)	4.0 (3.6)	4.5 (4.2)	5.0 (4.8)	5.5 (5.4)	6.0 (6.0)
AA + to AA- covered	0.9%* dur.	4.5% + 0.5%* (dur. -5)	0.9 (1.1)	1.8 (2.2)	2.7 (3.3)	3.6 (4.4)	4.5 (5.5)	5.0 (6.6)	5.5 (7.7)	6.0 (8.8)	6.5 (9.9)	7.0 (11.0)
A+ to A- covered	1.4%* dur.	7% + 0.7% * (dur. -5)	1.4 (1.4)	2.8 (2.8)	4.2 (4.2)	5.6 (5.6)	7.0 (7.0)	7.7 (8.4)	8.4 (9.8)	9.1 (11.2)	9.8 (12.6)	10.5 (14.0)
AAA to AA- sovereign	0,0%	0,0%	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
A+ to A- sovereign	1.1%* dur.	5.5% + 0.58* (dur. -5)	1.1 (1.1)	2.2 (2.2)	3.3 (3.3)	4.4 (4.4)	5.5 (5.5)	6.1 (6.6)	6.7 (7.7)	7.2 (8.2)	7.8 (9.9)	8.4 (11.0)
AAA corporate	0.9%* dur.	4.5% + 0.53%* (dur. -5)	0.9 (0.9)	1.8 (1.8)	2.7 (2.7)	3.6 (3.6)	4.5 (4.5)	5.0 (5.4)	5.6 (6.3)	6.1 (7.2)	6.6 (8.1)	7.2 (9.0)
AA+ to AA- corporate	1.1%* dur.	5.5% + 0.58%* (dur. -5)	1.1 (1.1)	2.2 (2.2)	3.3 (3.3)	4.4 (4.4)	5.5 (5.5)	6.1 (6.6)	6.7 (7.7)	7.2 (8.8)	7.8 (9.9)	8.4 (11.0)
A+ to A- corporate	1.4%* dur.	7% + 0.7% * (dur. -5)	1.4 (1.4)	2.8 (2.8)	4.2 (4.2)	5.6 (5.6)	7.0 (7.0)	7.7 (8.4)	8.4 (9.8)	9.1 (11.2)	9.8 (12.6)	10.5 (14.0)
AAA securitisation	7%* dur.		7	14	21	28	35	42	42	42	42	42
AA securitisation	16%* dur.		16	32	48	64	80	80	80	80	80	80

* values in brackets are from QIS 5

Figure 2: Impact of proposed changes on required spread difference between covered bonds and other asset classes

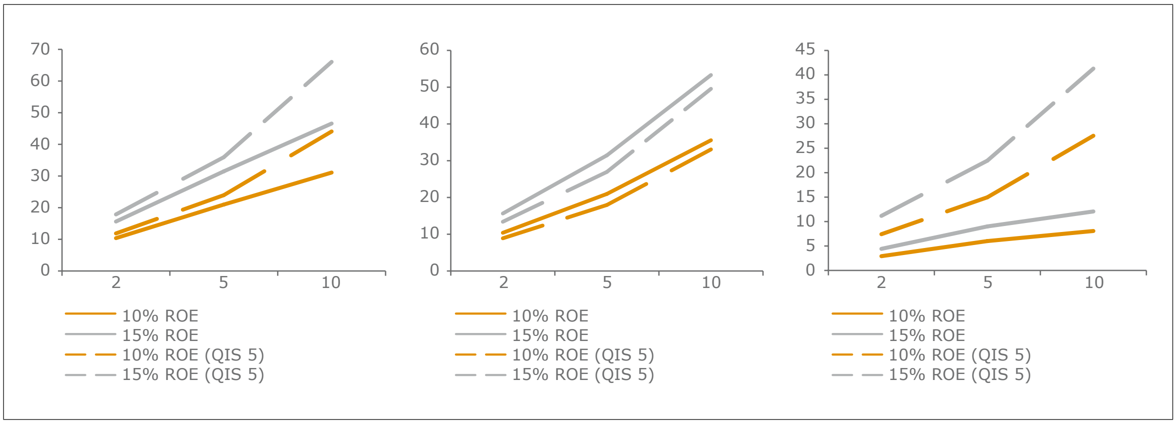
	AAA sovereigns	AAA covered bonds	AA covered bonds	AAA senior unsecured	A unsecured
AAA covered bonds	Increase	-	Decrease	Decrease	Decrease
AA covered bonds	Decrease	Decrease	-	Increase	Increase

Source: Crédit Agricole CIB

As a result of the slightly higher capital charge, AAA rated covered bonds lose a little bit of their edge over senior unsecured bonds and the capital charge difference to highly rated sovereign bonds increases slightly. The new rules have the biggest positive impact on AA rated covered bonds though, which is crucial as more and more bonds are downgraded to below AAA these days.

In the past it had been a major concern to see a downgrade from AAA to AA+. For an insurance company which has an internal required rate of return on capital of 15%, the required spread difference in the ten year segment used to be 41bp. This figure now shrinks to a mere 12bp. In the five year segment, the difference goes from 23bp to only 9bp.

> Figure 3: Spread needed to compensate for additional capital between AAA rated covered bonds and …
…A rated senior unsecured (bp) …AAA rated sovereign (bp) …AA rated covered bonds (bp)



Source: EU, Crédit Agricole CIB

When looking at the comparison between covered bonds and RMBS one thing becomes apparent:

> Securitisations are the big loser of Solvency II and even the current proposal did not do much to address this.

> Capital charges for 5Y AAA covered bonds are only 1/10 of these for AAA rated securitisations (3.5% vs. 35%). AA rated 5Y covered bonds have a little more than 1/20 the capital charge than an AA rated securitisation (4.5% vs. 80%).

Especially in the residential mortgage sector we would expect insurance companies to maintain their focus on covered bonds and away from RMBS. In the commercial mortgage market, even though covered bonds are much better off than CMBS, the most attractive instrument for an insurance company from a capital perspective is still the underlying commercial mortgage loan.

So what is our take on the new proposal…?

The recent changes are positive for covered bonds in general and especially for the AA rated sector. After many investors have already turned their focus away from the AAA rating level, the insurance sector was the last group out there for which a downgrade below AAA had a significant economic meaning.

The difference between AAA and AA rated covered bonds will still be there but compared to the QIS 5 numbers it has become very small. As is the case within the banking sector, the relevant rating level to focus on these days is AA-. Dropping below this level will mean that covered bonds will be treated as senior unsecured exposure, with capital charges in the 5Y sector going up from 4.5% to 7%. We would expect the negative bias towards below AAA rated covered bonds, that we have from time to time witnessed in the insurance sector, to be much less of a factor now as long as we stay within the double A category.

The adjusted treatment of longer dated maturities across asset classes reduces the capital charges quite significantly across the board beyond five years. Regulators apparently try to incentivise insurance companies to remain active at the long end of the curve, also in non-government bond segments. As such, this can be seen as at least the beginning of harmonisation across the banking and insurance sector regulation landscape which was initially missing.

Slightly amended timeframe

According to the FT, the Commission has slightly changed the timetable for Solvency II. The final implementation date still is 1 January 2014, this has not changed. What has changed however is the publication date of the final rules. The European Commission has pushed this one back by 9 months to 30 June 2013 blaming delays in the legislative process. Essentially this will mean that insurance companies will have less time to get their internal models approved. It might happen that initially a bigger number will have to start with the standardised model which will require more capital.

As a last piece of news, a recent article in the Financial Times Germany mentioned that Solvency II could be phased in over a number of years. As opposed to making Solvency II binding for all of an insurance company's assets and liabilities, the article said it could be compulsory for new contracts only first. We have no idea how to do this practically but it would obviously reduce the initial burden on the insurance sector and subsequently help lower rated covered bonds for some time.

2.2.3 COVERED BONDS AND EU BANKING REGULATIONS

By Fritz Engelhard, Barclays Capital

The regulatory landscape continues to evolve, which means that investors and issuers need to keep an eye on future regulatory changes when making decisions. This chapter provides an overview of the capital requirements for covered bonds under the European Commission's proposal on regulations for credit institutions. It also describes the treatment of covered bonds under the newly proposed liquidity risk management rules.

On 20 July 2011 the European Commission adopted a new "legislative package" for the regulation of the banking sector. It replaces the Capital Requirement Directives 2006/48 and 2006/49 and consists of two new proposals, a new directive which governs access to deposit-taking activities and a new regulation which establishes prudential requirements. In its meeting on 14 May 2012, the European Parliament's Economic and Monetary Affairs Committee voted on 1643 amendments to the legislative "CRD IV package" and on 15 May 2012, the EU's Economic and Financial Affairs Council agreed on a general approach regarding the "CRD IV package". On 12 June 2012, the European Parliament adopted the "CRD IV package" at first reading.

The foundations for the prudential rules on capital and liquidity requirements are set in the directive in Title VII (Prudential supervision), Chapter 2 (Review Processes), Section II (Arrangements, processes and mechanisms of institutions), Sub-Section 2 (Technical criteria concerning the organisation and treatment of risks). Article 77 of Sub Section 2 assigns the duty to "competent authorities" to ensure that credit institutions have appropriate credit and counterparty risk management rules in place. Article 84 of Sub Section 2 obliges "competent authorities" to put measures for appropriate liquidity risk management in place and article 85 addresses the "risk of excessive leverage".

The detailed rules on capital requirements and liquidity risk management are not part of the directive, but part of the regulation, the so-called "single rule book", which banks throughout the EU must respect. Consequently, national options and discretions which were available under the directive scheme will be removed. Member states will only be allowed to apply stricter requirements where these are (a) justified by national circumstances and (b) needed to maintain financial stability or (c) because of a bank's specific risk profile. The regulation consists of eleven parts and five annexes.

DEFINING COVERED BONDS

The definition of covered bonds is stipulated in Part Three (Capital requirements), Title II (Capital requirements for credit risk), Chapter 2 (Standardised approach), Section 2 (Risk weights) under article 124. It almost mirrors the definition of covered bonds under the previously relevant capital requirements directive. One minor difference lies in the fact that national regulators will have the discretion to allow the inclusion of substitute assets rated single-A (qualifying for "credit quality step 2") of up 10% of the total outstanding covered bonds where the limitation to exposures qualifying for credit quality step 1 would prevent adequate diversification.

Article 124 refers to the criteria of article 52(4) of the EU Directive 2009/65 (Directive on Undertakings of Collective Investment in Transferable Securities or UCITS) and additionally stipulates a series of eligibility criteria for cover assets. UCITS 52(4) gives a legal definition of a covered bond along the following lines:

[1] http://ec.europa.eu/internal_market/investment/ucits_directive_en.htm.

> The covered bond must be issued by an EU credit institution.

> The credit institution must be subject to special public supervision by virtue of legal provisions protecting the holders of the bonds.

> The investment of issuing proceeds may be effected in eligible assets only; the eligibility criteria are set by law.

> Bondholders' claims on the issuer must be fully secured by eligible assets until maturity.

> Bondholders must have a preferential claim on a subset of the issuer's assets in case of issuer default.

Beyond these more formal rules, a series of eligibility criteria for cover assets are stipulated. The eligibility criteria set a 10% limit for the use of RMBS and CMBS notes and allow an unlimited use of RMBS and CMBS notes only until 31 December 2013 and only in cases where the underlying mortgages were originated within the same consolidated banking group, where a member of the same banking group holds the first loss tranche and where the notes are at least rated AA-. According to the adopted criteria, the asset pool of a covered bond may include:

a) Exposures to or guaranteed by central governments, central banks, public sector entities, regional governments and local authorities in the EU.

b) Exposures to or guaranteed by third country central governments, non-EU central banks, multilateral development banks, international organisations with a minimum rating of AA- and exposures to or guaranteed by non-EU public sector entities, non-EU regional governments and non-EU local authorities with a minimum rating of AA- and up to 20% of the nominal amount of outstanding covered bonds with a minimum rating of A-.

c) Substitute assets from institutions with a minimum rating of AA-; the total exposure of this kind shall not exceed 15% of the nominal amount of outstanding covered bonds; subject to consultation with the EBA, authorities might allow the inclusion of substitute assets rated at least -A of up 10% of the total outstanding covered bonds where the limitation to exposures qualifying for a minimum rating of AA- would prevent adequate diversification; exposures caused by transmission and management of payments of the obligors of, or liquidation proceeds in respect of, loans secured by immovable property to the holders of covered bonds shall not be comprised by the 15% limit; exposures to institutions in the EU with a maturity not exceeding 100 days shall not be comprised by the AA- rating requirement, but those institutions must as a minimum qualify for an A- rating.

d) Loans secured by residential property or shares in Finnish residential housing companies up to an LTV of 80% or by senior RMBS notes issued by securitisation entities governed by the laws of a Member State, provided that the relevant supervisory authorities ensure that at least 90% of the assets of such securitisation entities are composed of mortgages up to an LTV of 80% and the notes are rated at least AA- and do not exceed 10% of the nominal amount of the outstanding issue.

e) Loans secured by commercial immovable property or shares in Finnish housing companies up to an LTV of 60% or by senior CMBS notes issued by securitisation entities governed by the laws of a Member State provided that the relevant supervisory authorities ensure that at least 90% of the assets of such securitisation entities are composed of mortgages up to an LTV of 60% and the notes are at least rated AA- and do not exceed 10% of the nominal amount of the outstanding issue; national regulators may allow also for the inclusion of loans with an LTV of up to 70% in case a minimum 10% over-collateralisation is established and such over-collateralisation is protected in case the respective issuer is subject to insolvency procedures.

f) Ship mortgage loans with an LTV of up to 60%.

The use of "immovable property" as collateral for covered bond assets is restricted and must meet specific legal and valuation requirements set out in articles 203 and 224(1) of the new regulation. The legal requirements include the enforceability of the mortgage charge, the ability to realize the security value of the protection within a reasonable timeframe and adequate insurance against risk of damage. The valuation requirements stipulate that properties should be valued by an independent valuer and be documented in a transparent and clear manner.

PLANNED AMENDMENTS

Within the amendments to the legislative "CRD IV package" adopted by the European Parliament's Economic and Monetary Affairs Committee in May, a number of changes also refer to the definition of covered bonds. For example, the latest proposal enhances the eligible residential property loans to residential loans fully guaranteed by an eligible protection provider with a minimum single-A minus rating. Furthermore, it converts the current waiver for the use of intra-group RMBS and CMBS notes to a general rule. A newly proposed article 124 (5a) also clarifies that no other ABS or covered bond notes should be used under a so-called "repackaging" framework.

In addition to the criteria attached to the regulatory framework and the eligibility of cover assets, the latest proposal stipulates further criteria which must be met by covered bonds in order to benefit from a beneficial treatment. These include mainly transparency and asset-encumbrance rules. In the introductory remarks under point 91c a specific reserve for deposit taking credit institution is proposed, in case covered bond issuance exceeds a certain limit. When this is this case, the respective credit institution is subject to a financial transfer to an internal deposit reserve. Whilst 91c makes still reference to article 124 (5a), which originally stipulated a covered bond issuance limit of 4% of total assets, the respective part of article 124 (5a) has been taken out in the proposal of the European Parliament. In article 124 (3), a general rule has been inserted saying that covered bonds would only benefit from the application of specific risk weights in case "up to date portfolio information is disclosed and made readily available to investors on an ongoing basis, at least quarterly".

In part five (Exposure to transferred credit risk) of the EU's single rule book, under Title II (Requirements for investor institutions) a new article 395 (2a) is proposed. Under this article, investors are required to undertake due diligence on the underlying assets before investing in covered bonds and as appropriate thereafter. In order to enable investors to comply with this regulation, which initially has been designed for investments in securitisation notes, the new article 395 (2a) stipulates that institutions originating covered bonds shall ensure that investors and prospective investors have all necessary information to comply with the due diligence obligations. In our view, the proposed inclusion of due diligence requirements for investors may lead to increased regulatory burden for investors and could have a detrimental effect on demand.

In newly proposed language for article 478 the risk weight for covered bond holdings is made dependent on meeting additional criteria, including an adequate quality differentiation between covered bonds, adequate transparency of the covered bond market, the extent of asset encumbrance and the impact of the use of covered bonds as liquid asset on the resilience of credit institutions. In the proposal discussed by the European Parliament's Economic and Monetary Affairs Committee in May a "quality benchmarking" of covered bonds was suggested.

ASSIGNMENT OF RISK WEIGHTINGS

The general principles for capital requirements are stipulated in Part Three (Capital requirements), Title II (Capital requirements for credit risk), Chapter 1 (General principles). The assessment of risk weightings is conducted within the context of either a standardised approach or an Internal Ratings-Based Approach (IRBA). The latter comes in both foundation and advanced forms. Application to individual banks depends on the level of sophistication of their risk management systems.

Compared to CRD III, the major change in the articles of the EU's single rule book is that the calculation of the risk weighting of covered bonds within the standard approach is now directly linked to the covered bond rating and not to the rating of the issuer or sponsor bank. Figure 1 shows that a risk weighting of 10% will apply where the covered bonds are rated at least AA-/Aa3 and a risk weighting of 20% will apply where the covered bonds are rated between BBB-/Baa3 and A+/A1. This compares with risk weightings of 20% and 50%, respectively, for similarly rated senior bonds issued by banks.

FIGURE 1: COVERED BOND RISK WEIGHTINGS UNDER THE STANDARD APPROACH (COVERED BOND RATING ASSIGNED)

Credit quality step	1	2	3	4	5	6
Rating* (covered bond)	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-	≤ CCC+
Risk weight	10%	20%	20%	50%	50%	100%

Note: Mapping based on FSA rules

Source: European Commission, FSA, Barclays Capital

In case nor rating has been assigned to the respective covered bonds, the risk weighting is linked again to the risk weighting of senior unsecured exposures of the issuer according to the table below.

FIGURE 2: COVERED BOND RISK WEIGHTINGS UNDER THE STANDARD APPROACH (COVERED BOND RATING NOT ASSIGNED)

Credit quality step (issuer)	1	2	3	4	5	6
Rating* (issuer)	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-	≤ CCC+
Risk weight (issuer)	20%	50%	50%	100%	100%	150%
Risk weight (covered bond)	10%	20%	20%	50%	50%	100%

Note: Mapping based on FSA rules

Source: European Commission, FSA, Barclays Capital

Contrary to the standardised approach, an explicit direct link to the covered bond rating is missing in the IRBA. Thus, for banks using the IRBA and the advanced IRBA, the starting point for assessing the risk weighting of covered bonds will still be the probability of default by the issuer or sponsor bank, which generally is correlated to its senior unsecured rating.

Under the IRBA credit institutions can determine their capital requirements on the basis of internally generated estimates of the risk of loss on their assets. These estimates require inputs relating to the one-year Probability of Default (PD), the Loss Given Default (LGD), the Exposure At Default (EAD) and the Effective Maturity (M), which are combined to give capital requirements and risk weightings. The relevant measures are stipulated in Part Three (Capital requirements), Title II (Capital requirements for credit risk), Chapter 3 (Internal ratings based approach), section 4 (PD, LGD, and Maturity).

The proposed regulation provides a specific framework for calculating internal ratings-based risk weights for covered bonds. (non-EU based banks applying the Basel framework to covered bonds would have to treat them as senior bank debt.) The EU regulation specifies constraints on risk components as follows:

> PD (which relates to issuer rather than issue default risk) must be at least 0.03% (article 156).

> LGD should be assigned a value of 11.25%. This is stipulated in article 157. For banks applying the advanced approach, a lower LGD is possible. Historical data for residential mortgage assets underline that LGD levels are basically below 10%.

> M, the effective maturity of the bond, is limited to a range of one to five years in case banks apply the advanced approach. For the foundation approach, the regulations specify an effective maturity of 2.5 years for all bonds (article 158).

The below illustrations of risk weightings are based on an 11.25% LGD. The table illustrates figures for the range of possible effective maturities, as well as the central 2.5 yr case.

The room for discretion on the part of individual banks is limited, given the constraints on the specification of LGD and M. For PD, the default probability input, one-year default probabilities published by the rating agencies provide at least a starting point.

Figure 3: Rating agency cumulative one-year default rates (%)

	S&P (1981-2010)	Moody's (1983-2010)	Fitch (1991-2010)
AAA/Aaa	0.00	0.00	0.00
AA/Aa	0.02	0.02	0.04
A/A	0.08	0.06	0.24
BBB/Baa	0.25	0.20	0.58
BB/Ba	0.95	1.20	1.28

Source: S&P, Moody's, Fitch.

Default probabilities produced by risk models used by individual banks may show some variation from these figures. Bank risk models generally operate on the basis of higher default probabilities than the rating agencies' historical studies suggest and banks apply more differentiation than is provided by the rating agencies' broad alphabetic bands.

Figure 4 provides an illustrative matrix of risk weightings based on plugging a range of different default probabilities and the average life figures in the respective functions.

FIGURE 4: RISK WEIGHTED ASSET RATIOS (%) FOR DIFFERENT DEFAULT PROBABILITIES AND AVERAGE LIVES (LGD = 11.25% IN ALL CASES)

	Probability of default (%)					
Bond Life (yrs)	**0.03%**	**0.05%**	**0.10%**	**0.20%**	**0.25%**	**0.35%**
1	2.01%	2.97%	4.95%	7.96%	9.19%	11.29%
2	3.22%	4.46%	6.89%	10.41%	11.80%	14.14%
2.5	3.83%	5.21%	7.86%	11.63%	13.11%	15.57%
3	4.43%	5.95%	8.83%	12.86%	14.42%	17.00%
4	5.65%	7.44%	10.77%	15.31%	17.03%	19.86%
5	6.86%	8.93%	12.71%	17.76%	19.65%	22.71%

Note: As five years is the maximum bond life that can be input, the bottom row of the table also provides the risk weighting to be applied to all longer maturities.

Source: Barclays Capital.

The 0.03% floor for PD is likely to be applied by most risk models, at least down to banks rated at the bottom of the AA range. For covered bonds issued by banks in this top category, the risk weighting will range from 2.0% to 6.9% depending on maturity. This represents a significant capital saving relative to the risk weightings under the standard approach. It also highlights that in the IRBA, the risk weighting is significantly affected by the remaining life of the bond, which is not the case in the standard approach. Banks applying the IRBA will have a significant incentive in terms of capital utilisation to invest in shorter maturities.

LIQUIDITY RISK FRAMEWORK

The rules for the use of securities as liquidity buffer investments are stipulated in the proposed regulation mainly in Part six (Liquidity) in articles 403, 404, 405, 406) and in Part ten (Transitional provisions, reports and reviews) in article 481. The overall liquidity buffer portfolio is divided into a (level 1) bucket of assets, which qualify for an "extremely high liquidity and credit quality", and a (level 2) bucket of assets with "high liquidity and credit quality". Level 2 can make up a maximum of 40% of the total liquidity buffer and it is subject to a 15% haircut. There is no limitation on any asset class that qualifies as level 1 or level 2 assets, except claims against credit institutions (except covered bonds and public sector banks) and claims against other financial firms (ie, investment firms, insurance companies, financial holding companies).

Those covered bonds that are only compliant with article 52(4) of Directive 2009/65/EC, but not with the enhanced collateral criteria of article 124 of the CRD IV, may also qualify for the liquidity buffer. In addition, the use of securitization special purpose entities (SSPEs) has been also added to the list of assets qualifying for liquidity buffer portfolios.

According to article 481(2), the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Central Bank (ECB) have the mandate to develop "appropriate uniform" definitions of level 1 and level 2 assets by mid 2013. In this process, it shall test the adequacy of the following criteria and the appropriate levels for such definitions. When it comes to liquidity the following criteria shall apply: (1) minimum trade volume, (2) minimum outstanding volume, (3) transparent pricing and post-trade information, (4) proven record of price stability, (5) average volume traded and average trade size, (6) maximum bid/ask spread, (7) remaining time to maturity and (8) minimum turnover ratio. With regards to quality, the following criteria where stipulated: (1) credit quality steps

(2) additional quality criteria on top of those set by central banks (3) support financing of the European economy. At the latest within one year EBA and the European Systemic Risk Board (ESRB) shall evaluate the market impact and the effectiveness in contributing to financial stability. Below we give some evidence to what extend covered bonds fulfil the respective criteria.

Another important amendment relevant for covered bond issuers refers to the general rules of liquidity management and leverage. Article 481(1) obliges EBA in consultation with ESRB to monitor and report on all those cases where the application of liquidity requirement regulations will have a "material detrimental impact on the business and risk profile of Union institutions, on financial markets or the economy and bank lending". This wording may allow authorities to amend certain liquidity management rules for countries with a significant presence of specialized credit institutions.

Finally, we note that final decisions will only be made after prolonged testing periods. In this respect, ample powers were assigned to the EBA, ESMA, ESRB and the ECB to make proposals for appropriate definitions and monitor the impact of the application of liquidity rules. With regards to maintenance of liquidity ratios and buffers, the respective bodies shall report by end of 2013 on adequate definitions for level 1 and level 2 assets. By 31 December 2015 authorities should make a proposal on adequate liquidity management rules and "if appropriate", by 31 December 2016, the EU should submit a legislative proposal to the European Parliament and Council.

EMPIRICAL DATA SUPPORTING A BENEFICIAL TREATMENT OF COVERED BONDS IN THE LIQUIDITY FRAMEWORK

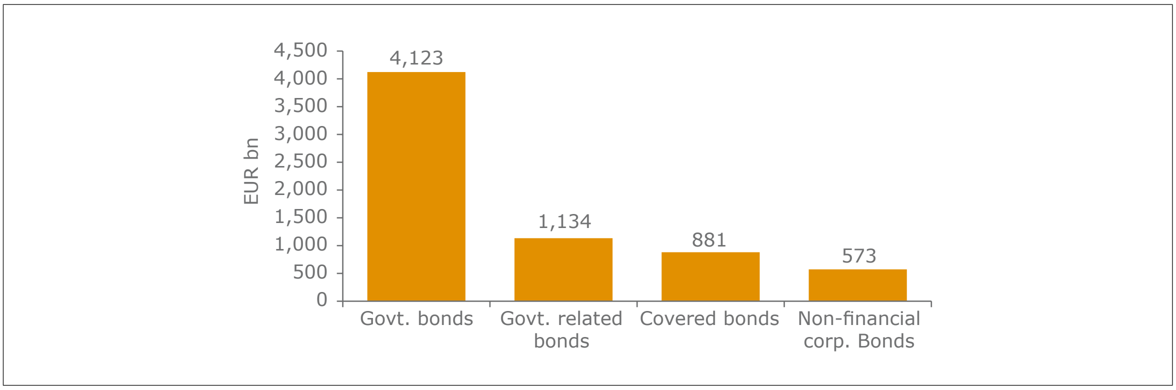
The proposed regulation provides room for the eligibility criteria for the LCR to move away from simple bond type and rating rules. The overall framework is more flexible and enables a focus more on the actual liquidity of the instrument in question. This is a development that we welcome as the liquidity of a bond depends on a wide variety of factors. Liquidity levels differ strongly within product categories and rating bands, for example, lower rated bonds can sometimes have higher liquidity levels than highly rated ones and covered bond are often significantly more liquid than some sovereign bonds.

European regulatory authorities will play a major role in assessing what can be considered to be liquid and which category a certain asset will belong to. There are a number of qualitative criteria that have been brought into the discussion such as market depth and size, maximum bid-offer spreads, maximum price decline or spread widening in a certain period. To get a feeling for how covered bonds fare in this regard against other potentially eligible assets such as sovereign bonds and non financial corporates, we have taken a look at some numbers.

MARKET SIZE

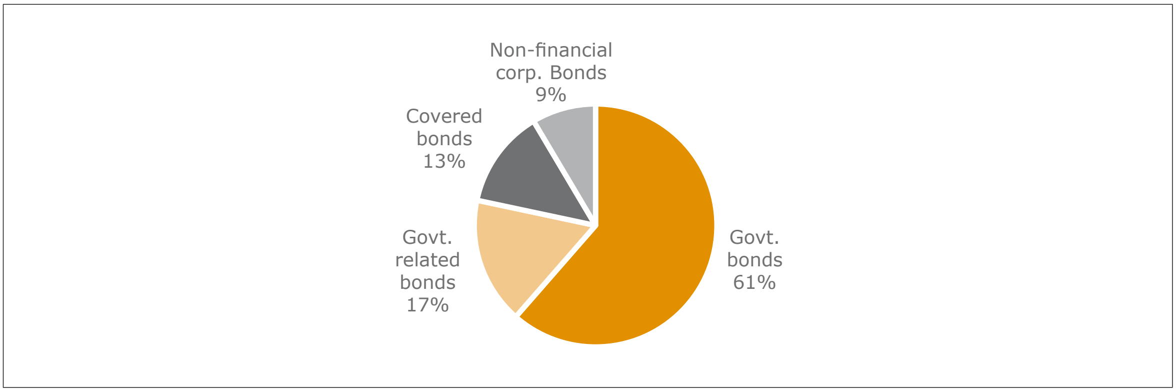
Covered bonds are one of the largest private sector debt markets in the world. At the end of 2011, the overall volume stood at EUR 2.7 trillion. Looking only at the benchmark fixed coupon market, the volume comes in at EUR 880 bn as at mid 2012. This compares to EUR 573 bn of non-financial corporate benchmark bonds, EUR 1,134 bn of government-related bonds (incl. supranational, sub-sovereign, agency and government guaranteed bank debt) and EUR 4,123 bn of government bonds.

> Figure 5: Outstanding volume of selected EUR fixed coupon benchmark sectors with an investment grade rating (June 2012)



Source: Barclays

> Figure 6: Market share of selected EUR fixed coupon benchmark sectors with an investment grade rating (June 2012: EUR 6.7trn)



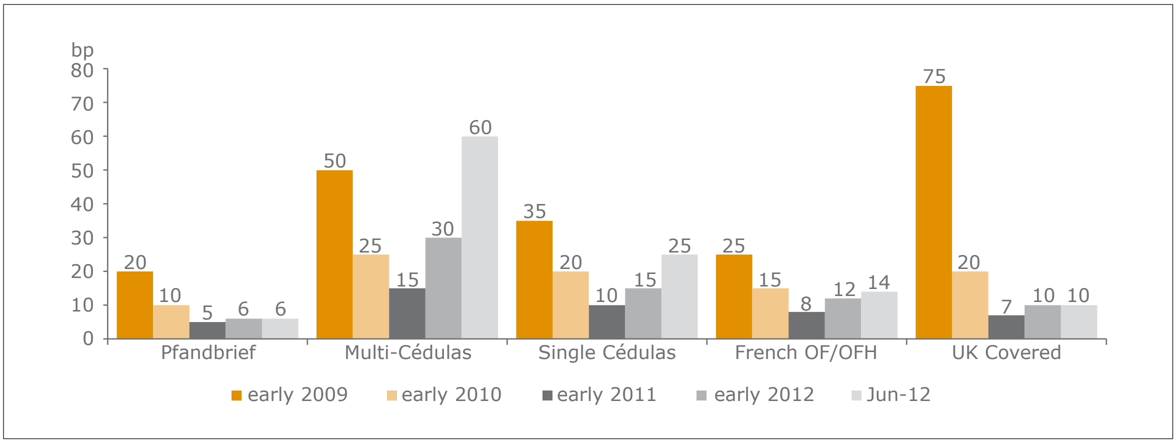
Source: Barclays

BID-ASK SPREADS

Bid-ask spreads are one additional criterion that the European authorities are mandated to review when assessing which assets can be assigned into the "extremely high liquidity" and "high liquidity" categories. Figure 6 below shows the historical development of 5y generic covered bonds from various jurisdictions over the past three years.

When looking at the numbers, it becomes apparent that bid ask spreads were subject to some variations throughout the financial market crisis and they have also varied substantially across jurisdictions. Particularly those markets, were the volatility in underlying government bonds was pronounced, bid ask spreads of covered bonds were also subject to stronger variations.

> FIGURE 7: DEVELOPMENT OF BID-ASK SPREADS OF 5Y GENERIC EUR BENCHMARK BONDS IN SELECTED COVERED BOND JURISDICTIONS*



Note: Bid / Ask spreads and sizes are on indicative basis and can vary according to specific request

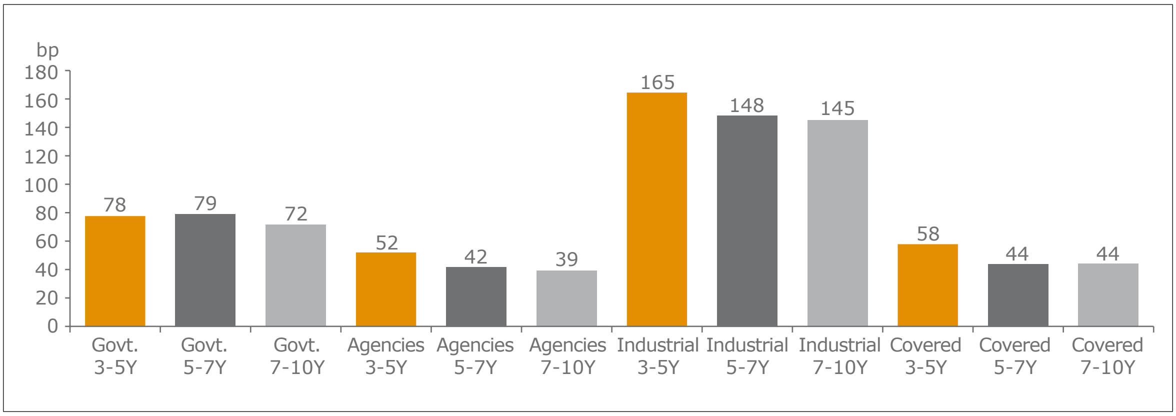
Source: Barclays

SPREAD VOLATILITY

We have analysed the swap spread development in major euro area fixed income market segments with an investment grade rating over the past ten years by using weekly data from Barclays Euro Aggregate indices. The relevant market sectors include government bonds, public-sector agency bonds, non-financial corporate bonds and covered bonds. As spread measures we focus on the maximum swap spread change over a rolling 5 week period. Given the rather distressed market environment over the past five years and given that the value of liquidity buffer investments should be comparatively stable in distressed market situations, we believe that particularly the second volatility measure more then well captures these aspects.

The aggregate measures across the major instruments and across major maturity buckets indicate that maximum swap spread volatility was the lowest in agency and covered bonds, somewhat more elevated in the segment of government bonds and by far the most pronounced in non-financial corporate bonds, where the maximum swap spread change has been about three times as high as for agency and covered bonds.

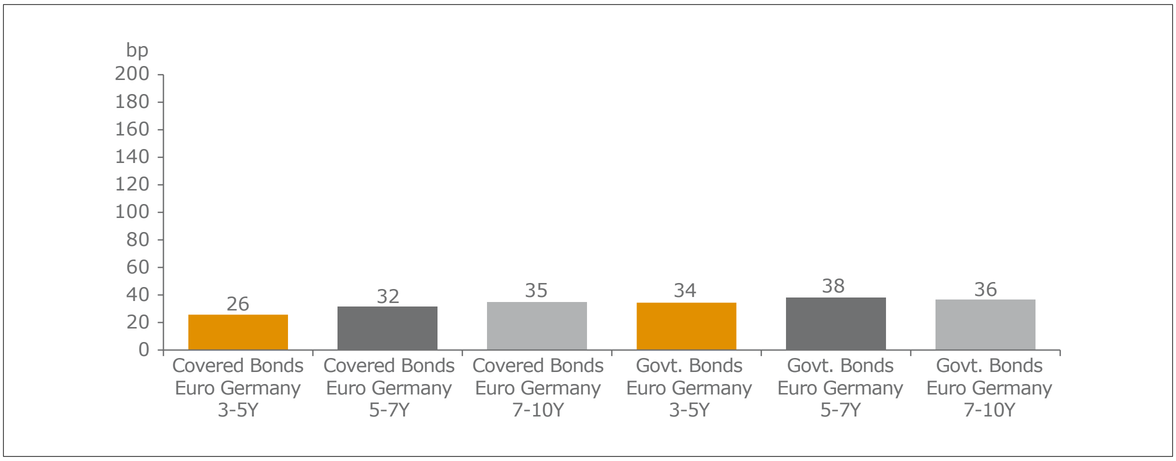
> FIGURE 8: MAXIMUM FIVE WEEK SWAP SPREAD CHANGE OF MAJOR MARKET SEGMENTS OVER A ROLLING 5 WEEK PERIOD BETWEEN JANUARY 2002 AND JULY 2012



Source: Barclays

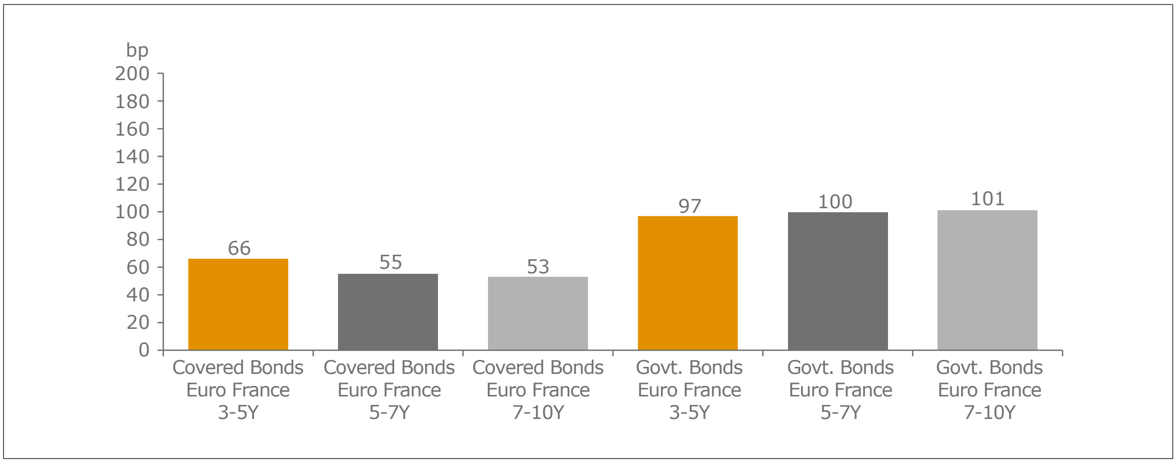
Over the past three years, spread volatility has been strongly influenced by the evolution of the European sovereign debt crisis and consequently volatility measures varied a lot between different countries. What is interesting though is that in extreme situations with major market swings, swap spread volatility of covered bonds has been consistently below the swap spread volatility of underlying government bonds. Figures 9 to 11 show that over the past ten years the maximum five week swap spread change of covered bonds has been below the same measure for government bonds in Germany, France and Spain across various maturity buckets.

> FIGURE 9: MAXIMUM FIVE WEEK SWAP SPREAD CHANGE OF GERMAN COVERED AND GOVERNMENT BONDS OVER A ROLLING 5 WEEK PERIOD BETWEEN JANUARY 2002 AND JULY 2012



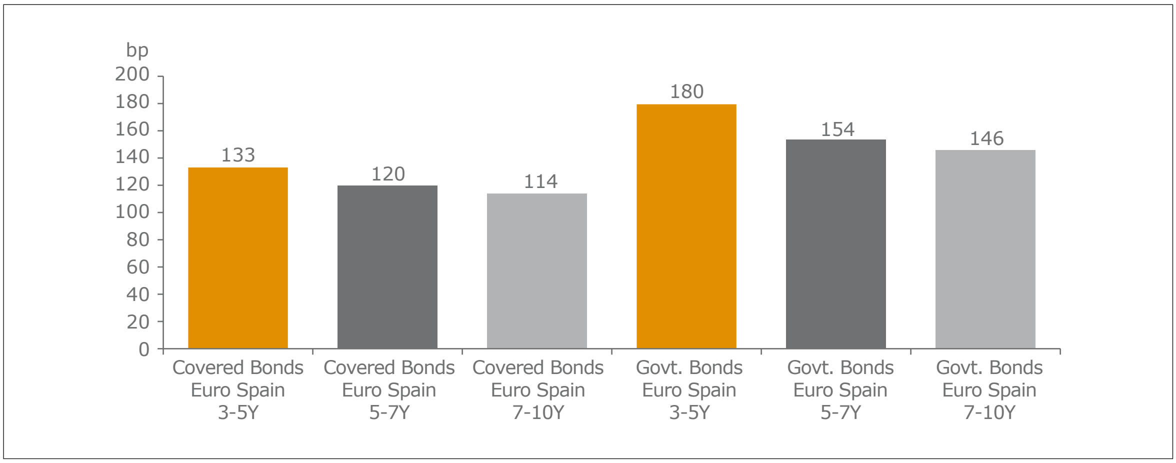
Source: Barclays

> Figure 10: Maximum five week swap spread change of French covered and government bonds over a rolling 5 week period between January 2002 and July 2012



Source: Barclays

> Figure 11: Maximum five week swap spread change of Spain covered and government bonds over a rolling 5 week period between January 2002 and July 2012



Source: Barclays

ASSESSMENT

We regard the holistic approach of lawmakers as a positive for the industry, as it takes into account recent market developments, which underline that secondary market liquidity of assets, is not purely a function of the asset type and ratings but subject to a more complex set of criteria. As highlighted above, there is empirical evidence that covered bonds comply with the highest standards in terms of liquidity and quality. The proposed regulation also takes into account the specific importance of the covered bond product in certain jurisdictions and the role of specialised institutions.

On the negative side we note a number of inconsistencies, such as the use of two different definitions of covered bonds, the narrow definition of article 124 for the assessment of risk weightings and the broader definition of article 52(4) of Directive 2009/65/EC for investments in liquid assets, within the same piece of regulation. Furthermore, the flipside of the higher flexibility in the definition of liquid assets and their allocation to the "high" and "extremely high" liquidity and quality buckets is that it is unclear for bank treasury managers what exactly qualifies as a liquid asset under the new rules until a narrower definition has been made. In the meantime, to be on the save side, they may put the focus on frequent and high volume borrowers, who will very likely qualify for the liquid asset portfolio, as otherwise according to article 481 this could have a "material detrimental impact" on financial markets. Finally, referring the risk weighting of covered bonds in the standard approach purely to the outcome of the rating process not only institutionalizes the reliance on rating agencies, but also contrasts with the IRB approach, where a narrow link has been kept in place between the default probability of the issuer and the risk weighting for covered bonds.

2.3 COVERED BONDS AND REPO

By Frank Will and Jan King, RBS

INTRODUCTION

Central bank repos: the safety net for the banking system

Since the onset of the credit crunch and particularly the bankruptcy of Lehman Brothers, central banks worldwide have stepped in, putting in place a number of measures to backstop the banking system. Widescale unsterilized asset purchases (Quantitative Easing or QE) have been extensively used by the Federal Reserve and the Bank of England. The European Central Bank (ECB) responded with its EUR 60 bn covered bond purchase programme initiated in mid-2009 and a second one with a total size of up to EUR 40 bn in late-2011. A crucial pillar of the responses of all central banks has been their monetary policy operations, either by increasing the number or nature of their short and long term repo operations such as the two 3-year LTROs from the ECB in December 2011 and in February 2012, or by widening the pool of repo eligible collateral.

The role of covered bonds in monetary operations varies by jurisdiction, not least since the nature of those operations is quite heterogeneous across jurisdictions. Broadly speaking covered bonds receive more favourable treatment amongst those countries in which they play a more pivotal role in the funding of the domestic banking sector. This applied primarily in terms of eligibility of covered bonds as collateral for repo operations, but also in terms of the haircuts applied. At many of the major central banks (at least some types of) covered bonds are eligible as collateral in the discount window for emergency lending.

> COMPARING THE ELIGIBILITY OF COVERED BONDS FOR MONETARY POLICY OPERATIONS

Central Bank	Operation	Covered Bonds eligible?	Eligible Covered Bonds	Currency	Minimum Rating	Rating Treatment	Minimum Size	Own-name
ECB	Repo Operations (Main and Long term refinancing operations)	Yes	Covered bonds compliant with UCITS Article 52(4) or similar safeguards	EUR	Up to BBB-	Best Rating	€1bn for Jumbo Covered Bonds, otherwise none	Yes
Fed	SOMA Operations	No	None	USD	n/a	n/a	n/a	n/a
Fed	Discount Window	Yes	US Issued Covered Bonds	AUD, CAD, CHF, DNK, EUR, GBP, JPY, SEK	BBB	Lowest Rating	n/a	No
			German Pfandbriefe		AAA			
BoE	Operating Standing Facilities, Short term OMOs	No	n/a	GBP, EUR, USD, AUD, CAN, CHF, SEK	n/a	n/a	n/a	n/a
	Longer Term Repo Operations	Yes	UK, French, German & Spanish regulated covered bonds		AAA	Must be provided by two or more of S&P, Moody's & Fitch	£1bn or €1bn (depending on issuance currency)	No
	Discount Window	Yes	UK, US & EEA Covered Bonds		A-/A3, if AAA at issue		none	Yes

Central Bank	Operation	Covered Bonds eligible?	Eligible Covered Bonds	Currency	Minimum Rating	Rating Treatment	Minimum Size	Own-name
SNB	Repo operations, Standing Facilities	Yes	Any covered fulfilling the eligible security and rating criteria, but not issued by a Swiss bank	CHF	Security: A/A2 with various exceptions Issuer's country: A/A2	Best Rating	CHF 100mln equivalent (issuance amount)	No
			Any covered fulfilling the eligible security and rating criteria, but not issued by a Swiss bank	EUR, USD, GBP, DKK, SEK, NOK	Security: AA-/Aa3 with various exceptions Issuer's country: AA-/Aa3		CHF 1bn equivalent (issuance amount)	
Norges Bank	Repo Operations	Yes	Any covered fulfilling the eligible security criteria	NOK, SEK, DKK, EUR, USD, GBP, JPY, AUD, NZD, CHF	Domestic currency: None but BBB- for favourable liquidity category (II not III)	Best Rating	None	Yes
					Foreign Bonds: A/A2			
Reserve Bank of Australia (RBA)	Repo Operations	Yes	Any covered bond fulfilling the eligible security criteria	AUD	AAA or BBB+ for domestic covered bonds >1Y	Lowest Rating	None	No
Reserve Bank of New Zealand (RBNZ)	Repo and/or Swap of NZ Government Bonds	No	None	n/a	n/a	n/a	n/a	n/a
	Overnight Repo Operations, Bond Lending Facilities	Yes	Any covered bond fulfilling the eligible security criteria	NZD	AAA from at least two rating agencies. If more than two ratings, then at least two agencies must rate the issue AAA, and no rating is below AA+		None	No

Source: RBS, Central Banks.

2.3.1 EURO AREA: ELIGIBILITY CRITERIA FOR COLLATERAL IN EUROSYSTEM OPERATIONS

The ECB has been a key source of liquidity for banks in the Eurosystem during the credit crunch and the ongoing European debt crisis through its repo operations. The role of covered bonds within the ECB's liquidity operations has become an increasingly important one. While during certain periods over the last four years the benchmark covered bond market was shut for many issuers out of Europe's periphery the ECB continued to provide liquidity to those banks. This includes the two 3-year Long-term refinancing operations the ECB conducted in December 2011 and in February 2012 where banks took more than EUR 1 trn in gross liquidity – backed by eligible collateral. Many covered bond programmes have been set up not just as an additional funding channel, but also to allow the banks to use the repo facilities at the ECB as means to access liquidity in a closed wholesale market.

After spurring the covered bond market into action in 2009 with its EUR 60 bn purchase programme, covered bonds have gone on to be one of fastest growing assets in terms of collateral posted to the ECB, increasing by c.73% in amounts posted since 2007 (second in terms of growth only to ABS and non-marketable assets) and exceeding the increase in total collateral posted for repo operations (56%). See the section below for a more detailed discourse on covered bond usage in ECB operations and the ECB classification of a 'covered bank bond'.

ECB repo operations

Article 18.1 of the Statute of the European System of Central Banks and of the European Central Bank states that the ECB and the national central banks may conduct credit operations with credit institutions and other market participants, as long as lending is "based on adequate collateral"[1]. According to the ECB, adequacy means firstly, that collateral must protect against losses in credit operations, and secondly that there must be sufficient collateral potentially available to ensure that the Eurosystem can carry out its tasks.

Consequently, underlying assets have to fulfil certain criteria in order to be eligible for Eurosystem monetary policy operations. The Eurosystem has developed a single framework for eligible assets common to all Eurosystem credit operations (the "Single List"). There is no collateral differentiation between monetary policy instruments or intraday credit, and a single auction rate is applicable to different types of collateral in tender operations. The scope of eligible collateral is broad and includes secured assets like covered bonds and ABS, the latter of which can be backed by receivables such as residential and commercial loans (secured and unsecured), auto loans, lease receivables etc. provided they satisfy certain eligibility criteria (set out below), as well as unsecured claims against governments, credit institutions or corporates. In February 2012 the ECB approved, for seven national central banks (Ireland, Spain, Portugal, Italy, Cyprus, France and Austria) specific national eligibility criteria to accept additional performing credit claims as collateral.

The Eurosystem additionally applies risk control measures in the valuation of underlying assets. The value of the underlying asset is calculated as the market value of the asset less a certain percentage ("valuation haircut"). The haircut-adjusted market value of the underlying assets used in its liquidity-providing reverse transactions must be maintained over time. This implies that if the value, measured on a regular basis, of the underlying assets falls below a certain level, the national central bank will require the counterparty to supply additional assets or cash (i.e. it will make a margin call). Similarly, if the value of the underlying assets, following their revaluation, exceeds a certain level, the counterparty may retrieve the excess assets or cash. The current eligibility of assets in the ECB framework and recent changes to this are set out below:

Criteria	Standard Collateral Rules
Type of Asset	> Debt instrument having a coupon that cannot result in a negative cash flow > Coupon should be zero coupon, fixed-rate coupon or floating-rate coupon linked to an interest rate reference or to rating of issuer or inflation-indexed > Debt instruments, including covered bonds, but not including ABS, must have a fixed, unconditional principal amount > Limits on the use of unsecured bank bonds: The value assigned to unsecured bonds issued by a credit institution or an entity with close links to a credit institution must be less than a share of 5% in the value of the collateral pool of a counterparty (after haircuts), unless the market value of these assets is not higher than €50m
Definition of Covered Bonds	> The ECB does not provide an official definition of what they classify as covered bonds in the context of eligible collateral > In general, 'Covered Bank Bonds' for ECB collateral purposes means bonds issued in accordance with Article 52 (4) of the UCITS Directive, (i.e. subject to covered bond specific legislation) or similar safeguards > Covered bonds which do not meet these criteria (general law-based covered bonds) but meet all other requirements are eligible but classified as 'Credit Institution Debt Instruments'

[1] Protocol on the Statute of the European System of Central Banks and of the ECB, Article 18.1.

Criteria	Standard Collateral Rules
Cash Flow Backing ABS	> Must be legally acquired in accordance with the laws of a member state in a "true sale" > Must not consist of credit-linked notes (i.e. cannot be a synthetic structure), or contain tranches of other ABS.
Tranche and Rating	> Tranche (or sub-tranche) must not be subordinated to other tranches of the same issue > The minimum rating threshold is BBB- (S&P) / Baa3 (Moody's) / BBB- (Fitch) / BBBL (DBRS) based on a "best rating approach", so only one rating at this level is required for eligibility. > The only exception to this is for ABS, for which the minimum ratings are BBB- (S&P) / Baa3 (Moody's) / BBB- (Fitch) / BBB (DBRS) on a second-best basis (since June 2012).
Place of Issue	European Economic Area (EEA)
Settlement Procedures	> Transferable in book-entry form > Held and settled in the euro area
Acceptable Market	Debt instrument must be admitted to trading on a regulated market or a non-regulated market as specified by the ECB
Type of Issuer/ Guarantor	Central banks, public sector or private sector entities or international institutions
Place of Establishment of the Issuer/ Guarantor	Issuer must be established in the EEA or in non-EEA G10 countries and guarantors must be established in the EEA
Currency of Denomination	EUR

Source: RBS, ECB

In January 2011 the ECB implemented its current haircut scheme, graduating haircuts according to differences in maturities, liquidity categories and the credit quality of the assets concerned (see the next two tables). The Governing Council also decided to retain the minimum credit threshold for marketable and non-marketable assets in the Eurosystem collateral framework at investment grade level.

There were no changes in the haircuts for category II (i.e. affecting Jumbo covered bonds). In category III, the haircut for maturities up to 3 years remained unchanged, however the haircuts for 3-5 year maturities was increased by 50bp, the 5-7 year bracket by 100bp, bonds with maturities of 7 years and more by 200bp. Haircuts are significantly higher for bonds in the triple-B bucket (see second table below).

In June 2012 the ECB further increased the collateral availability of ABS, when it reduced the minimum rating threshold to "BBB-" (second-best) from "A-". ABS with ratings below "A-" will be subject to higher haircuts of 26% or 32% respectively in case of CMBS.

At the end of 2010 non-EUR securities ceased to be eligible for ECB repo operations. Previously GBP, USD and JPY had temporarily been eligible with an additional 8% haircut compared to EUR-denominated securities.

> ECB Haircuts by Liquidity Category and Residual Maturity

Credit Quality Steps 1 and 2 (AAA to A-)	**Liquidity Category I**		**Liquidity Category II** (Local & Regional Govt, Supras & Agencies, Jumbo Covered Bonds*)		**Liquidity Category III** (Traditional Covered Bonds*, Structured Covered Bonds*, Multi-Issuer Covered Bonds* Corporates Bonds*)		**Liquidity Category IV** (Unsecured Bank Bonds*)		**Liquidity Category V** (ABS*)
Residual maturity (years)	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed or zero coupon
0-1	0.5	0.5	1.0	1.0	1.5	1.5	6.5	6.5	16.0
1-3	1.5	1.5	2.5	2.5	3.0	3.0	8.5	9.0	
3-5	2.5	3.0	3.5	4.0	5.0	5.5	11.0	11.5	
5-7	3.0	3.5	4.5	5.0	6.5	7.5	12.5	13.5	
7-10	4.0	4.5	5.5	6.5	8.5	9.5	14.0	15.5	
>10	5.5	8.5	7.5	12.0	11.0	16.5	17.0	22.5	

Source: ECB (*Assets that are given a theoretical value will be subject to an additional 5% haircut)

> ECB Haircuts by Liquidity Category and Residual Maturity

Credit Quality Step 3 (BBB+ to BBB-)	**Liquidity Category I**		**Liquidity Category II** (Local & Regional Govt, Supras & Agencies, Jumbo Covered Bonds*)		**Liquidity Category III** (Traditional Covered Bonds*, Structured Covered Bonds*, Multi-Issuer Covered Bonds*, Corporates Bonds)		**Liquidity Category IV** (Unsecured Bank Bonds*)		**Liquidity Category V** (ABS)
Residual maturity (years)	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed or zero coupon
0-1	5.5	5.5	6.0	6.0	8.0	8.0	15.0	15.0	26.0 or 32.0 (CMBS)
1-3	6.5	6.5	10.5	11.5	18.0	19.5	27.5	29.5	
3-5	7.5	8.0	15.5	17.0	25.5	28.0	36.5	39.5	
5-7	8.0	8.5	18.0	20.5	28.0	31.5	38.5	43.0	
7-10	9.0	9.5	19.5	22.5	29.0	33.5	39.0	44.5	
>10	10.5	13.5	20.0	29.0	29.5	38.0	39.5	46.0	

Classification of covered bonds within the Eurosystem operations

The ECB considers covered bonds to be a more liquid asset class. Hence, covered bonds benefit from preferential liquidity class classification and favourable haircut valuations for repo transactions with the ECB compared with, for example, ABS. Moreover, unlike senior bank debt, the ECB will accept self-issued 'covered bank bonds' as collateral (see below for more on this). Thus, like certain forms of ABS, covered bonds allow issuers to make assets held on their balance sheets eligible for the ECB's liquidity operations. This is very much in line with previous ECB statements which note that "covered bonds possess a number of attractive features from the perspective of financial stability".

The Eurosystem does currently not provide an official definition of what is classified as 'covered bond'. In general, the Eurosystem accepts both UCITS and non-UCITS compliant covered bonds as collateral as long as they otherwise fulfil the general eligibility criteria. Generally, debt instruments are classified as 'covered bank bonds' if they are issued in accordance with the criteria set out in Article 52(4) of the UCITS Directive. Those bonds are grouped either into liquidity category II in case of Jumbo covered bonds, i.e. bonds with a minimum issue size of EUR 1 bn and at least three market makers, or into liquidity category III in case of traditional non-Jumbo covered bonds.

'Structured' covered bonds are issued under a general legal framework, rather than being subject to 'special public supervision', they do not fall within the UCITS definition and as such have not been recognised as covered bank debt by the ECB from a liquidity haircut perspective and in the past were assigned to category IV similar to senior unsecured bank debt. However since 1 January 2011 all non-Jumbo covered bonds, including 'structured covered bonds' and multi-issuer covered bonds, together with traditional (UCITS-compliant) covered bonds, have been classified in liquidity category III.

For "structured covered bank bonds" there are additional requirements, including the following: (1) substitution asset limit of 10%, which can be exceeded at the discretion of the National Central Bank, (2) maximum LTV limit of 80% for residential and 60% for commercial mortgages, (3) minimum mandatory OC of 8% for residential and 10% for commercial mortgages, (4) maximum loan amount for residential real estate loans of EUR 1 m, (5) covered bond must have a long-term minimum rating of A-/A3

Covered Bonds and 'Close Link' Exemption

"Covered bank bonds" also benefit from certain preferential treatments compared with other bank debt when it comes to self-issued bonds. The ECB states that "irrespective of the fact that a marketable or non-marketable asset fulfils all eligibility criteria, a counterparty may not submit as collateral any asset issued or guaranteed by itself or by any other entity with which it has close links"[2]. This means that banks cannot, for example, use their own senior unsecured debt directly as collateral with the ECB.

In the past, issuers were able to securitize assets on their balance sheet and retain them as collateral for central bank repo operations. However, in addition to certain other changes outlined below, as a result of the increased use of securitisation technology to create ABS assets solely for use as collateral for central bank liquidity purposes, the ECB broadened the definition of "close links", which also extends to situations where a counterparty submits an asset-backed security as collateral when it (or any third party that has close links to it) provides support to that asset-backed security by entering into a currency hedge with the issuer or guarantor of the asset-backed security or by providing liquidity support of more than 20% of the nominal value of the asset-backed security.

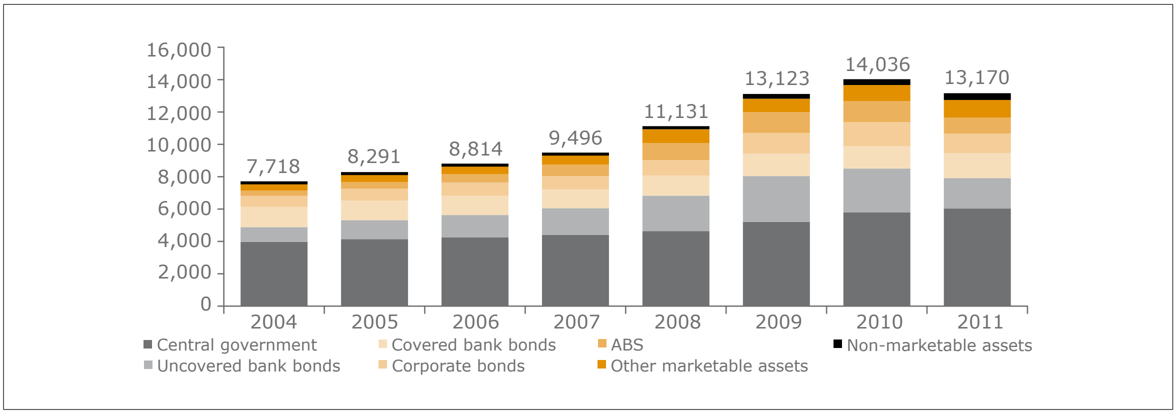
The main exemptions from the "close links" rule remain "covered bank bonds". Self-issued UCITS compliant covered bonds (as well as structured covered bank bonds, subject to strict additional criteria, as outlined above) can be used by counterparties as collateral, i.e. an issuer can use its own covered bonds and there are no close link prohibitions. This has been one of the drivers of the strong increase in new covered bond programmes since 2008.

[2] "Close links" means the counterparty is linked to an issuer/debtor/guarantor of eligible assets by one of the following forms:(i) the counterparty owns directly, or indirectly, through one or more other undertakings, 20 % or more of the capital of the issuer/debtor/guarantor; or (ii) the issuer/debtor/guarantor owns directly, or indirectly through one or more other undertakings, 20 % or more of the capital of the counterparty; or (iii) a third party owns more than 20 % of the capital of the counterparty and more than 20 % of the capital of the issuer/debtor/guarantor, either directly or indirectly, through one or more undertakings [ECB, "The Implementation on Monetary Policy in the Euro Area", February 2011].

Use of covered bonds as collateral in Eurosystem operations

The overall volume of marketable assets which had become eligible for repo operations had increased over 80% from EUR 7.7 trn in 2004 to EUR 14 trn at year-end 2010. In 2011 the eligible collateral volume decreased for the first time – by c.EUR 1 trn. The decrease was largely attributed to a decrease in eligible uncovered bank bonds as well as ABS and corporate bonds - due to rating downgrades. At end-2011 this meant central government debt accounted for the largest share (46%) followed by uncovered bank bonds (14%), covered bank bonds (12%), corporate bonds (9%), ABS (7%) and other bonds, such as supranationals (8%).[3]

> Figure 1: Eligible collateral by asset type



Source: ECB, RBS

The actual breakdown by type of the collateral used for repo transaction differs significantly from the market composition of the available eligible collateral as relative value considerations play an important role in the banks' decisions as to which collateral to post.

Over the last few years, there has been a general trend to lower the overall quality and/or liquidity of the collateral used by the banks for repo operations. The share of central government debt had fallen sharply, from a 31% share in 2004 to just 11% in 2009; though this rose slightly in 2010 and 2011 to 14%

The use of covered bank bonds (which includes only UCITS compliant covered bonds) in the Eurosystem repo operations dropped from 26% in 2004 to 11% in 2008 but subsequently increased to 16% in 2011.

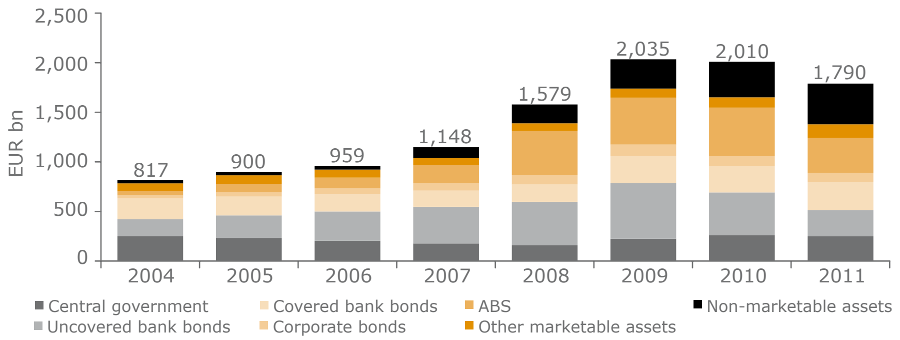
The share of uncovered bank bonds (which included general law based covered bonds) dropped from 21% in 2010 to 15% in 2011 after it had significantly increased from 21% in 2004 to 32% in 2007.

The most notable increase over the period was in ABS, which grew from 6% to 28% in 2008 before stabilising at 23% and 24% in 2009 and 2010 respectively. In 2011 their share decreased to 20%. The share of non-marketable securities continued to rise, representing 23% in 2011, compared to 18% in 2009 and only 9% in 2008.

[3] Although included within the list of eligible collateral, the volume of potentially eligible non-marketable assets is difficult to estimate since the eligibility of credit claims (the largest share of non-marketable assets) are not assessed until they are registered with the Eurosystem.

Figure 2 also shows the large rise in the main and long-term refinancing operations of the Eurosystem banks in autumn 2008 and then an even larger increase during the course of 2009. Total usage stabilised in 2010 and declined in 2011 to a total usage of EUR 1,790 bn.

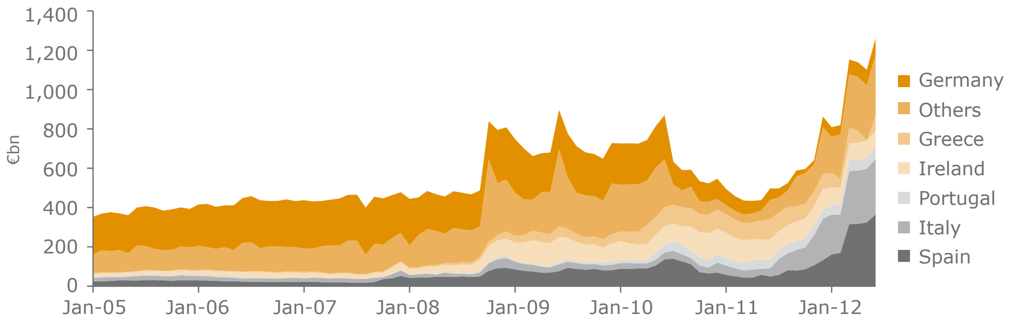
> FIGURE 2: ACTUAL USE OF COLLATERAL BY ASSET TYPE



Source: ECB, RBS

Only some of the European central banks publish figures of the national take-up of the repo facilities. Nonetheless these clearly show that whilst banks have all increased their usage of the ECB facility since the beginning of the credit crunch, with the onset of the sovereign crisis (spring 2010) the composition of the banks using the facility has changed significantly with a disproportionally high increase in usage of ECB repo facilities from banks in the Europe's periphery. Figures by the national central banks show that the usage of the central bank facilities by the banks out of Europe's periphery has significantly increased in the course of 2011 and remains elevated as of July 2012 as the ECB remains one of the major funding channels for many of these banks. The two huge long-term LTROs conducted in December 2011 and February 2012 have further boosted the repo volumes.

> FIGURE 3: COMPOSITION OF TOTAL EUROSYSTEM LENDING TO EURO AREA CREDIT INSTITUTIONS



Source: Eurosystem, RBS

Funding via the Eurosystem's Refinancing Facilities is awarded on an auction basis. Traditionally this auction has taken the form of a variable rate tender, whereby financial institutions bid for funds. Bids with the highest interest rate levels are satisfied first and subsequently bids with successively lower interest rates are accepted until the total liquidity to be allotted is exhausted. In 2008 the effective refinancing rate tended to be above the target refinancing rate, as the number of banks bidding for funding through the ECB's refinancing operations had spiked, pushing the effective rate higher due to the greater demand. To counteract this and to bring the effective rate in line with the target rate, the ECB decided to perform its refinancing operations on a fixed-rate tender basis from March 2009, originally until March 2010. This has meant that for many issuers, the cost of raising funds via the ECB has been significantly cheaper compared to issuing covered bonds in the capital markets.

In March 2010 the ECB announced that it would begin return to regular variable rate tenders in the regular three-month operations, beginning with those in April 2010, as part of the gradual phasing out of the non-standard measures. However as a result of the sovereign debt crisis, this has been postponed on a number of occasions - firstly in May 2010 (alongside the initiation of the Security Markets' Programme), then subsequently in June, September and December 2010 as well as in March and June 2011. In August 2011, the ECB again announced of the extension of fixed rate, full allotment procedures for all the Q4 2011 operations, as well as a supplementary 6m LTRO. In late 2011 the ECB announced two 3-year Longer-term refinancing operations (LTROs) that were conducted as fixed rate tender procedures with full allotment at the end of December 2011 and in February 2012.

The ECB has proved reluctant to move back to variable rate tenders whilst there remains a risk of a spike in the bid rates for liquidity, which would indicate acute liquidity needs from some financial institutions.

Conclusion on covered bond treatment

The ECB, to a greater extent than any of its central bank peers, has both outlined and demonstrated its support in the past for the covered bond market. This was most obviously the case with its highly successful EUR 60 bn covered bond purchase programme in 2009/2010, but also with the creation of the EUR 40 bn second purchase programme in late 2011 although this has so far only modestly been used. Perhaps even more important is the ECB's positive stance towards covered bonds which it maintains for several reasons. Firstly the ECB has focussed on the importance of covered bonds as a means for banks of accessing long term funding: "Issuing covered bonds enhances a bank's ability to match the duration of its liabilities to that of its mortgage loan portfolio, enabling a better management of its exposure to interest rate risk. Other secured funding products, such as repos, are unlikely to have the same asset-liability matching attributes offered by covered bonds. All these issues are all the more important today given the increasing role of short-term refinancing in banks' balance sheets. In certain instances, rolling over short-term funding might be less expensive or better in terms of reputation, but this could pose challenges to the management of assets and liabilities at some point. In addition to improving banks' structural asset-liability mismatch, covered bonds offer a wider geographical diversification, as issuers tap into a larger European market"[4].

[4] European Central Bank, "Covered Bonds in the EU Financial System", December 2008.

Moreover, a key second justification is regarding the absence of effective risk transfer and the desirable incentives this creates for the originating banks. As former ECB president Trichet himself noted: "importantly, covered bonds do not involve the transfer of the credit risk implied by underlying assets from the issuer to the investor. The credit risk stays with the originator, preserving the incentives for prudent credit risk evaluation and monitoring"[5]. The two points are reflected both in the ECB's current favourable treatment of covered bonds within its repo operations, such particularly the favourable liquidity category (Jumbo covered bonds ranking alongside the debt of the EFSF, EIB and the explicitly German-guaranteed agency KfW no less) and also in the ongoing changes the ECB implements to these operation, for example the re-classification of liquidity category and more favourable haircut now applied to 'structured covered bonds' and 'multi-issuer covered bonds' since the beginning of 2011.

2.3.2 THE UK: ELIGIBILITY CRITERIA FOR BANK OF ENGLAND OPERATIONS

The Bank of England (BoE) operates a rather stricter regime than the ECB in terms of eligible collateral within the Sterling Monetary Framework. The BoE defines three collateral sets, which are eligible to varying degrees for its monetary operations: (1) the Narrow Open-Market-Operations (OMO) collateral set, (2) the Wider OMO collateral set and (3) Discount-Window-Facility (DWF) Collateral.

Within the Sterling monetary framework operations, covered bonds are only included within the latter two wider collateral sets, namely the "Wider OMO Collateral Set" and "DWF Collateral". The eligibility criteria for covered bond inclusion can be found below:

>Figure 4: Bank of England's covered bond eligibility criteria

	Wider OMO Collateral Set	DWF Collateral
Eligible currencies	GBP, EUR, USD, AUD, CAN, CHF, and SEK	
Geography	UK, French, German and Spanish regulated Covered Bonds	EEA
Minimum Rating by two or more of S&P, Moody's and Fitch	AAA rated	A3/A- provided that AAA rated at time of issuance
Minimum Size	At least £1bn or €1bn (depending on issue currency)	n/a
Own Name Covered Bonds	No	Yes
Underlying assets	UK or EEA residential mortgages, social housing loans or public sector debt	UK, EEA residential mortgages, UK, US or EEA social housing loans or public sector debt, commercial mortgages, SME loans and certain ECA-guaranteed loans

Source: Bank of England, RBS

For the Wider OMO Collateral Set, only a subset of the covered bond universe is eligible. The criteria are based on a combination of both credit quality (hence underlined by the AAA rating requirement) and liquidity. For example covered bonds from Nordic issuers, one of the core covered bond markets with an acknowledged safe haven status, are not included in the Wider OMO Collateral Set, whereas Spanish covered bonds are generally included but do currently not fulfil the minimum rating requirement anymore. Meanwhile under the current guidelines, even for some of the UK banks, mainly their

[5] Keynote address by Jean-Claude Trichet, Munich, 13 July 2009.

Euro covered bonds would be eligible, given that many of the Sterling covered bonds still fall below the minimum issue size threshold of GBP 1 bn.

Covered bonds do not qualify for the Bank of England's narrow collateral set which is restricted to Gilts (including gilt strips), Sterling Treasury bills, Bank of England securities, HM Government non-sterling marketable debt and Sterling, euro, US dollar and Canadian dollar-denominated securities (including associated strips) issued by the governments and central banks of Canada, France, Germany, the Netherlands and the US.

In 2011, bonds issued in domestic currency or in Sterling, Euro or US dollars from Australia, Austria, Belgium, Denmark, Finland, Italy, Japan, Luxembourg, New Zealand, Norway, Portugal, Slovenia, Spain, Sweden, and Switzerland, as well as supranational debt were moved from the narrow to the wider collateral set and are therefore not eligible for short term repo operations. Thus even some AAA countries such as Norway, Denmark or Finland are no longer eligible for short-term repos under the narrow collateral definition. These amendments were the result of an internal BoE's review and reflect the stronger focus on liquidity, as well as credit risk. As mentioned above, the Bank of England conducts a number of different monetary policy operations. The table below shows the eligibility of different collateral sets for the various operations.

Monetary Operation	Narrow OMO Collateral Set	Wider OMO Collateral Set	DWF Collateral
Real Time Gross Settlement	Yes	No	No
Operational Standing Facilities	Yes	No	No
Short-term OMOs	Yes	No	No
Indexed Long-term Repo Operations	Yes	**Yes**	No
Discount-Window Facility	Yes	**Yes**	**Yes**
Extended Collateral Term Repo	Yes	**Yes**	**Yes**
Funding For Lending Scheme	Yes	**Yes**	**Yes**

Source: Bank of England, RBS

Operational Standing Facility

The Operational Standing Lending Facility provides a ceiling for the overnight interest rates through its overnight lending facility (against the narrow OMO collateral set), which is usually set at 25bp above the Bank of England rate. The Operational Standing Deposit Facility is an unsecured overnight deposit with the central bank which is currently set 50bp below the Bank of England rate. This is designed to limit volatility in overnight interest rates by providing an arbitrage mechanism to prevent money market rates moving far from the bank rate and allowing participating banks to manage unexpected frictional payment shocks.

Short-term Open Market Operations (OMOs)

Short-term Open Market Operations (OMOs) are designed to supply the quantity of reserves consistent with the aggregate target set by the banks for that maintenance period (the period over which compliance with reserve requirements is calculated) under the reserve averaging process. These operations have been suspended since March 2009 as a result of the BoE's asset purchase scheme (QE), so the supply of reserves is currently determined by the level of reserves. At the moment the BoE is operating a 'floor system' where all reserves are remunerated at the Bank Rate.

Long-term repo operations

Long term indexed repo operations are provided by the Bank of England "to provide indexed liquidity insurance without distorting banks' incentives for prudent liquidity management and minimising the risk being taken onto the BoE's balance sheet." These operations are indexed to the bank rate, allowing counterparties to use the facility without having to take a view on the future path of the Bank rate (and also reducing the BoE's exposure to market risk). In these operations banks can borrow against narrow, as well as wider OMO collateral, which includes covered bonds meeting the aforementioned criteria.

The BoE typically offers funds in long-term repo operations once every month; offering a preannounced quantity at a single maturity. Normally, two operations with a three-month maturity and one operation with a six-month maturity are offered; though the bank can alter these in cases of wider stress.

The BoE has a **unique auction pricing mechanism** and does not provide a simple schedule of long-term operations, as is the case for the ECB. Instead it operates a unique auction design. Firstly the size of the long-term indexed repo is fixed in advance. Subsequently, participants submit bids for a nominal amount of liquidity and a spread in basis points to the bank rate. Banks can submit separate bids against narrow OMO collateral or against the wider OMO collateral (where covered bonds are eligible). Multiple bids can be placed against either of the collateral sets[6]. Alternatively (or in addition) 'paired' bids can be submitted consisting of a single nominal amount and two spreads the counterparty is willing to borrow at, one for each collateral set. If both bids at above the clearing spread for the auction, the participants will be allocated against the bid which offers them better value which is defined as the highest spread relative to the clearing spread of the two collateral types. For example a paired bid for GBP 2 m of liquidity, at Bank rate +15bp for the narrow collateral set and Bank rate +35bp for the wider collateral set, where the auctions clear at Bank rate +10bp and Bank rate +34bp, then the participant would be allocated against the narrow collateral set (which is 5bp above the clearing rate, whilst the wider one is only 1bp over). This is a trade off against the risk of overallotment if the participant instead submits two separate bids.

The auction then prices using a 'uniform price' format, meaning all successful bidders (those bidding for liquidity at a higher price than the clearing spread) ultimately pay only the clearing spread.[7] There is one clearing spread for the narrow collateral and one for the wider collateral set. Thus, when pledging covered bonds in the BoE's long-term indexed repo operations, the ultimate cost to a bank will depend on the spread set for the wider collateral set in the auction. Crucially the proportion of the total fixed amount on offer which is allocated to each collateral set "is based on the pattern of bids received and the Bank's preferences for supply funds against each collateral set." This determines the amount of liquidity, against which covered bonds can potentially be pledged. So in this system the amount of liquidity on offer against the wider collateral set depends not only on demand for long-term repos on these assets but also on those in the narrower collateral set.

The Discount Window Facility (DWF)

The discount window is a bilateral facility used for emergency lending to an institution; providing liquidity insurance. It allows participants to borrow Gilts (or in extreme cases even cash) against a wider range of potentially less liquid eligible collateral. It acts as a "liquidity upgrade of collateral", hence the

[6] There is no maximum number of bids, only a maximum total value of bids from a single participant.

[7] The rationale here is to avoid participants basing their bids on assumptions about others' behaviour.

wider range of eligible collateral. Fees are paid when the Gilts are returned to the BoE in return for the original assets.

Collateral, which can be pledged, encompasses both the narrow and wider OMO collateral sets (described as level A and level B assets below) but also additional assets types. These can be subdivided further into high quality but illiquid collateral (level C) and level D (own name covered bonds and securitisations). The fees charged for the discount window depend upon the type of collateral used and the proportion of eligible liabilities, which the lending would represent.

Hence covered bonds could potentially fall into three different categories. Firstly covered bonds which already qualify for the wider collateral set (see above) are considered level B assets. Then for covered bonds qualifying as DWF collateral but not the wider OMO collateral, these classify as level C assets, unless they are own-name covered bonds, in which case they classify as level D assets.

The Extended Collateral Term Repo (ECTR)

The ECTR was launched in December 2011 and activated in June 2012. It is a contingency liquidity facility that the BoE can activate in response to actual or prospective exceptional market-wide stress to undertake operations against a wider set of collateral than with its indexed long-term repo operations. All DWF Collateral is eligible for the ECTR facility – including own-name covered bonds. The BoE "intends to hold an ECTR auction at least once a month until further notice"[8].

The Funding for Lending Scheme (FLS)

The FLS was launched on 13 July 2012 and is intended to encourage banks and building societies to increase their lending to UK households and corporates. Participants can borrow UK Treasury Bills against all DWF collateral. Both the fee and the amount participants can borrow will depend on their lending growth. The drawdown period runs from 1 August 2012 to 31 January 2014.

The fees payable in the DWF operations depend on the category of collateral. For lending provided in return for Gilts[9] the fees (in basis points) for the different categories of collateral are set out below:

Collateral Set				
% of Eligible Liabilities	**A (Narrow collateral)**	**B (Wider collateral)**	**C**	**D**
0%-10%	50	75	125	200
10%-20%	75	125	200	300
20%-30%	100	175	275	400
30%+	At discretion of the bank			

Source: Bank of England, RBS

[8] According to its Market Notice published on 15 June 2012.

[9] In the event that cash is lent instead, then the fee is the indexed bank rate in addition to the fees shown in the table; though such fees can vary at the bank's discretion.

The DWF is intended for borrowings of up to thirty days. A further 25bp will be added for drawings with an initial maturity of more than 30 days (though the current theoretical maximum is 364 days). The table below summarises the above mentioned monetary operations:

	Operational Standing Facilities	Indexed Long-term Repo	Discount Window Facility (DWF)	Extended Collateral Term Repo Facility
What is the primary purpose of the operation?	Monetary policy implementation Bilateral liquidity insurance to deal with frictional payment shocks	Liquidity insurance	Bilateral liquidity insurance	Liquidity insurance
What is being borrowed?	Deposit facility: n/a Lending facility: sterling cash	Sterling cash	Gilts	Sterling cash
Eligible Collateral	Deposit facility: n/a Lending facility: Narrow	Narrow, Wider	DWF	Narrow, Wider, DWF
Fee	Deposit facility: 0% Lending facility: 0.75%	Auction determined uniform spread indexed to Bank Rate	Fee dependant on size of drawing and collateral delivered	Auction determined uniform spread indexed to Bank Rate
Maturity	Overnight	Typically 3 or 6 months	30 or 364 days	6 months
Frequency	Available daily, all day	Typically monthly	Available daily, all day	Monthly

Source: Bank of England, RBS (as of July 2012)

Additional disclosure requirements for residential mortgage covered bonds

The Bank of England requires additional disclosure and transparency for RMBS and covered bonds backed by residential mortgages. The BoE requirements include anonymised loan level information for securities from these two asset classes to be provided at least quarterly. This must be provided for investors, potential investors and "certain other market professionals acting on their behalf." The information must be provided on at least a quarterly basis and within one month of an interest payment date.

During a transition period until 30 November 2012 securities not meeting the new requirements may remain eligible but will be subject to increasing haircuts, of 5% at the beginning of the period (December 2011) and a further 5% for each subsequent month. At the end of the period any covered bonds backed by mortgages which do not fulfil the criteria will be ineligible for use in any of the Bank of England's monetary policy operations[10].

Loan-level reporting will also include "the requirement for credit bureau score data" to be made available. This will need to be provided within a three-month period of the transaction's origination and must be updated on a quarterly basis. This is provided to enhance comparability between providers. The banks must provide the information on a 'comply or explain' basis. Where issuers are not able to provide certain data fields, this will not render a transaction ineligible automatically; instead the BoE will look at the rationale before determining eligibility and may choose to add additional haircuts. Nonetheless the BoE expects that ultimately all the mandatory information will need to be provided.

These additional transparency requirements do not apply to public sector covered bonds.

[10] With the exception of covered bonds already pledged within the Special Liquidity Scheme.

2.3.3 THE US: ELIGIBILITY CRITERIA FOR FEDERAL RESERVE OPERATIONS

The monetary policy operations of the Federal Reserve System work rather differently to those at the ECB or the Bank of England. The Federal Reserve Bank of New York implements monetary policy on behalf of the Federal Reserve System, as mandated by the Federal Open Market Committee (FOMC). Monetary policy is implemented through sales and purchases on the System Open Market Account (SOMA) at the Federal Reserve Bank of New York. This account is used both to maintain the overnight target rate for the federal funds rate (i.e. the US policy rate), as well as to undertake large scale asset purchase programmes decided upon by the FOMC. In particular, the two rounds of asset purchases (quantitative easing), the first consisting of Treasury securities, GSE debt and GSE-guaranteed MBS and the second solely Treasuries, as well as the reinvestment of the coupons and principal payments received from the first round of QE, have all gone through this account. Currently covered bonds are not eligible for any of SOMA operations, which are restricted to US Treasury Bills, Notes and Bonds (including TIPS), Federal Agency securities[11] and MBS guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae; all of which must be denominated in USD. Any of the additional operations put in place during the first stage of the financial crisis are no longer in place, meaning the only significant other monetary operation is that of the discount window.

Covered bonds and the Discount Window

Only a very small list of covered bonds are eligible for the discount window, namely: **US-issued covered bonds** and **AAA-rated German Jumbo Pfandbriefe**. In the case of the German Pfandbriefe, for the AAA requirement the lowest rating of S&P, Moody's and Fitch is relevant. A much softer rating restriction of simply being investment grade is applied to US-issued covered bonds.

"In general, the Federal Reserve seeks to value all pledged collateral at an internal fair market value estimate. Margins are applied to the Federal Reserve's internal fair market value estimates and are based on risk characteristics of the pledged asset as well as the anticipated volatility of the internal fair market value estimate of the pledged asset over an estimated liquidation period. Securities are typically valued using prices supplied by external vendors. Eligible securities for which a vendor price cannot readily be obtained will be assigned an internally modelled price."

The haircuts applied to the various assets eligible for use in the discount window are outlined below. Notably the foreign currencies eligible for the discount window are AUD, CAD, CHF, DKK, EUR, GBP, JPY and SEK.

The haircuts applied to covered bonds in the discount window operations are not very high and only marginally higher than those for Treasuries. For example for tenors of 5-10 years, USD-denominated Pfandbriefe are subject to a haircut of only 4%, the same as stripped Treasury notes or supranational paper, whilst US Covered bonds are only 1% higher. Nonetheless this reflects a positive stance of the Fed to all secured debt, since CMOs and AAA-rated ABS also receive this haircut.

Nonetheless the eligibility criteria for foreign issued covered bonds are very strict, including solely German Pfandbriefe, the alleged "Gold Standard" of the covered bond market. All other covered bonds effectively appear to be treated in the same manner as unsecured bank debt, i.e. effectively being excluded from the discount window. Even other well-developed legislation based covered bond types, such as Obligations Foncières or any of the various Nordic covered bonds have not been included.

[11] Fannie Mae, Freddie Mac and Federal Home Loan Bank.

		% of Market Value (by Maturity)		
Asset Class	**Asset Type**	**0-5 yrs**	**>5-10 yrs**	**>10 yrs**
US Treasuries	Bills/Notes/Bonds/TIPs	1.0	3.0	4.0
	STRIPs/Zero Coupon	2.0	4.0	8.0
FDIC Guaranteed	USD Denominated Bills/Notes/ Bonds	2.0	4.0	5.0
	USD Denominated Zero Coupon	3.0	5.0	9.0
	Foreign Denominated Bills/Notes/ Bonds	8.0	10.0	11.0
GSEs	Bills/Notes/Bonds	2.0	4.0	5.0
	Zero Coupon	3.0	5.0	9.0
Foreign Government Agencies	USD Denominated	2.0	4.0	7.0
	Foreign Denominated- AAA rated	8.0	10.0	13.0
Foreign Government, Foreign Government Guaranteed and Brady Bonds	USD Denominated- AAA rated	2.0	4.0	5.0
	USD Denominated- BBB-AA rated	3.0	5.0	6.0
	Foreign Denominated	8.0	10.0	11.0
Supranationals	USD Denominated	2.0	4.0	5.0
	Foreign Denominated- AAA rated	8.0	10.0	11.0
	Zero Coupon	3.0	5.0	9.0
Corporate Bonds	USD Denominated- AAA rated	3.0	5.0	6.0
	USD Denominated AA-BBB rated	5.0	7.0	8.0
	Foreign Denominated- AAA rated	9.0	11.0	12.0
US Issued Covered Bonds	**AAA rated**	**3.0**	**5.0**	**6.0**
	AA-BBB rated	**5.0**	**7.0**	**8.0**
German Jumbo Pfandbriefe	**AAA rated-USD Denominated**	**2.0**	**4.0**	**5.0**
	AAA rated- Foreign Denominated	**8.0**	**10.0**	**11.0**
Asset Backed Securities	AAA rated	2.0	5.0	17.0
	AA-BBB rated	11.0	14.0	18.0
	CDOs- AAA rated	8.0	9.0	10.0
	CMBS- AAA rated	3.0	7.0	8.0
Agency Backed Mortgages	Pass throughs	2.0	4.0	5.0
	CMOs	2.0	4.0	10.0
	Private-label CMOs- AAA rated	10.0	16.0	17.0
	Trust Preferred Securities	7.0	8.0	9.0
	Trust Deposit Facility- Term Deposits	0	n/a	n/a
	CDs, Bankers' Acceptances, CP, ABCP	3.0	n/a	n/a

Source: Fed, RBS

There is also a separate schedule for the percentage margin applied to loans, a number of categories of which are also eligible for the discount window facility. A further stipulation from the Fed is that obligations of the pledging depository institution are not eligible collateral. In our understanding, this rules out own-name covered bonds.

2.3.4 SWITZERLAND: ELIGIBILITY CRITERIA FOR SWISS NATIONAL BANK (SNB) OPERATIONS

SNB monetary policy operations

Under its monetary policy framework, the Swiss National Bank (SNB) sets a 100bp target range for the 3-month Swiss Franc LIBOR rate, with SNB targeting the middle of this range. Repos are its preferred open market operation used to achieve this target. These are conducted in parts by auctions, which are typically held every day in form of volume tender (though a rate tender is also possible). The SNB can also conduct bilateral repo operations to affect money market operations during the course of the day. All these repo transactions must be 100% collateralised. The terms are set on a daily basis and the maturity of the operations may vary from one day to twelve months. Hence, the SNB does not have distinct long-term repo operations in the same manner as the ECB or the BoE. Furthermore, the SNB can issue it own debt certificates as a means of absorbing liquidity through its money market operations when targeting the aforementioned policy rate (or range). Such debt certificates can also be posted back to the SNB in its repo operations (but cannot be used by banks to satisfy their minimum reserve requirements).

Under the SNB's typical volume tender, each counterparty offers for the amount of liquidity it is willing to provide for a given repo rate. If the total volume of offers exceeds the SNB's predetermine allotment volume, the SNB reduces the amounts offered proportionally. Each of counterparties receives the interest rate they bid. SNB Bill auctions are, as a rule, conducted in the form of a variable rate tender. Counterparties submit their offers comprising the amount of liquidity they are willing to provide and price at which they will do so. Counterparties can submit multiple bids, including at different interest rates. The SNB obtains liquidity from the participants that have made offers at or below the highest interest rate accepted by the SNB, paying the participants the interest rate stated in their offers.

In addition the SNB provides standing facilities (a liquidity shortage facility and an intraday facility). For such facilities the SNB does not actively intervene in the market but rather "merely specifies the conditions at which counterparties can obtain liquidity"[12]. Repo transactions within the context of standing facilities must cover at least 110% of the funds obtained. The remaining monetary policy operations used by the SNB are an intraday facility for banks, foreign exchange swaps with various central banks, as well as foreign exchange purchases (a means of intervening into foreign exchange markets affecting CHF).

Covered bonds and other collateral eligible for SNB repo operations

For the aforementioned monetary policy operations the SNB has a standard collateral set which does not distinguish between collateral eligible for different operations. This is in line with the ECB but in contrast to the BoE policy. The SNB accepts a slightly wider set of collateral for its operations. In this sense the SNB operates much more like the ECB than the Fed or BoE with the latter restricting eligible assets of short-term monetary policy operations to only the very highest-quality liquid government securities, with the exclusion of covered bonds.

[12] Guidelines of Swiss National Bank (SNB) on Monetary Policy Instruments.

Only collateral included in the list of eligible collateral for SNB repos may be pledged in the repo transactions. In order to be eligible, the collateral assets must fulfil the following criteria:

> They are issued by central banks, public sector entities, international or supranational institutions and private sector entities (securities issued by domestic banks and their subsidiaries abroad are not generally eligible as SNB collateral).

> They have a fixed principal amount with an unconditional redemption

> They have a fixed rate, floating rate or zero coupon

> They are traded on a recognised exchange or a representative market in Switzerland or member of the EEA with price data published on a regular basis.

> They fulfil the rating requirements (at least one of the three rating agencies S&P, Moody's and Fitch rates the country and issue above the minimum threshold).

As such covered bonds are eligible, as long as they are not issued by a domestic Swiss bank. The criteria for the various classes of eligible assets are further split between foreign and Swiss franc denominated criteria, the latter being somewhat less stringent. Please find these below:

	Currency of Issue	Min. Rating of Creditor's Country of Domicile	Min. Rating of Security	Minimum issue size	Additional Criteria
Swiss Franc Securities	CHF	A/A2*	A/A2**	100 CHF mln	Securities of foreign issuers must be listed on SIX Swiss Exchange
Foreign Currency Securities	EUR, USD, GBP, DKK, SEK, NOK	AA-/Aa3* (and must have registered office in Switzerland or an EEA country)	AA-/Aa3**	> CHF 1bn equivalent (at time of issuance)	

* Securities of supranational organisations may be eligible irrespective of rating of country of domicile.

** Swiss public authorities, domestic mortgage bond institutions (Pfandbriefanstalten), the central issuing office of Swiss municipalities and Swiss issuers with explicit guarantee from Swiss Confederation are excluded from this requirement.

Source: SNB, RBS

All securities contained in the list of collateral eligible for SNB repo transactions form part of the SNB GC Basket. Based on their characteristics, the securities in this collective basket are assigned to three different baskets. The CHF GC Basket contains the securities denominated in Swiss francs. Securities in foreign currencies issued by sovereign countries and central banks make up the Government GC Basket (GOV GC Basket). The International GC Basket (INTL GC Basket) contains all other foreign currency securities. Securities in Swiss francs with a minimum volume of CHF 1 bn and a minimum rating of AA-/Aa3 are eligible for two baskets: the CHF GC Basket and either the GOV GC Basket or the INTL GC Basket.

As is the case with all central banks the SNB can decide on a case-by-case basis which securities are eligible for its repo operations. Its rules explicitly state that it "may reject the inclusion of securities or withdraw securities that were previously included in the list, without providing any justification".

Own name covered bonds

The SNB publicly states that it does not accept counterparties' own securities or "those issued by persons or companies that form an economic unit with the counterparty." It defines an enterprise as belonging to the same economic unit as the counterparty if 20% of the capital or voting rights are held. Nonetheless it explicitly states that "this 20% rule does not apply to participations in mortgage bond banks or similar institutions". Although it is not explicitly stated in official documents, SNB officials confirmed to us that own name covered bonds cannot be included within the boundaries set by the definition of eligible collateral.

2.3.5 NORWAY: ELIGIBILITY CRITERIA FOR NORGES BANK OPERATIONS

Norges Bank monetary policy operations

The policy rate of Norges Bank is the sight deposit rate, the rate of interest banks receive on their overnight deposits in Norges Bank. Unlike other central banks the key policy rate is not a target for overnight interest rates realised in money markets. Instead, the sight deposit rate form a floor for very-short term money rates, whilst the overnight lending rate charged to banks for overnight loans (for "D-Loans", see below) is the other though less important interest rate, which forms a ceiling for very short term money rates. This is typically set 100bp above the key policy rate. Norges Bank uses F-deposits (fixed-rate deposits) to remove unwanted liquidity out of the system.

In terms of providing liquidity, Norges Bank provides intraday and overnight loans ("D-Loans"), which must be 100% collateralised. The bank also provides longer term liquidity through "F-loans" (fixed-rate loans), repurchase agreements and currency swaps. F-loans are ordinary fixed rate loans with a given maturity provided against acceptable collateral "in the form of approved securities." The interest payable on such loans is determined by a multi-price ('American') auction. Just like in the case of the SNB, Norges Bank determines the total amount to be allotted in such an operation. Bids for the loans are ranked in decreasing order and allotments are made until the total amount is distributed with every counterparty paying its respective bid price. Such loans also must be 100% collateralized.

Norges Bank has primarily granted "F-loans" to financial institutions rather than longer-term repo operations, following previously unsuccessful attempts to encourage the use of repo facility in the past. F-loans are provided for a number of different maturities, much like the longer-term ECB-refinancing operations. Again in an ECB-reminiscent manner, longer maturity F-loans were provided during the credit crunch; these even included the provision of a 3-year F-loan by the Norges Bank in February 2009.

The collateral set eligible for short-term "D-loans" at Norges Bank is identical to that for the longer-term "F-loans". Norges Bank only uses one collateral set for all its operations. Its collateral rules group different securities into various liquidity categories, much like the ECB (see below for further detail on these).

Covered bonds and other collateral eligible for Norges Bank repo operations

In order to be eligible as collateral, securities must be listed on Norges Bank's website and have to fulfill the following eligibility criteria:

Type and Jurisdiction

> Bonds, notes and short-term paper issued from Norwegian and foreign issuers;

> Securities issued outside the EEA may be accepted provided that Norges Bank has legal confirmation that there are no problems associated with the realising of the collateral;

> Norwegian bond and money market funds (confined to investing in bonds, notes and short-term paper) are eligible as collateral provided that they are managed by a management company registered in Norway whose unit holdings are registered with the VPS and that Norges Bank has access to price information from Oslo Børs Informasjon.

Credit rating

> Securities issued by foreign issuers and bonds, notes and short-term paper issued by Norwegian private entities are subject to credit rating requirements. Covered bonds issued under Norwegian law are exempt from the rating requirement if they are backed by domestic mortgage loans. For securities issued by Norwegian entities a credit rating of the issuer is sufficient.

> Norges Bank accepts credit ratings from S&P, Fitch and Moody's. A best rating approach is used, i.e. a satisfactory credit rating from just one of these three agencies is sufficient. The lowest acceptable credit rating for bonds with foreign issuers is A/A2, while the lowest acceptable credit rating for bonds issued by Norwegian issuers is BBB-/Baa3[13].

Listing

> Securities issued by private entities are subject to listing requirements. Private securities must be pledged in the VPS, must be listed on a stock exchange or other market place approved by Norges Bank.

> Securities pledged as collateral in another securities depository approved by Norges Bank must be listed on a stock exchange.

> The listing requirement does not apply to notes and short-term paper.

Requirements relating to minimum volume outstanding

> Securities issued by private entities are subject to requirements relating to minimum volume outstanding: securities in NOK must have a minimum outstanding volume of NOK 300 m, whilst securities in a foreign currency must have a minimum volume equivalent to EUR 100 m.

> If a security issued by a private entity is denominated in a foreign currency, a bank may not pledge more than 20% of the loan's outstanding volume to Norges Bank. The same applies to asset-backed securities (ABS) denominated in NOK.

Currency Restrictions

> Securities shall be denominated in NOK, SEK, DKK, EUR, USD, GBP, JPY, AUD, NZD or CHF.

Multilateral development banks, government-guaranteed and regional debt securities

> The Norges Bank may, subject to an assessment, exempt securities with irrevocable and unconditional government guarantees from the listing and minimum outstanding volume requirements. Subject to an assessment, Norges Bank may also permit a bank to collateralise more than 20% of the outstanding volume of a security of this type.

> Subject to an assessment, Norges Bank may grant the equivalent exemption for securities issued by regional or local authorities or multilateral development banks, as well as for government-guaranteed securities. These securities must then have a risk weighting of 0% in accordance with the capital adequacy requirements.

> In the case of government-guaranteed securities and securities issued by regional or local authorities or multilateral development banks, Norges Bank may, subject to an assessment, accept a credit rating provided by the issuer or the government guarantor.

[13] The lowest acceptable credit rating for notes and short-term paper issued by foreign entities is A-1 from S&P or the equivalent rating from Fitch or Moody's, while the lowest acceptable credit rating for notes and short-term paper from Norwegian issuers is A-3 from S&P or the equivalent rating from Fitch or Moody's.

ABS and Other Restrictions

- Asset Backed Securities (ABSs) must have a AAA credit rating from S&P, Fitch or Moody's at the time of collateralisation and must be assessed by Norges Bank as what are termed "true sale" ABSs and must not be secured on commercial property loans.
- Only the upper tranche will be accepted as collateral and the borrower cannot pledge more than 20 per cent of the volume outstanding of any deal.
- An ABS may be rejected if the pledging bank has close ties to the special purpose vehicle of an ABS (for example in the form of agreements on interest rate or currency swaps, lines of credit or the servicing of loans)
- Collateralised debt obligations (CDOs) are not eligible as collateral.
- Unsecured securities issued by banks and other financial institutions, or unsecured bonds issued by companies where banks or other financial institutions indirectly or directly own more than 33% are not eligible.

Own-name covered bonds

- A bank may pledge covered bonds and ABS as collateral even if the securities are issued by the bank itself or by an entity that is part of the same corporate group as the bank. Own-name covered bonds are subject to an additional haircut of 5%.

Haircuts

- The haircuts applied to the market value of a security are set out by category below:

> Norges Bank Haircuts by Category and Residual Maturity (% of market value)

Liquidity Category	**Liquidity Category I**		**Liquidity Category II**		**Liquidity Category III**		**Liquidity Category IV**	
Eligible Collateral	> AAA rated Government Bonds > Money market and bond funds confined to investments in the above securities.		> Government bonds rated AA+ to A > Covered bonds rated AAA to AA- > Norwegian local government paper > Foreign local government paper rated A or better > 0% RW paper > AAA rated corporates		> Covered bonds rated A+ to A > Corporate bonds rated AA+ to A.		> Norwegian covered bonds rated A- or lower and unrated > Norwegian corporate bonds rated A- to BBB-	
Maturity	Fixed	Floating	Fixed	Floating	Fixed	Floating	Fixed	Floating
0-1 year	1.0	1.0	3.0	3.0	4.0	4.0	8.0	8.0
1-3 years	3.0	1.0	5.0	4.0	6.0	5.0	11.0	10.0
3-7 years	5.0	1.0	7.0	5.0	10.0	7.0	17.0	14.0
7+ years	7.0	1.0	10.0	6.0	13.0	9.0	22.0	17.0

Source: RBS, Norges Bank

Securities in foreign currencies and own-name covered bonds are subject to a further 5% haircut. ABS are subject to a 15% haircut, regardless of maturity. Additional haircuts apply on FRNs if no price information is available.

Temporary Norges Bank monetary policy operations, a unique swap arrangement

Another monetary policy instrument used by Norges Bank, which is somewhat unique in the context of covered bonds, is a swap arrangement where banks could swap covered bonds in return for government securities. The arrangement was put in place in November 2008 for NOK 230 bn. The maturity of the swaps was originally three years but was subsequently extended to five years.

2.3.6 AUSTRALIA: ELIGIBILITY CRITERIA FOR RESERVE BANK OF AUSTRALIA (RBA) OPERATIONS

The Reserve Bank of Australia (RBA) expresses its desired stance of monetary policy through the operating target for the cash rate, the money market rate on overnight interbank funds. The RBA targets this through its short-term open-market operations. The same collateral set is also applicable to the longer-term operations provided.

Covered bonds and RBA eligible collateral

In order to be considered as eligible collateral by the RBA, all securities, including covered bonds, must fulfil the following criteria:

- > **Currency:** The security is denominated in Australian dollars and traded in Austraclear. The RBA will not accept securities that trade as Euro-entitlements.
- > **Rating:** The minimum credit rating for the security and issuer is based on the lowest rating of all major credit rating agencies. For covered bonds only security ratings are considered as long as long as at least two ratings are available. Otherwise minimum issuer ratings will also be considered.
- > **Structured bonds:** Highly structured securities or those with embedded derivatives are not eligible.
- > **Own name bonds:** Securities issued by the own bank or related entities are not eligible. A related party is deemed to be an institution that has a significant relationship to the credit quality of the security and so includes (but is not restricted to) the loan originator, swap counterparties and liquidity providers[14]. This 'related party exemption' also applies to covered bonds and as such "own name covered bonds" are not eligible for RBA repo operations.

RBA repos

When the RBA buys securities under repurchase agreement it does so in two broad classes of securities: General Collateral and Private Securities. Since the mid 1990s, the RBA has gradually widened the range of highly-rated securities that it is prepared to accept in response to the decline available government debt and taking into account the changing structure of financial markets.

In February 2012 the RBA changed the range of securities eligible for its repos. The only change pertained to the eligibility of securities issued by authorised deposit-taking institutions (ADIs) where the rating requirements were lowered. Generally, the lowest available security or issuer rating applies. For covered bonds only the lowest security rating is considered. The current set of eligible securities and the respective minimum rating requirements are given below:

[14] An exception applies in extraordinary circumstances when the RBA may accept related party RMBS or ABCP.

	Minimum Rating
General Collateral	
A$ Commonwealth Government Securities	n/a
A$ Semi-governments Securities	n/a
A$ Domestic Issues by Supranationals and Foreign Governments	A-1 or AAA*
A$ Securities with an Australian Government Guarantee	n/a
A$ Securities with a Foreign Sovereign Government Guarantee	A-1 or AAA*
Private Securities	
Securities (including Covered Bonds) issued by authorised deposit-taking institutions (ADIs)	
Residual maturity of 1Y or less	Any public rating
Residual maturity > 1Y	At least two ratings, the lowest being minimum BBB+
Asset Backed Securities	
Standard	A-1 or AAA
Other	A-1 or AAA
Other Securities	A-1 or AAA

* In the case of securities guaranteed by the New Zealand government AA+ is the minimum rating.

This mainly comprises covered bonds denominated in AUD and issued in the Kangaroo market (i.e. onshore) to be eligible for Repo transactions with the RBA. The RBA is willing to accept "other AAA assets" which includes covered bonds, as well as senior unsecured bank debt as long as it is rated AAA and denominated in AUD. The RBA accepts both legislative and structured covered bonds. Of course as with all central banks, the RBA retains the right to reject any particular security or securities from any issuer and specifically stated that it will not accept "highly structured" securities. This however does not apply to covered bonds but rather to CDOs or other such structures.

2.3.7 NEW ZEALAND: ELIGIBILITY CRITERIA FOR RESERVE BANK OF NEW ZEALAND (RBNZ) OPERATIONS

RBNZ monetary policy operations

The monetary operations of New Zealand are composed of (a) Liquidity Operations, (b) Standing Facilities and (c) Other Domestic Operations. The Open Market Operations (OMO) of the Reserve Bank of New Zealand (RBNZ), including *overnight repo transactions* and issuance of RBNZ bills (to remove unwanted liquidity) fall within the 'Liquidity Operations', as do the FX Swaps and Basis Swaps operations provided. The Standing facilities are made up of the Overnight Reverse Repo Facility and a Bond Lending Facility. Finally 'Other Domestic Operations' consist of the repurchase or swapping of New Zealand government securities.

The following securities are eligible for the RBNZ's overnight repo transactions within the Liquidity Operations and the Bond Lending Facilities (part of the Standing facilities):

> New Zealand Government Treasury bills

> New Zealand Government bonds

> New Zealand Government inflation-indexed bonds

> Other (non-New Zealand Government Securities) as approved by the RBNZ.

Covered bonds potentially fall within this final definition, as long as they comply with the eligibility criteria. These are set out in the section below.

Covered bonds are not eligible for the other RBNZ monetary operations. The eligibility of securities for the 'Overnight Reverse Repo' under the RBNZ Standing facilities is restricted solely to New Zealand Government bonds, Treasury bills and RBNZ bills. For the 'Other Domestic Operations', the RBNZ from time to time offers to either repurchase and/or swap New Zealand Government securities. The RBNZ announces its intention to repurchase and/or swap the relevant securities via the electronic media and the conditions applying to the operation are included. Purchases may be for the RBNZ's own account or on behalf of the Crown.

Covered bond eligibility for RBNZ operations

As explained above, covered bonds are eligible for the RBNZ's overnight repo transactions within the Liquidity Operations and the Bond Lending Facilities, as long as they fit the following criteria:

Rating

> Issues are rated AAA by at least two acceptable rating agencies. In case of more than two issue ratings, at least two agencies must rate the issue as AAA, and no rating should be lower than AA+.

> The issuer has a credit rating from at least two acceptable rating agencies.

Cover Pool

> The cover pool must be comprised of New Zealand originated first registered mortgages on New Zealand residential properties.

> The mortgage collateral is owned by a special purpose vehicle (SPV) that is bankruptcy remote from the originator.

> The loan to value ratio for each individual mortgage does not exceed 80%.

> Mortgages with loan to value ratios that exceed the 80% level will be removed from the cover pool and replaced with qualifying mortgages.

> Only loans that are performing have been included in the pool (non-performing loans are defined as those that are 90 days or more past due).

> "Asset monitors" independent from the trustee and the originator will verify calculations relating to asset coverage tests and any other key ratios and provide these, and any other relevant reports, to the RBNZ on a regular basis.

Price Sources

> Covered bond pricing will be available on at least 80% of days via the NZFMA's NZ Credit Market Daily Pricing Service. Pricing will be available at all month-ends.

Currency

> Issues are denominated in New Zealand dollars (NZD only)

Settlement

> Covered bonds are lodged and settled in NZClear. Eligibility criteria for lodgment into NZClear include having a suitable registrar, and paying agent.

Own-name bonds

> Covered bonds are repo eligible on a two-name basis only, thus removing the possibility that issuers posting 'own-name' covered bonds to the RBNZ.

Of course, as is the case for all central banks, the RBNZ reserves the right to refuse an asset for any reason and is not required to disclose such reasons. In particular, "it should be noted that if the credit rating of the issue falls below the Reserve Bank's threshold, then the issue will cease to be eligible in the Reserve Banks' operations."

Thus the RBNZ applies relatively strict criteria in setting eligibility for covered bonds, in particular the requirement that the cover pool can only comprise of New Zealand originated first registered mortgages on New Zealand residential properties currently restricts the use of the repo facility to covered bonds issued by domestic banks[15] (or New Zealand subsidiaries of foreign banks using domestic loans); nonetheless if a foreign issuer were to have eligible loans in the pool (and fulfill all the other criteria), their covered bonds could also be eligible. This of course would also subject such bonds to the strict criterion restricting eligibility to solely NZD-denominated covered bonds. This is consistent with the RBNZ criteria for all other securities eligible in a similar manner to covered bonds, with securities guaranteed by the NZ government being the sole exception; even foreign government issued or guaranteed paper must be NZD-denominated, so Treasuries or Bunds in their domestic currencies would technically not be eligible for the RBNZ's operations.

The full haircuts schedule can be found below. It shows that NZD Covered bonds receive relatively benign haircuts, in line with two-name basis NZD-denominated RMBS, but significantly better than single-name RMBS, all but AAA bank and corporate debt and state owned enterprise bonds. In fact the haircuts of 5% and 8% for securities above and below 3-years respectively are even lower than the 6% and 8% for NZD-denominated New-Zealand government guaranteed securities and NZD foreign-government guaranteed claims. In effect only Kauri and New-Zealand government securities (and RBNZ bills) receive lower haircuts. Thus ultimately, the eligibility criteria for repo are strict but eligible covered bonds receive highly favourable treatment.

[15] As of end-July 2012, only two covered bonds were eligible: the Bank of New Zealand 6.0% June-2015 and Bank of New Zealand 6.425% June-2017 covered bonds.

Eligible Security	Minimum Rating	Haircut	
		< 3 years	≥ 3 years
NZ Government & RBNZ			
Treasury Bills	AAA	1%	3%
Bonds			
Inflation-linked Bonds			
RBNZ Bills	n/a	1%	3%
Acceptable Kauri issues (NZD)	AAA	3%	5%
	AA-	6%	8%
	A-	10%	15%
Bank Securities (NZD)			
Bank bonds - NZ Registered Banks only	AAA	5%	8%
	AA-	8%	10%
	A-	10%	15%
	BBB-	15%	20%
NZ Registered Bank RCD's	A-1+	10%	n/a
	A-1	15%	n/a
	A-2	20%	n/a
Local Authorities (NZD)			
Bonds	AAA	5%	8%
	AA-	8%	10%
	A-	10%	15%
	BBB-	15%	20%
CP	A-1+	10%	n/a
	A-1	15%	n/a
	A-2	20%	n/a
State-Owned Enterprises (NZD)			
Bonds	AAA	5%	8%
	AA-	8%	10%
	A-	10%	15%
	BBB-	15%	20%
CP	A-1+	10%	n/a
	A-1	15%	n/a
	A-2	20%	n/a
Corporate Securities (NZD)			
Bonds	AAA	5%	8%
	AA-	8%	10%
	A-	10%	15%
	BBB-	15%	20%
CP	A-1+	10%	n/a
	A-1	15%	n/a
	A-2	20%	n/a

Eligible Security	Minimum Rating	Haircut	
		< 3 years	≥ 3 years
Securities guaranteed by NZ government			
NZD Denominated	AA+	6%	8%
	A-1+		
Non-NZD Denominated	AA+	11%	13%
	A-1+		
Securities issued/guaranteed by Foreign governments			
NZD Denominated	AA+	6%	8%
Securities issued/guaranteed by Foreign governments (NZD)			
Bonds	AA+	6%	8%
CP			
RMBS (NZD- on a single name basis)			
Bonds	AAA	19%	
CP			
RMBS (NZD- on a two name basis)			
Bonds	AAA	5%	8%
CP			
Covered Bonds (NZD)			
Bonds	AAA	5%	8%

COVERED BONDS AND REPOS: CONCLUSION

The comparison of the various treatments of covered bonds by some of the major central banks underlines the special status of covered bonds. This is driven in our opinion by the macro-economic benefits of covered bonds through the provision of cheap residential (and commercial) mortgages and by giving banks a stable and relatively cheap additional funding channel. However, there is not one uniform approach and the stances towards covered bonds of the various central banks differ considerably. As already indicated in the introduction, broadly speaking covered bonds receive more favourable treatment amongst those countries in which they play a more pivotal role in the funding of the domestic banking sector. This applies primarily in terms of eligibility of covered bonds as collateral for repo operations, but also in terms of the haircuts.

2.4 COVERED BONDS VS. SENIOR UNSECURED BANK DEBT AND RMBS

By Bernd Volk, Deutsche Bank and Frank Will, RBS

2.4.1 COVERED BONDS VS. RMBS

Pre-crisis convergence of covered Bonds and MBS

Mortgage Backed Securities (MBS) are eligible as collateral for covered bonds in numerous jurisdictions (e.g. France, Italy, Ireland and Luxembourg). Moreover, the boundaries between covered bonds and MBS were in certain instances starting to become blurred before the crisis. In countries without specific legal framework for covered bonds, so-called structured (or general law based) covered bonds were structured with the help of securitisation techniques to replicate the dual claim characteristic for covered bonds.

Covered bonds are an on-balance sheet funding tool

However, in contrast to securitisations, in case of covered bonds, the assets remain on the balance sheet of the issuers. Some covered bond structures could be seen as utilizing a quasi-SPV specifically dedicated to the issuance of covered bonds because although the issuer is a credit institution, it is in fact a specialised covered bond bank. The specialised issuer uses the issue proceeds to buy mortgage loans at the operating bank or to grant loans to the operating bank, the originator of the mortgage loans. In case of the latter, the operating bank keeps the mortgage loans on its balance sheet and pledges them to guarantee the loans received from the covered bond bank. However, in both cases, covered bonds are an on-bank-balance sheet funding tool.

Covered bonds have a dynamic cover pool

All outstanding covered bonds by one issuer are typically backed by all loans in the cover pool. There is no connection between a specific cover asset and outstanding covered bonds (like typically in case of MBS). In case of issuer insolvency no further assets will typically be added to the cover pool - i.e. the cover pool administrator loses the capability to bring in sufficient new assets in order to comply with the coverage regulations. As long as the issuer is solvent, the issuer manages the cover pool and can take in and out cover assets.

MBS have typically a static pool and credit enhancement by tranching

As covered bonds typically have a fixed rate bullet structure, the cover pool has to be constantly ‘refilled’, i.e. mortgage loans becoming due have to be reinvested. This can lead to higher credit and market risk in the cover pool compared to triple senior tranches of MBS transactions. Generally, a dynamic cover pool creates the need of an accurate asset liability management including stress test scenarios. Apart from the credit risk of the cover pool assets, risks are the potential lower yield of newly added assets (negative carry risk as a result of differing amortization profiles of covered bonds and cover assets), the management of the interest rates risks between the fixed rate covered bonds and (often) variable rate mortgage loans, and typically the need to sell cover assets in case of issuer insolvency to pay covered bonds with bullet maturities. As a result of the dynamic pool, covered bonds typically have a longer maturity than MBS. Due to the above-mentioned market risk in case of issuer insolvency, overcollateralisation (OC) requirements by rating agencies regarding covered bonds are typically much bigger than subordination requirements for senior tranches of RMBS.

Maturity extension as main risk of RMBS

One of the main risks of MBS is sharp maturity extensions. MBS prepayment varies from jurisdiction to jurisdiction. The UK is predominantly characterised by Master Trusts, which rely upon high prepayment rates to meet scheduled maturities. Sponsors have however injected assets into trusts, issued further bonds or purchased notes in order to meet scheduled redemptions. MBS from Ireland, Portugal and the Netherlands will typically rely upon varying degrees of prepayment and sponsor call. Lower prepayment rates along with the lack of fully functioning debt capital markets have meant that extension risk has become a core consideration in European RMBS.

In MBS, the highest credit risk is concentrated in the subordinated bonds where losses hit first according to the "tranching" of the mortgage portfolio. Investors have no recourse against the originator of the assets, and the risk is limited to the pool of assets that has been securitized. MBS cover pools are, in most cases, static in the sense that even if assets can be substituted after a deal's launch (for instance in UK MBS Master Trusts), these additional assets do not lead to an increase in overcollateralisation as they would in a covered bond. However, overcollateralisation does increase as the underlying pool of mortgage loans decreases over time due to borrowers paying back their obligations. MBS Master Trusts are different in this regard, having revolving cover pools where principal repayments are re-invested in new assets, subject to a set of eligibility criteria and concentration limits that the underlying assets have to conform to both on a single asset and on a portfolio level. Nevertheless, in contrast to covered bonds, MBS investors are more exposed to the performance of the pool. Bad performance of the portfolio erodes investor protection. Investors in MBS only bear the risk arising from these mortgage loans and are independent from the credit risk of the respective (former) owner of such assets (the originator/seller e.g. a bank).

In case of covered bonds, increasing non-performing loans in the cover pool are a negative indicator regarding issuer credit quality. The issuer typically takes out non-performing loans (i.e. keeps the pool clean). In most countries, issuers are obliged to do so by law. When non-performing loans in the cover pool increase, it suggests that the issuer is no longer able to support the cover pool, in turn, indicating declining issuer credit quality.

OC of covered bonds typically much bigger than subordination of MBS

Typically, OC requirements of rating agencies to achieve triple-A ratings are much higher for covered bonds than for senior RMBS tranches. This is mainly due to covered bonds facing not only credit risk but also market risks, due to typically high mismatches between cover pool assets and outstanding fixed bullet covered bonds. Spanish Cédulas for instance typically face minimum OC requirements significantly over 25% to keep current ratings. At the same time, numerous Spanish RMBS have credit enhancements of only above 10%. In this respect, the latest rating agency statistics, comparing expected cover pool losses (credit risk) and OC requirements (credit risk and market risk) of covered bonds, is interesting, again showing that OC requirements are driven mainly by market risk.

Covered bondholders have recourse against a bank

A crucial difference between covered bonds and MBS is that covered bondholders have recourse against a bank, not only the underlying assets transferred to a SPV as in case of MBS. Hence, investors have a dual claim. MBS proponents typically highlight that there is a high correlation between the credit quality of the cover pool assets of covered bonds and the credit quality of the issuer. In case the cover pool credit quality worsens, the issuer credit quality will also worsen. However, in such a scenario, the issuing bank (or the parent company) might receive external support by its banking group or public sector entities.

Regulatory changes regarding banks relating to capital, liquidity buffers, net stable funding ratio, risk weighting and leverage limit are likely to make the banks fundamentally stronger which in turn would support covered bond markets. In our view, this is one of the reasons for covered bonds outperforming MBS at the beginning of the financial market crisis. At the end of the day, covered bonds are bank bonds. The preferential claim on the cover pool is an add-on, something which may be valued more or less by investors.

Covered bonds are excluded from bail-in

Whereas there was no support for MBS (i.e. investors were fully exposed to the risk of the underlying assets and the structure they bought) there was strong support for covered bonds via support for the issuing banks in numerous cases (e.g. Washington Mutual, Northern Rock, Bradford and Bingley, Hypo Real Estate, Düsseldorfer Hypothelenbank, Kauphting, etc.). One could argue that while that has occurred to date, given sovereign pressures, a key risk is the willingness and ability of governments to bail out banks. However, in our view, declining willingness of sovereigns to support banks will first impact Lower Tier 2 and senior bonds. Covered bond investors continue to rank highest regarding potential support. This is confirmed for instance by the German Bank Restructuring Act which explicitly excludes Pfandbriefe from direct potential burden-sharing measures stipulated in case of a bank restructuring. The same is certainly expected regarding upcoming EU bank resolution regime and was mentioned in numerous consultation papers already.

Regulatory support for covered bonds, regulatory restrictions for RMBS

Generally, particularly compared to pre-crisis, MBS face increasing legal and regulatory restrictions. On the other hand, legislators and regulators continue to support covered bonds. For instance:

> CRD II imposed 5% retention and greater disclosure requirements for MBS;

> CRD III provides more onerous capital requirements for securitisations held in trading books;

> CRD IV aims to establish more onerous liquidity requirements and RMBS - in contrast to covered bonds are not eligible for liquidity coverage requirements;

> The capital surcharge under Solvency II regime is significantly higher than for covered bonds (up to 10 times for AAA rated RMBS compared to AAA Covered Bonds); and,

> The ECB collateral –criteria required two triple A ratings in case of MBS compared to triple B minus in case of covered bonds.

All of the mentioned examples point to significant regulatory support for covered bonds compared to securitisations.

Conclusion

While public issuance of securitisations recovered somewhat, issuance levels are still far from historical On the other hand, issuance levels of covered bonds remain much higher and despite numerous countries being shut from market access, dominate bank funding.

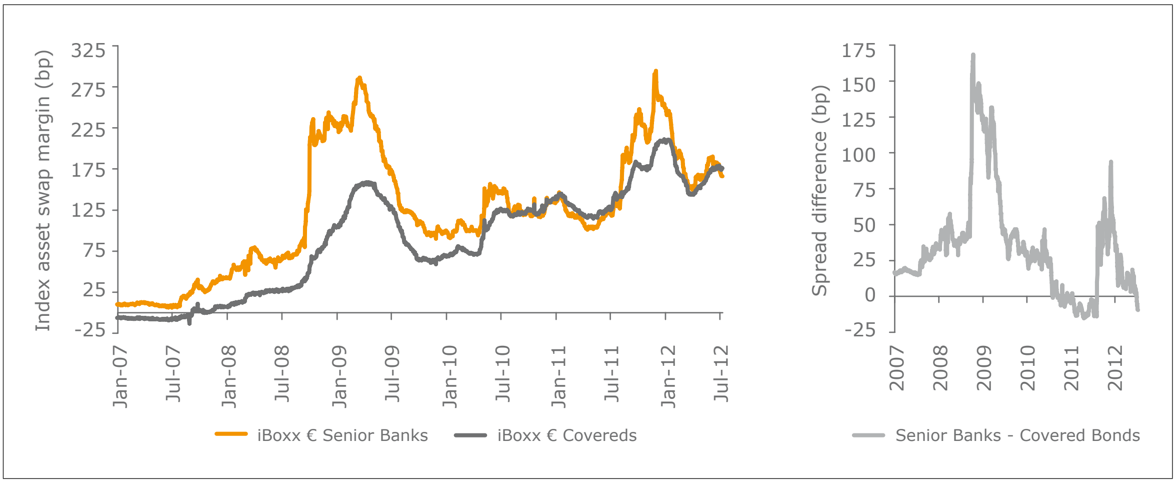
Despite convergence of covered bonds and MBS pre-crisis, there are crucial differences between the two products. MBS investors are more exposed to the risk of underperformance of the cover pool and maturity extension. With the financial crisis, high non-performing loans and lower pre-payments are drivers of cover pool under performance and maturity extensions of MBS. Covered bonds are bank bonds and covered bondholders benefit from a preferential claim on a cover pool, the support of the issuing bank and every kind of external support provided to the issuing bank. Hence, covered bondholders are not limited to cover pool assets and, hence, are not necessarily directly impacted by lower pre-payments or a worsening asset quality. While legal and regulatory sentiment remains adverse for MBS, covered bonds benefit from increasing regulatory support. Mainly due to the fact that covered bond pools are dynamic and due to typically high asset liability mismatches between cover assets and outstanding covered bonds, OC requirements by rating agencies for covered bonds are much higher than credit enhancements for senior tranches of MBS, in turn leading to strong investor protection. Even taking into account that systemic support for banks will decline going forward, we systemic support for covered bonds remains high.

Overall, also driven by increasing regulatory (and central bank support) and even taking into account increasing country differentiation, covered bonds are likely to remain an important funding tool for banks in the post-crisis financial market architecture.

2.4.2 COVERED BONDS VS. SENIOR UNSECURED BANK DEBT

Over the last few years, we have seen an increasing interest in covered bonds from traditional credit investors. Many of them preferred senior unsecured bank debt in the past due to the attractive yield pick-up offered by this asset class. However, in mid-2010 the yield differential between covered bonds and senior unsecured tightened to the lowest level since 2006 (see Figure 1 below). In the first half of 2011 the iboxx € *Senior Unsecured Bank Debt* index traded even inside of the *Covered Bond* index, something we have not seen in the past. This trend reverted in the second half of 2011 reflecting concerns about senior unsecured funding. However, the two long-term LTROs by the European Central Bank (ECB) and the EU decision to implement bail-in legislation not until 2018 calmed down the market sentiment. At the time of writing (July 2012), swap spread differentials are again negative. Whilst acknowledging that the composition of both indices is not identical in terms of issuers and countries and that the modified durations of the indices are not the same (although relatively similar), we believe that such a market anomaly is not justified fundamentally and creates attractive switch opportunities.

> FIGURE 1: SWAP SPREAD € INDICES FOR SENIOR UNSECURED BANK DEBT AND COVERED BONDS



Sources: RBS, Markit

The current dislocation of the market is, in our view, the result of the ongoing concerns about sovereign risk, which currently are the main drivers of senior unsecured and covered bond spreads. The correlation analysis shows that the swap spread performance of both asset classes is highly correlated with the respective 5-year sovereign CDS spreads (with positive correlation coefficients of 0.8 to 0.9 for both covered bonds and unsecured bank debt). Covered bond investors are typically more risk averse than unsecured bank debt investors and often demand a higher risk premium for increased sovereign risk, which is reflected in the current spread levels.

Covered bonds vs. senior unsecured

As shown above, the gap between senior unsecured debt and covered bonds has narrowed significantly. Usually, the gap between senior unsecured and covered bonds tends to be wider for lower rated issuers as the rating uplift offered by covered bonds is higher, i.e. the rating advantage from an investor perspective between a double-A rated issuer and its AAA covered bond is lower than in case of AAA rated covered bond from a weak single-A or triple-B issuer. There were instances of covered bonds of a particular issuer trading wider than its unsecured debt in the respective maturity bucket in the past such as Washington Mutual in the months before the Lehman crisis in 2008. These cases were driven by a great level of distress and high uncertainty for issuers and highlighted the limited overlap of the investor bases of both products. However, we have not seen a market anomaly like the current one on such a wide scale before the current financial market and sovereign crisis. We believe that this creates interesting trading opportunities and we recommend - on a selective bond-by-bond basis - switching out of senior paper into covered bonds from the same issuer.

On the following pages we summarise the pros and cons for switching from senior unsecured debt into covered bonds. As highlighted in the table, both asset classes have a number of benefits and strengths. The key reasons for investing in senior unsecured bank debt are the usually higher yield offered by this asset class compared to covered bonds and the seniority of the claim versus the subordinated hybrid capital and equity investors. The main advantages of covered bonds are firstly the double recourse to the issuer and - in case of issuer insolvency - to the cover pool, secondly the higher rating (even though the number of issuers with AAA rated covered bonds is shrinking, the extent the downgrade is not as severe as in the case of the issuer ratings) and thirdly the favourable regulatory treatment for both, bank treasuries and insurance companies. The latter aspect is discussed in detail below.

> Figure 2: Pros & cons of covered bonds vs. senior unsecured

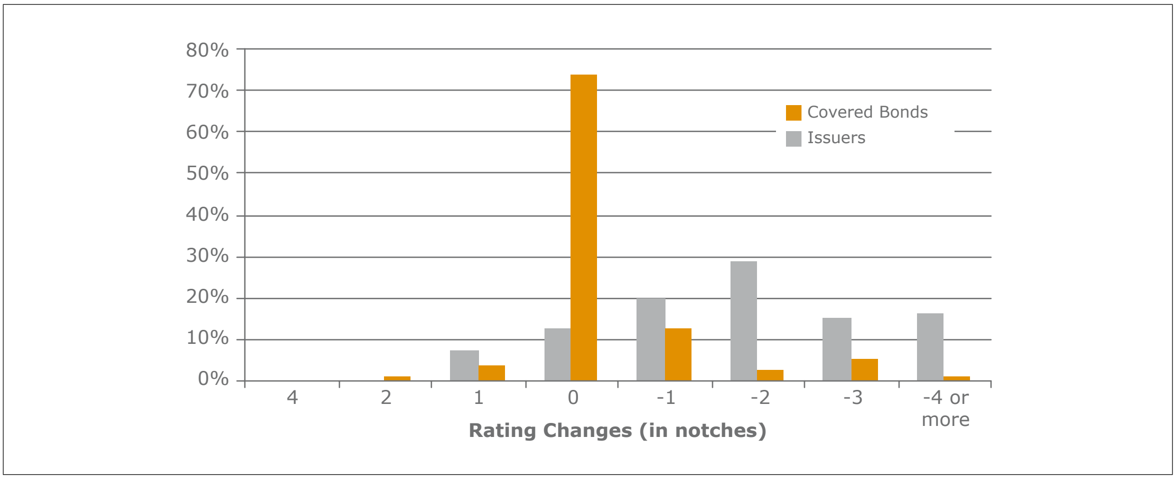
Advantages of Covered Bonds	Advantages of Senior Unsecured Debt
> double recourse to issuer and cover pool > higher ratings than unsecured debt/higher rating stability > lower risk weighting for EAA Covered Bonds bought by EEA banks > favourable treatment under Solvency II > generally better liquidity through larger issue size > favourable repo treatment at ECB and other central banks > eligible as liquid assets under upcoming Basel III rules > no risk of bailing-in	> higher yield (although 'spread give up' is currently at historically low levels) > less benchmark supply at the moment (but plenty of non-benchmark issuance) > often high turnover despite smaller deal sizes (due to lower portion of buy-and-hold investors)

Source: RBS

Higher rating stability of covered bonds

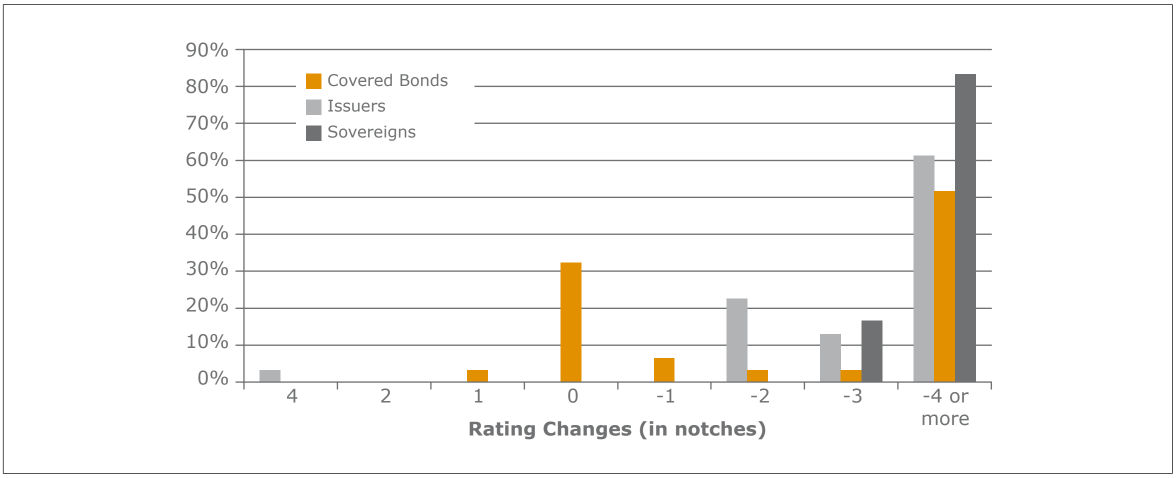
In March 2012, Moody's published a study on the impact of the recent issuer and sovereign downgrades on the rating migration of covered bonds. Moody's analysis is based on data for the 4-year period from January 2008 to February 2012. During that time, many sovereigns have been downgraded, most notably in Europe. Moody's study is split in two parts: one part analyses the covered bond rating migration in countries with stable sovereign ratings and the other part examines the rating behaviour of covered bonds in countries where the sovereigns were downgraded.

In countries, which have experienced stable sovereign ratings since the beginning of 2008, the covered bond issuers have been on average downgraded by more than two notches. On the other hand, the average covered bond downgrades have been limited to less than half a rating notch. The graph below shows that more than 70% of covered bonds have managed to retain their Moody's rating and only ~5% were downgraded by 3 notches or more. In comparison, 80% of the issuers were downgraded, and almost 30% of the issuers were downgraded by 3 notches or more. Hence, covered bond ratings have proved significantly more stable than the issuer ratings. However, Moody's data also shows that they were not completely immune to issuer downgrades.



Source: Moody's, RBS

In countries where the sovereign has been downgraded, the picture looks considerably less rosy. In Moody's study, out of the downgraded countries, 83% of the sovereigns were cut by four notches or more with the remainder being subject to 3-notch downgrades. The average covered bond downgrade in these countries was about 4 notches. At the same time, issuers have been downgraded by an average of 5.5 notches. The chart below shows that 65% of the covered bonds have been downgraded when their respective sovereigns have been downgraded, with the bulk (52%) being in the four-notch area. Over the same period, 97% of issuers have been downgraded with 61% facing downgrades of four notches or more. Interestingly, despite the sovereign downgrades, 32% of the covered bond ratings remain unchanged whilst 3% were even upgraded by one notch. This shows that covered bonds can withstand issuer and even sovereign downgrades up to a certain extent.



Source: Moody's, RBS

This is also underlined by Standard & Poor's data. During 2011 and the first half of 2012 the average S&P covered bond issuer rating has significantly declined. About half of the covered bond issuers have seen their issuer ratings been lowered by up to three notches (though two-thirds thereof by just one notch). The majority of bank downgrades happened to covered bond issuers in France, Spain, Portugal, UK and Italy. S&P also stated that the average covered bond rating has declined less than the issuer ratings as covered bonds have been able to benefit from the "unused notches of rating uplift" and as a result none of the French or UK covered bonds were downgraded during the 18-month period. Only about one-sixth of the covered bond programmes were lowered and larger downgrades only happened when the sovereign rating became a constraining factor.

ECB repo haircuts

As part of its open market operations, the ECB has implemented risk-control measures to protect itself from potential collateral losses in case the underlying assets must be liquidated due to the counterparty's default. These measures encompass initial margins, valuation haircuts, variation margins, limits, additional guarantees and exclusions. The value of the underlying asset is calculated as the market value of the asset less a certain percentage ("valuation haircut"). The ECB applies different valuation haircut for covered bonds and senior unsecured debt.

In July 2010 the ECB announced a new haircut scheme that differentiates haircuts according to the maturities, the liquidity categories and the credit quality of the assets concerned (see the table below for A- or higher rated collateral; repo haircuts are significantly higher for bonds in the triple-B bucket). The new haircuts entered into force on 1 January 2011. UCITS-compliant Jumbo covered bonds are generally in Category II for which the haircuts remained unchanged. Non-Jumbo covered bonds, general law-based/structured covered bonds, multi-issuer covered bonds such AyT Cédulas and Cédulas TdA are now classified as category III bonds. Under the new rules, the haircuts of category III bonds for maturities up to three years were left unchanged whilst the haircuts for longer maturities were raised by 50bp to 200bp. The new haircut scheme further increased the gap between senior unsecured debt and covered bonds making the latter even more attractive for bank treasury investors. The haircut differential between a 4-year Jumbo covered bond and a 4-year senior unsecured bank bond increased to 7.5 percentage points and is even 9.5 percentage points in case of maturities beyond ten years.

The table below shows the favourable repo haircuts for covered bonds compared to senior unsecured bank. Currently, an ECB repo-eligible UCITS-compliant Jumbo covered bond with a fixed coupon and a maturity of four years would be subject to a haircut of 3.5% whilst similar senior unsecured bank debt would have a significantly higher haircut of 11%. Non-Jumbo covered bonds, general law-based/structured covered bonds, multi-issuer covered bonds such AyT Cédulas and Cédulas TdA are classified as category III bonds and would be subject to a 5% haircut for maturities within the 3-5 year bracket – still 6% below that of an unsecured bond.

> Figure 3: ECB haircuts by liquidity category and residual maturity

Credit Quality Steps 1 & 2 (AAA to A-)*	**Liquidity Category I** (Government Bonds)		**Liquidity Category II** (Local & Regional Govt, Supras & Agencies, Jumbo Covered Bonds*)		**Liquidity Category III** (Traditional Covered Bonds*, Structured Covered Bonds*, Multi-Issuer Covered Bonds*, Corporates Bonds*)		**Liquidity Category IV** (Unsecured Bank Bonds**)		**Liquidity category V** (ABS*)
Residual maturity (years)	**Fixed coupon**	**Zero coupon**	**Fixed coupon**	**Zero coupon**	**Fixed coupon**	**Zero coupon**	**Fixed coupon**	**Zero coupon**	**Fixed or zero coupon**
0-1	0.5	0.5	1	1	1.5	1.5	6.5	6.5	16
1-3	1.5	1.5	2.5	2.5	3	3	8.5	9	
3-5	2.5	3	3.5	4	5	5.5	11	11.5	
5-7	3	3.5	4.5	5	6.5	7.5	12.5	13.5	
7-10	4	4.5	5.5	6.5	8.5	9.5	14	15.5	
>10	5.5	8.5	7.5	12	11	16.5	17	22.5	

*Assets that are given a theoretical value will be subject to an additional 5% haircut.
** There are higher haircuts for BBB-rated securities.

Source: ECB

Other central banks also favour covered bonds

Other central banks' repo policies such as those of Danmarks Nationalbank, Norges Bank, the Reserve Bank of New Zealand, and the Reserve Bank of Australia also favour covered bonds. In Norway, senior unsecured debt is no longer eligible as collateral for repos, whilst covered bonds will continue to be eligible. Under Bank of England's narrow repo rules only government debt is eligible; neither covered bonds nor senior unsecured debt qualify. However, under its wider definition of Open Market Operations (OMO) collateral, covered bonds are eligible whilst senior unsecured debt does not qualify.

Basel III's liquid asset buffer rules

In December 2009, the Basel Committee on Banking Supervision published a consultation paper defining minimum short-term and long-term liquidity levels for banks by introducing a liquidity coverage ratio and a net stable funding ratio. The Liquidity Coverage Ratio (LCR) requires banks to hold a stock of unencumbered high quality liquid assets to meet 30 days cash outflows under an acute stress scenario. Meanwhile the Net Stable Funding Ratio (NSFR) measures the amount of longer-term, stable sources of funding employed by a bank relative to the liquidity profiles of the assets and the potential for contingent calls on funding liquidity arising from off-balance sheet commitments and obligations. Following an extensive consultation process, the Committee implemented several amendments in July 2010, which confirmed amongst others that covered bonds will be eligible as liquid assets if rated AA- or higher and meeting some additional criteria. Senior unsecured bank debt will not qualify as a liquid buffer asset. The LCR is expected to be introduced at the beginning 2015. However, the observation period will already start at the beginning of 2013 and the Committee stated that they will put in place "rigorous reporting processes to monitor the ratios during the transition period and to review the implications". The new liquid buffer rules will come into force in 2015 but we expect that banks will not wait until then and will start implementing the new policy ahead of its official introduction given that the observation period starts this year. The NSFR will be implemented by 2018 according to the current plan and gives incentives to banks to increase their long-term funding. This should make covered bonds more attractive from an issuer perspective as this asset class benefits from higher investor demand than senior unsecured.

Solvency II

Solvency II is the new capital adequacy regime for the European insurance industry. It was adopted in 2009 and will apply to insurers from the beginning of 2014 after being delayed for one year. The aim of the new solvency regime is to ensure the financial soundness of insurance undertakings, and in particular to enable them to withstand turbulent periods, to protect policyholders and the stability of the financial system as a whole. Solvency rules stipulate the minimum amounts of financial resources that insurers and reinsurers must have in order to cover the risks to which they are exposed.

Solvency II will introduce economic risk-based solvency requirements across all EU Member States for the first time. These new solvency requirements will be more risk-sensitive and more sophisticated than in the past, thus enabling a better coverage of the real risks run by any particular insurer. The new requirements move away from a crude "one-model-fits-all" way of estimating capital requirements to more entity-specific requirements. Solvency requirements will also be more comprehensive than in the past. Whereas at the moment the EU solvency requirements concentrate mainly on the liabilities side (i.e. insurance risks), Solvency II takes into account the asset-side risks as well.

In particular, insurers will now be required to hold capital against market risk (i.e. fall in the value of insurers' investments), credit risk (e.g. when third parties cannot repay their debts) and operational risk (e.g. risk of systems breaking down or malpractice). These are all risks which are currently not covered by the EU regime. However, experience showed that all these risk types can pose material threats to insurers' solvency.

The new framework – like the current rules – applies to almost all EU insurers and reinsurers. Only the smallest ones (which fulfil a number of conditions, including having gross written premium income of less than EUR 5 m annually) will not be subject to these new rules, although they can choose to 'opt in'. Solvency II does not apply to pension funds covered by Directive 2003/41/EEC (the "occupational pension funds" Directive, or IORPs). The Commission is currently examining if suitable solvency requirements should be developed for pension funds.

The Solvency Capital Requirement (SCR) should ensure that the market value of assets will fall below the present value of liabilities only once in 200 years (99.5% 1-year VaR). The basic idea behind the standard formula for the SCR is that capital should be enough to absorb the total underperformance of assets compared to liabilities if a number of extreme market events happen simultaneously. Market risks are considered separately and then summed, with some benefit given to asset diversification. Covered bonds are treated the same as other fixed-income investments in the market risk module except for the spread risk and concentration risk subcategories where they benefit from a favourable treatment compared to corporate and senior unsecured bank debt.

Spread risk applies to various debt products, including investment grade corporate bonds, high yield bonds and covered bonds. No capital charge applies to government debt or government-guaranteed debt from a European Economic Area (EEA) state and issued in the currency of the government or multilateral development banks. Capital requirements do apply to exposures to governments or central banks from outside the EEA and rated single-A or lower. Triple-A rated covered bonds fulfilling the criteria of Article 52(4) of the European UCITS directive receive a lower spread risk factor between 0.7% and 6.0%

depending on the maturity compared to 0.9%-7.2% for senior unsecured and corporate bonds with the same rating assuming lower losses in a shock scenario. Double-A rated covered bonds also benefit from lower spread risk factors versus senior unsecured and corporate debt which are up to 1.4 percentage points lower in case of a ten-year maturity. Single-A rated covered bonds, however, are treated in line with similar rated corporate debt.

Bail-in risk

An increasing number of investors are concerned about the bail-in risk of senior unsecured bank debt. A number of supervisory authorities including the Basel Committee on Banking Supervision, the European Commission as well as the regulators in Germany, the UK and Denmark have recently introduced resolution frameworks or have released consultation papers on that topic.

> **Basel**

One of the first papers that addressed the bail-in of senior unsecured bank debt was the Basel Committee paper on the loss absorbency of regulatory capital at the point of non-viability released in August 2010. It stated in the last paragraph of its appendix that "parallel efforts are ongoing to ensure that all banks that fail are capable of being effectively resolved and losses allocated to both senior and subordinated instruments." In its consultation paper, the Basel Committee argues that during the recent global financial crisis a number of distressed banks were rescued by their respective governments through common equity and other forms of tier-1 capital injections. This supported not only depositors but also investors in regulatory capital instruments and senior unsecured debt. Consequently, senior and subordinated debt did not absorb losses incurred by those banks that would have failed without the public sector support. The Basel Committee believes that public sector injections of capital "should not protect investors in regulatory capital instruments from absorbing the loss that they would have incurred had the public sector not chosen to rescue the bank".

> **European Union**

In January 2011, the European Commission published a consultation paper on how to deal with future bank failures in the EU and on how to minimise the risks of contagion, protect retail depositors and avoid costly bailouts by the taxpayer. The proposal took some guidance from the German restructuring law by including the extension of the powers of the regulators such as making changes to the business organisation and structure of banks, transferring assets and liabilities to another (bridge) bank, and writing down debt (and/or its conversion to equity) of a failing bank. At the end of March 2012, the European Commission published a new Discussion paper on this new debt write-down tool and bail-in proposal. This document provided a more accurate view of the future tool to be implemented and stated that covered bonds would be exempted from the scope of this new tool. The European Commission eventually published in June 2012 its proposal for a Directive establishing a framework for the recovery and resolution of credit institution and investment firms Commission's proposal on the Framework for Bank Recovery and Resolution. The EC proposal explicitly exempts covered bonds from write-down and conversion powers as they are regarded as "secured liabilities" (Art. 38, para 2 (b)). Our understanding is that the resolution authorities can bail-in the senior unsecured claim of a secured liability (i.e. should the cover pool not be big enough to cover all outstanding covered bonds, then the senior unsecured claim against the issuer for the portion of the original liability exceeding the cover pool assets can be subject to write-down or even bail-in). However, the draft Directive states that national authorities may exempt UCITS 52(4), former 22(4), covered bonds from this provision.

> The US

While in Europe regulators are thinking of bailing-in unsecured investors, the US is following a different route trying to ensure a swift and orderly wind-down of financial institutions with the Federal Deposit Insurance Corporation (FDIC) emphasising that holders of long-term senior debt, subordinated debt, or equity interests "must expect to absorb losses in any liquidation."

> Germany

The German Restructuring Law came into force at the beginning of 2011 and has been applied retrospectively, i.e. there was not any grandfathering or phase-in period. The law introduced a restructuring mechanism for German banks which foresees three different restructuring procedures ranging from (1) internal restructuring to (2) reorganisation to (3) a transfer order. The restructuring process is initiated by the bank and is an internal process which cannot interfere with third-party rights[1]. A reorganisation, however, can affect third-party rights of creditors and shareholders and may include debt-for-equity swaps of subordinated and senior claims as well as haircuts of unsecured debt. The reorganisation process is initiated by the credit institution. The bank submits a reorganisation plan to the BaFin which defines any potential haircut for creditor claims, any potential compensation for creditors, deferral periods, and details of any debt-to-equity swap. The BaFin assesses if the existence of the bank is at risk and if the collapse of this credit institution would represent a systemic risk. If these criteria are fulfilled, the BaFin will ask the regional court for approval of the plan.

Importantly, the rights of Pfandbrief investors are not directly impacted by the restructuring law as the preferential claim on the pool remains protected. In order to ensure this, the Pfandbrief Act was amended and a new Article 36a 'Separation Principle in case of Reorganisation or Restructuring of the Pfandbrief bank' (Trennungsprinzip bei Reorganisation oder Restrukturierung der Pfandbriefbank) was introduced. This article clarifies that the measures of the new Restructuring Law will not be applied to the remaining part of the bank after issuer insolvency, the so-called 'Pfandbriefbank with limited business activities' (Pfandbriefbank mit beschränkter Geschäftstätigkeit). In case of a reorganisation, articles 30-36 of the Pfandbrief act (which deal with the insolvency of the issuer, define the duties and powers of the cover pool administrator and govern the (partial) transfer of the cover pools and liabilities), would remain applicable for the Pfandbrief business. The cover pool administrator (Sachwalter) should support the reorganisation plan unless it would be disadvantageous for the Pfandbrief creditors. In case of a transfer order, the transfer must take into account the Articles 30-36 of the Pfandbrief Act and the cover pool administrator is not bounded to the transfer order if it negatively impacts Pfandbrief creditors.

So far, the German restructuring law has never been applied.

[1] As part of the restructuring process, the bank is allowed to raise debt which is senior to its existing debt. This amount of super senior debt is nevertheless limited to 10% of its regulatory own funds.

> The UK

In the UK, the Banking Act 2009 introduced a Special Resolution Regime (SRR) which gives the HM Treasury, Bank of England and FSA tools to deal with distressed UK banks and building societies. The SRR powers allow the authorities to transfer all or part of a bank to a private sector buyer and a bridge bank pending a future sale, place a bank into temporary public ownership, apply for putting a bank into the Bank Insolvency Procedure (BIP) which is designed to allow for rapid payments to Financial Services Compensation Scheme (FSCS) insured depositors and last but not least apply for the use of the Bank Administration Procedure (BAP) to deal with a part of a bank that is not transferred and is instead put into administration.

Most importantly in our view, the review clarifies the scope of proposed 'bail-in' powers of the UK authorities. The FSA/HMT emphasised that covered bond holders' rights to collateral should not be over-ridden by any potential bailing in of senior unsecured investors, and that the claims of covered bond holders in relation to the supporting asset pool should not be affected.

As of the end of July, the Special Resolution Scheme in the UK has been used twice so far. In March 2009, core parts of Dunfermline Building Society (a small building society with total assets of just £3.3bn) including retail and wholesale deposits, branches, head office and originated residential mortgages (other than social housing loans and related deposits) were transferred to Nationwide Building Society. The social housing loans of Dunfermline's customers (and related deposits) were transferred temporarily to a bridge bank owned and controlled by the Bank of England. In July 2009 the social housing loans (and related deposits) held by the bridge bank were also transferred to Nationwide Building Society. In June 2011, Southsea Mortgage & Investment Company, a small Portsmouth-based bank with a portfolio of housing developments loans, was placed into the Bank Insolvency Procedure. The Financial Services Compensation Scheme (FSCS) was triggered and eligible depositors with balances up to the limit of £85,000 were protected. Any money above the FSCS limit of £85,000 was covered by the FSCS and the affected depositors were treated like other creditors of the insolvency in relation to the remaining balance. Southsea had 267 customers with deposits totalling some £7.4.m of which only 14 customers had deposits of more than £85,000.

> Denmark

In Denmark the Bank Package III came into force in September 2010 when the initial full guarantee on Danish bank deposits and senior debt expired. Since then, 'at the point of insolvency' a bank can decide to use either the new Orderly Liquidation Framework or the existing legal framework for insolvency. If the ailing bank chooses to use the Orderly Liquidation Framework, then assets & liabilities are transferred to 'Finansiel Stabilitet', a subsidiary of the Financial Stability company. In February 2011, Amagerbanken was the first bank to use the "orderly liquidation framework". The senior unsecured debt and depositors (beyond the DKK 750,000 threshold) of small Danish lender suffered a 41% write-down. In June 2011, Fjordbank Mors A/S became the second Danish bank to use the "bail-in" framework rather than the insolvency law. Senior unsecured creditors and unguaranteed deposits were subject to a 26% haircut. Covered bonds, however, are explicitly excluded.

The tough Danish regulation significantly increased the funding costs of Danish banks in the international markets. In May 2011, Moody's downgraded six Danish banks reflecting the reduced expectation of systemic support in the aftermath of the default of Amagerbanken and the subsequent losses for senior unsecured investors. The systemic uplift for the smaller banks was removed whilst the rating uplifts for larger players were reduced to one notch. In July 2011, S&P stated that it is gradually becoming apprehensive about the riskiness of Danish banks and said that around 15 banks could default, due to boom year loans made to commercial property and farm sectors. In response to the negative market reaction, the major political parties in Denmark agreed the new Bank Package IV. Key features of the new package include the possibility for stronger banks to take over ailing banks thereby avoiding any write-downs of senior debt and unguaranteed deposits. The government will support such mergers by allowing (1) the replacement of senior unsecured debt by up to DKK 10bn of new government-guaranteed debt, (2) a up to 3-year extension of up to DKK 40bn of existing government-guaranteed debt and (3) the split of an ailing bank into a good and a bad bank. In such a scenario, the Danish government might take over the bad bank to avoid haircuts for senior debt holders and unguaranteed deposits.

Structural subordination

Another factor supporting the covered bond market is rising concerns from senior unsecured investors about structural subordination. The increased use of the covered bonds by banks over the last few years means that more and more assets are ring-fenced. As assets in the cover pool are not available to cover the claims of senior unsecured investors in case of issuer insolvency[2], investors have started to worry about the growth in covered bond issuance and the subsequent reduction of assets available to unsecured investors in an insolvency scenario. This problem is exacerbated by the rating agencies' demands for higher over-collateralisation levels, which in most cases significantly exceed the legal over-collateralisation requirements and further reduce the available assets for investors outside the cover pool.

While we understand the concerns in the market, we think the recent discussions often tend to overstate the problem arising from structural subordination while ignoring offsetting factors. The use of covered bonds usually results in lower funding costs for the banks and significantly broadens the investor base allowing issuers to tap rates investors such as central banks. In addition, it is a more stable funding base. Even if the unsecured market is closed for a certain issuer, the bank may still be able to access the wholesale markets by the means of covered bonds or, in a worst case scenario, it will be able to retain the bonds to use them for repo transactions with central banks such as the ECB.

In addition, the potential volume of covered bond issuance is not unlimited. The available eligible assets are a restricting factor for covered bond issuance putting a cap on the actual issue volumes. Also the aforementioned rating agencies' requirements of high over-collateralisation levels further reduce the available headroom for covered bond issuance.

The charts below show that senior unsecured funding still represents about half of European banks' funding. In the period of 2011 to H1 2012, based on dealogic figures, covered bonds made up 45% of total issuance of European financial institutions (excluding securitisation and short-term funding) compared with 45% of senior unsecured funding and 11% of sub debt and government guaranteed funding. If retained covered bond and government guaranteed issuance is excluded, the portion of senior funding exceeds the 50% mark.

[2] If all the covered bonds of an insolvent issuer have been repaid and the claims of all covered bond investors have been satisfied, the remaining assets in the respective cover pool would generally be made available on a pro-rata basis to the senior unsecured investors. Moreover, in some jurisdictions, such as Germany, in case of issuer insolvency senior unsecured investors would have access to assets in the cover pool that will obviously not necessary to cover the outstanding covered bonds and related liabilities. Given the dynamic character of the market a very high hurdle must be overcame in order for this process to trigger, and we would expect that only in very few, selected cases the insolvency administrator of the cover pool would agree to such a transfer.

Figure 4: Issuance by European banks since 2007

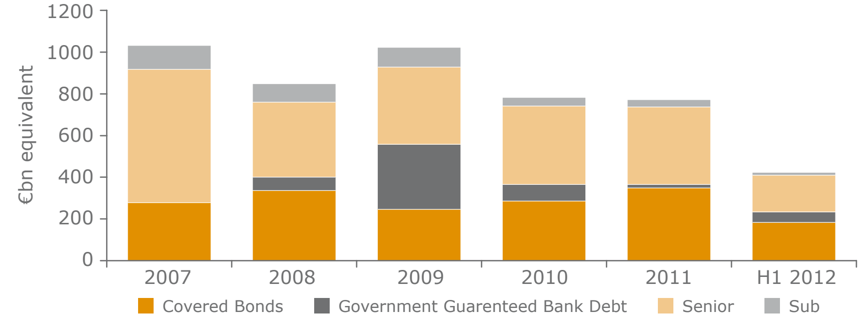
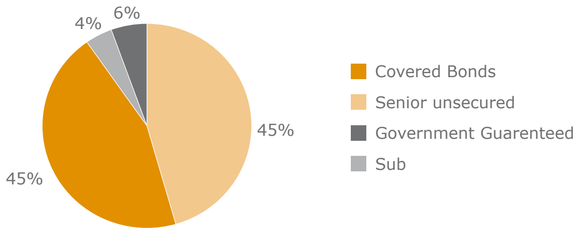


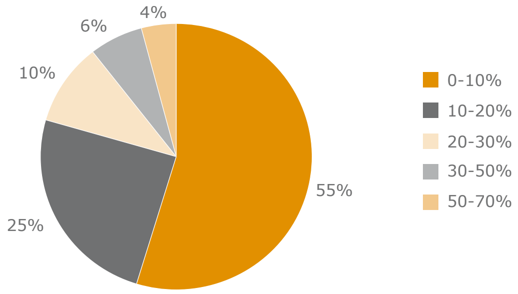
Figure 5: Issuance by European Banks in 2011/H1 2012



Sources: dealogic, RBS (excluding short-term debt and securitisation)

Fitch's covered bond study published in June 2012 showed that more than 50% of the covered bond issuers rated by Fitch have a funding reliance (defined as outstanding covered bonds in % of total assets) of less than 10%. Only 1 in 5 issuers has a funding reliance of more than 20%. These are almost exclusively specialised mortgage banks.

Figure 6: Covered bond funding reliance of issuer



Sources: Fitch, RBS (by number of issuers over the 141 CB issuers rated by Fitch; funding reliance is defined as outstanding covered bonds in % of total assets)

Investor demand

We believe that one of the drivers of the spread tightening between unsecured and secured bank debt is the limited overlap of senior unsecured and covered bonds investors. Analysing recent order books, we estimate that the investor overlap is increasing due to the higher participation of credit investors in new covered bond issues. We expect this trend to continue over the coming years and credit investors will account for a growing portion of the covered bond order books going forward, not least because of the bailing-in risk for European senior unsecured debt with maturity dates of 2018 and beyond.

The main reasons, in our view, for the current limited overlap are (1) that central banks and sovereign wealth funds are large buyers of covered bonds but not of senior unsecured debt, (2) that asset managers and pension funds have often higher limits for covered bonds than for senior unsecured bank debt and (3) that both assets classes are usually bought for different dedicated portfolios. In addition, covered bonds are sometimes used to enhance the yield of government portfolios without diluting the average rating or in genuine credit portfolios to improve the rating quality of the portfolio. Senior unsecured bonds are primarily bought by banks and assets managers and form part of the credit portfolio.

Conclusion

We view the current anomalies in the pricing of covered bonds relative to senior unsecured bank debt as a good opportunity to switch into covered bonds. The tight spread between the two asset classes means that the spread give-up for investors would be relatively small in most cases and those investors switching into covered bonds would be more than compensated by the aforementioned advantages of this asset class in terms of higher rating and additional investor protection, in our view. This holds particularly true for EU bank investors, who additionally benefit from the lower risk weighing under the European Capital Requirements Directive (CRD), the lower ECB repo haircuts and the prospect of covered bonds qualifying as liquid assets under the upcoming Basel liquid buffer rules. Insurance companies as well would benefit from investing into covered bonds as these instruments will receive a favourable treatment under the upcoming Solvency II rules. The structural subordination of senior unsecured investors as a result of increased covered bond issuance poses some problems, but the current discussion exaggerates the issue ignoring the advantages of having a stable and relatively cheap funding channel for the bank: this is beneficial for both covered bond and senior unsecured investors. Moreover, there is an increasing risk of a bailing-in of senior unsecured debt whilst covered bonds are explicitly excluded from such measures in the UK, Germany and Denmark as well as under EU and Basel proposals.

CHAPTER 3 - THE ISSUER’S PERSPECTIVE

3.1 AUSTRALIA

By Alex Sell, Australian Securitisation Forum

AUSTRALIA

The 'Aussie' covered bond market is in its infancy with legislation passing Parliament late in 2011.

The four 'Major' Australian banks, made up of Australia and New Zealand Banking Group Limited ("ANZ") (AA-, Aa2, AA-), Commonwealth Bank of Australia ("CBA") (AA-, Aa2, AA-), National Australia Bank ("NAB") (AA-, Aa2, AA-) and Westpac Banking Corporation ("Westpac") (AA-, Aa2, AA-), have all issued their inaugural covered bond transactions, with approximately AUD 20 bn issued by them to date.

Based on the issuance cap applied by way of cover pool being limited to 8% of Australian assets, the total for all potential issuers (nine in total) is approximately AUD 150 bn.[1]

Others banks with both the balance sheet size and credit rating that may be able to issue AAA covered bonds include Macquarie Bank Limited (A/A1/A+), Citigroup Pty Ltd (A-, A3, A), Suncorp Bank (A+/ A1 /A), and ING Bank (Australia) Limited (A,A3, NR).

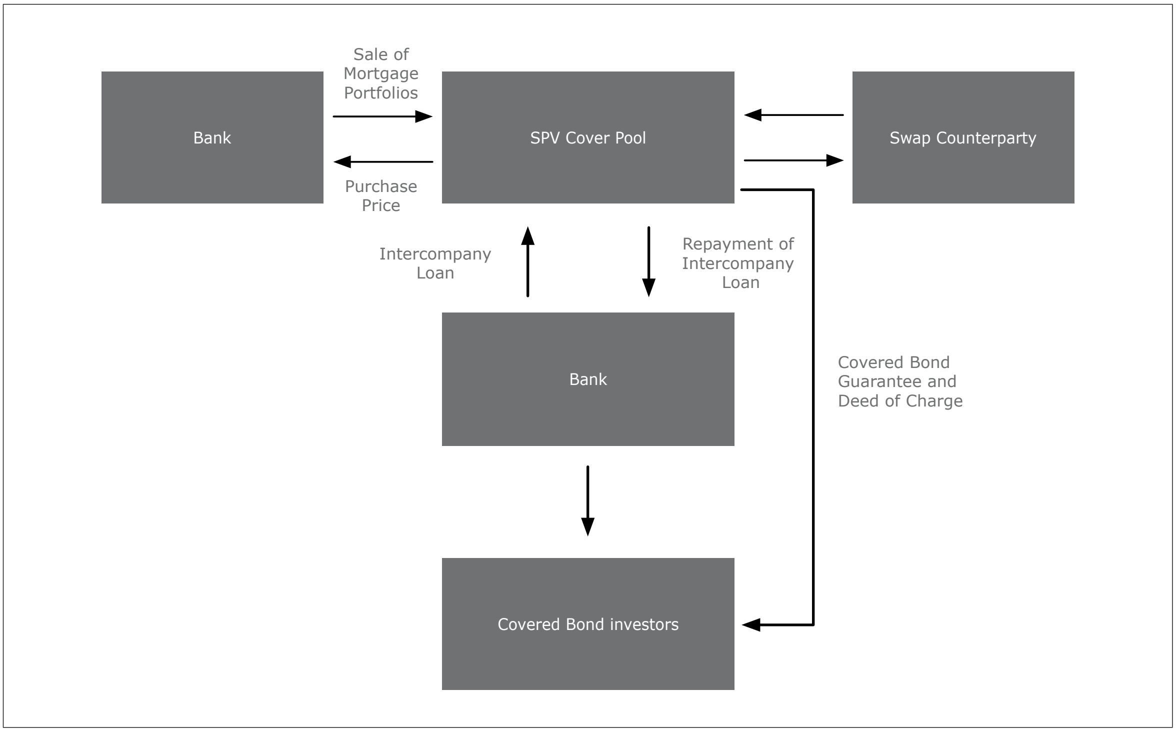
Australian covered bonds

Australian covered bond programs follow similar structures as the UK, Canada and New Zealand, given the similarity of the legal systems. Australian covered bonds are direct, unconditional obligations of the issuer. In the event of issuer insolvency or default, investors are entitled to be repaid from the pool of cover assets and they have a claim on the issuer ranking subordinate to statutorily protected depositors but pari passu with unsecured creditors. The cover assets are held in a bankruptcy remote special purpose entity, the Guarantor, which provides an unconditional and irrevocable guarantee of the issuer's obligations under the covered bonds. In Australian covered bond programs, the Guarantor are structured using trusts (in the same manner as that used for Australian RMBS). A security trustee holds security over the cover pool assets for the benefit of covered bondholders (and service providers).

Following an issuer event of default, the Guarantor is required to meet the covered bond obligations using the cash flows generated from the cover pool assets held for the benefit of the covered bondholders. See Figure 1 for an illustration of an Australian covered bond structure.

[1] Based on December 2011 asset information.

> Figure 1: Australian covered bond structure


Sale of Mortgage Portfolios
Bank
SPV Cover Pool
Swap Counterparty
Purchase Price
Intercompany Loan
Repayment of Intercompany Loan
Bank
Covered Bond Guarantee and Deed of Charge
Covered Bond investors

Banks issuing covered bonds: Authorised Deposit-taking Institutions (ADIs)[2] are permitted to issue covered bonds subject to complying with the covered bond regulatory structure.

Cap on covered bond issuance: A cap on the value of the cover pool of assets that can be held for the benefit of covered bondholders and service providers is set at 8% of an ADI's "Assets in Australia". This cap prevents covered bondholders having a claim over more than 8% of an ADI's assets in Australia at the point of issuance of covered bonds. In effect, this cap limits the subordination of unsecured creditors such as depositors.

Ring-fencing the cover pool of assets: The cover pool of assets that provides security to covered bondholders and service providers needs to be held by an insolvency remote special purpose vehicle, separate from the ADI issuing the covered bonds[3]. The covered bond special purpose vehicle owns (beneficially or otherwise) the cover pool assets. These entities may hold other assets related to issuing covered bonds outside the cover pool of assets (such as voluntary over-collateralisation and assets linked to assets held in the cover pool).

[2] *Authorised Deposit-taking Institutions* ("**ADIs**"), as they are known locally, are the equivalent of an EEA credit institution.

[3] Or by a *Covered Bond Credit Institution* if the arrangement involves several ADIs.

Australian Prudential Regulation Authority's (APRA's) powers: The prudential regulator has the power to restrict the issuance of covered bonds where inter alia the ADI has not complied with the covered bond legislation. However, APRA has no powers over the cover pool of assets which are held for the benefit of covered bondholders, or any statutory manager. APRA may provide prudential standards on any matters relating to covered bonds including:

- The issuing of covered bonds;
- Assets in cover pools; and
- Maintenance of cover pools.

Eligible assets: The eligible assets which can be included in the cover pool are specified in the legislation. These assets are essentially high quality assets (such as residential mortgages) and mirror the Capital Requirements Directive.

Maintenance of the cover pool: The ADI is required by statute to maintain the cover pool of assets so that the value of these assets is sufficient to meet 103% of the face value of the outstanding covered bonds. However, in order to achieve AAA ratings, most programmes have levels of over-collateralisation in the range of 18% to 20%. This may involve the ADI transferring additional assets to the cover pool and replenishing assets in the cover pool. APRA does have the power in particular circumstances (e.g. financial system risk) to prevent an ADI from replenishing the cover pool.

Cover pool monitor: The ADI issuing the covered bonds is required to appoint a cover pool monitor. The functions of the cover pool monitor include:

- Assessing the ADI's register of the assets in the cover pool; and
- Reviewing the cover pool's compliance with the ADI's requirement in respect of the nature of the assets in the cover pool, and the value of the cover pool of assets.

As a matter of law, the organisation must:

- Be registered as an Approved Auditor under the Corporations Act 2001; or
- Hold an *Australian Financial Services Licence issued under the Corporation Act 2001*.

Winding up the cover pool: In the event of resolving a failing ADI, an ADI statutory manager or external administrator has no powers over the cover pool of assets held for the benefit of covered bondholders and service providers, apart from contractual matters. This is to ensure that the resolution process relating to the ADI does not impact on the cover pool of assets providing security to covered bondholders. Further, as mentioned above, APRA has no powers over the cover pool of assets held for the benefit of bondholders at any time, other than to prevent top-ups.

Arrangements involving several ADIs: Two models will be facilitated by law to enable a group of ADIs to enter into an arrangement to facilitate the issuing of covered bonds. One model involves the ADIs establishing a specialised ADI, called a Covered Bond Credit Institution, which pools assets of the participating ADIs and issues the covered bonds. The other model involves the participating ADIs establishing a separate entity that aggregates covered bonds issued by these ADIs and issues a new instrument backed by these covered bonds. The merits of the Covered Bond Credit Institution as an ADI regulated by APRA remains under consideration. The four 'Major' Australian banks are unlikely to utilise these aggregating structures. To date, there has been no issuance of covered bonds under this arrangement.

I. FRAMEWORK

The Australian covered bond regime emulates the UK RCB in most respects. The issuance is from the bank rather than an SPV. With the benefit of an intercompany loan from the issuer, the SPV acquires the cover pool collateral from the issuer's balance sheet, but the cover pool assets remain consolidated on the issuer's balance sheet for accounting, tax and prudential (regulatory capital) purposes.

II. STRUCTURE OF THE ISSUER

The legislation requires the issuer to be an ADI[4] (see Figure 1).

Australian covered bonds are direct, unconditional obligations of the issuer. However, investors also have a right to repayment from a pool of cover assets in the event of the insolvency or default by the issuer. The legislation requires all cover pool assets (including any substitution assets) to be segregated from the insolvency estate of the issuer by being sold to the SPV, which guarantees the issuer's obligations under the bonds.

III. COVER ASSETS

Assets permitted in the cover pool that are restricted to this list must be exclusively Australian (e.g. US dollar cash or a New Zealand residential mortgage would not qualify):

- An at call deposit held with an ADI and convertible into cash within 2 business days;
- Any bank accepted bills or certificates of deposit not issued by the ADI issuing the covered bonds that are eligible for repurchase transactions with the Reserve Bank of Australia (up to a maximum of 15% of the cover pool);
- An Australian government debt instrument issued by the Australian Commonwealth, an Australian State or an Australian Territory;
- A loan secured by a residential property;
- A loan secured by a commercial property;
- A contractual right relating to the holding or management of another asset in the cover pool (for example, a mortgage insurance policy and a right for compensation in the event the ADI does not meet any of its contractual obligations in respect to managing the assets in the cover pool); and
- A derivative used for the purposes of protecting the value of another asset in the cover pool.

IV. VALUATION AND LTV CRITERIA

The properties securing the mortgage loans are likely to be valued using Australia mortgage market accepted practice, unless otherwise specified in the transaction documents. Whatever valuation method is used, it must be the most recent.[5]

[4] Or the CBCI aggregated structure (however, this structure is yet to be confirmed).

[5] Note also that ANZ, CBA, NAB and Westpac have all introduced indexation of their security values for the purposes of calculating the Asset Coverage Test.

The LTV limit for mortgages for the purposes of the 103% statutory over collateralisation must not vary across different programmes (80% for residential mortgages; 60% for commercial mortgages). It is important to note that mortgages above one of these two LTV limits are able to be included in the cover pool but the amount of any loan that exceeds the LTV limit is excluded from counting towards the 103% statutory over collateralisation.

V. ASSET-LIABILITY MANAGEMENT

The legislation prescribes a minimum level of over collateralisation (OC) of 103%.

In addition, issuers typically perform a dynamic Asset Coverage Test (ACT) usually on a monthly basis to ensure contractual OC requirements are satisfied.

The issuer is required to cure any breach of the ACT by the next calculation date by transferring additional cover assets to the special purpose vehicle (SPV). If the breach is not rectified by the following calculation date, the trustee will serve a notice to pay on the SPV, subject to any further “cure” periods allowed under the transaction documentation.

VI. TRANSPARENCY

Given the newness of this market (December 2011), industry participants have developed the following transparency standards, which will be reviewed as the market develops.

Australia and New Zealand Banking Group, Commonwealth Bank of Australia, National Australia Bank and Westpac Banking Corporation formed a working group in 2011 to agree on the format of their covered bond reports. They are published monthly on the website of each issuer.

The issuer cover pool reports can be found at:

> Australia and New Zealand Banking Group: http://www.debtinvestors.anz.com/phoenix.zhtml?c=248688&p=debt-disclaimer1;

> Commonwealth Bank of Australia: http://www.commbank.com.au/about-us/group-funding/covered-bonds;

> National Australia Bank: http://www.nabcapital.com.au/popup-disclaimers/securitisation-deal-summaries.phps; and

> Westpac Banking Corporation: http://www.westpac.com.au/about-westpac/investor-centre/fixed-income-investors/covered-bonds/.

The covered bond reports include the following information:

> Program ratings;

> Numerical results of the Asset Coverage Test;

> Covered bonds outstanding; and

> Cover pool summary tables including LTV, geographic distribution, product types, arrears and prepayment speed.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The issuer is responsible for regular monthly cover pool monitoring and reporting. In addition, the ACT calculation is typically independently verified by an *Approved Auditor* or an *AFSL* holder at least annually.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Broadly-speaking the covered bond legislation requires cover pool assets to be beneficially-owned by a SPV, not by the ADI. If the ADI is in default, its statutory manager (or APRA) still cannot access the cover pool assets unless they constitute part of the voluntary over-collateralisation.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Australian covered bonds - to the extent they are issued out of a non-EEA entity - will not by definition achieve UCITS compliance, even if they meet every non-jurisdictional UCITS requirement. This has consequences for insurance companies subject to Solvency II, such that they would likely be subject to 100% risk-weight rather than 10% risk-weight. Certain EEA nations, notably Norway, have permitted Australian RMBS on to their local central bank's eligible collateral lists. There must surely be some hope that this will continue for Australian covered bonds, offering as they will diversification away from EEA sovereigns, issuers, and collateral.

In terms of the Australian market, the Australian central bank, The Reserve Bank of Australia, has added Australian covered bonds to the list of open market operations' (OMO) eligible collateral.[6]

X. ADDITIONAL INFORMATION

The volume of outstanding Australia regulated covered bonds could amount to about AUD 150 bn based on the "Assets in Australia" of the most likely issuers. Clearly, it will take time for issuers to reach their 8% limits.

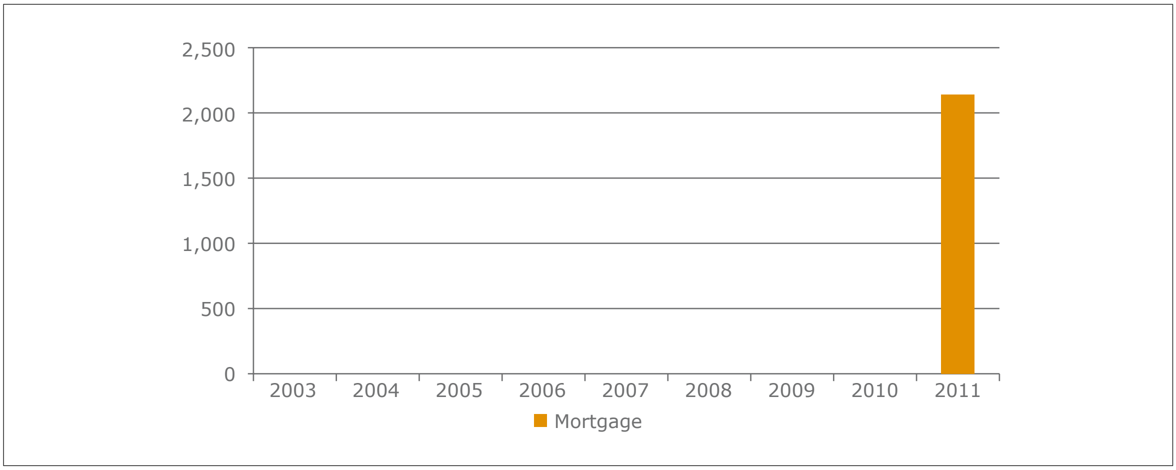
> Australian Bank Covered Bond issuance summary

Issuer	Programme size (US$bn)	Issuance to date in benchmark format (US$M equiv.)	Issuance to date in private placement format (US$M equiv.)	Issuance to date in fixed rate format (US$M equiv.)	Issuance to date in FRN format (US$M equiv.)	Issuance currencies
ANZ	20	6,432	334	4,248	2,517	AUD, USD, EUR, NOK, CHF
CBA	30	9,684	2,056	9,591	2,149	AUD, USD, EUR, NOK, CHF, GBP
NAB	20	2,053	776	2,055	774	EUR, GBP, NOK
WBC	20	7,108	464	5,571	2,001	AUD, USD, EUR, NOK
Total	**90**					

Source: Australian Securitisation Forum and KangaNews, May 31 2012

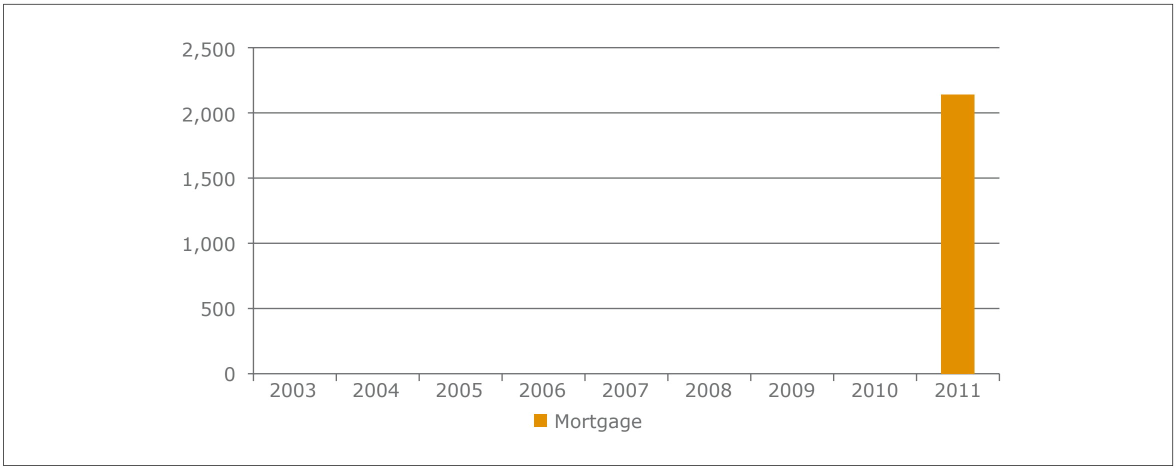
[6] See: http://www.rba.gov.au/mkt-operations/xls/eligible-securities.xls

> Figure 2: Covered Bonds Outstanding 2003-2011, EUR m



Source: EMF/ECBC

> Figure 3: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/98/Australian_Covered_Bonds

3.2 AUSTRIA

By Dr. Friedrich Jergitsch, Freshfields Bruckhaus Deringer
and Alexa Mezei, Erste Group Bank

I. FRAMEWORK

Austria has three different frameworks under which covered bonds can be issued. These are:

1. Hypothekenbankgesetz: Mortgage Banking Act (Law of 7/13/1899, last amended 2005) "Pfandbriefe"
2. Gesetz betreffend fundierte Bankschuldverschreibungen: Law on Secured Bank Bonds (Law of 12/27/1905, last amended 2005) "FBS"
3. Pfandbriefgesetz: Mortgage Bond Act (Law of 12/21/1927, last amended June 1, 2005) "Pfandbriefe"

Under these laws banks can issue two kinds of covered bonds, Pfandbriefe which are issued under the Mortgage Banking and Mortgage Bond Act, and Fundierte Bankschuldverschreibungen (FBS) issued under the Law on Secured Bank Bonds.

Amendments of all three laws have been brought forward during 2012 with the aim of further harmonizing/unifying Austrian Pfandbrief legislation including, for example, improved risk management system and standardised reporting requirements and the possibility to issue SME backed covered bonds. The initiative should support the Austrian SME sector.

II. STRUCTURE OF THE ISSUER

The Mortgage Banking Act stipulates a specialist banking provision and this would apply to any new mortgage bank. In practice, due to grandfathering of bonds issued before the law was implemented, exceptions are allowed and, in practice, all types of commercial banking activity are allowed. The Mortgage Bond Act applies to public-sector banks. And the Law on FBS is applicable for all other issuers.

Under all frameworks, the issuer holds the assets on the balance sheet and the assets are not transferred to a separate legal entity. This means that the covered bonds are an unconditional obligation of the issuer, rather than a direct claim on the cover assets. In the case of insolvency of the issuer, the cover assets will be separated from the rest of the assets and a special cover pool administrator will be appointed. The covered bond holders have a preferential claim on the cover assets.

III. COVER ASSETS

The cover pools have either mortgage-backed or public-sector assets. ABS/MBS are not eligible.

A Pfandbrief or Fundierte Bankschuldverschreibung (FBS) issue always corresponds to one asset class.

The geographical scope of eligible mortgage assets is restricted to EU / EEA countries and Switzerland;

USA, Canada and Japan are not eligible. For eligible countries that do not recognise a preferential claim, a 10% limit is in place. For öffentliche Pfandbriefe, the geographic scope of assets is the same.

The limits for FBS are similar. In addition, also bonds that have the status of "Mündelgelder" (i.e. which are suitable for the investment of monies of a ward) are eligible (such as other local public bonds, or Austrian Pfandbriefe).

Derivative contracts are allowed in the cover pool and the Austrian legislation allows for interest rate currency and credit derivatives. Derivatives are only allowed for hedging and there is no limit in place on the volume of derivatives in the cover pool.

Substitute cover assets are limited to 15% and can consist of cash, bank deposits and bonds from public issuers from EEA countries and Switzerland.

IV. VALUATION AND LTV CRITERIA

The Mortgage Bank Act stipulates conditions for property valuation and the value of mortgage lending and the valuation method must be approved by the regulator. One condition is a 60% LTV (loan to value) for residential and commercial mortgages based on the mortgage lending value.

There is no provision for property valuation for FBS. In practice, issuers have incorporated an LTV provision into their articles of association which is 60% LTV.

In practice, monitoring of the property value is done by the issuer and a regular audit of the cover register is undertaken. The valuation of the property used in the calculations cannot exceed the resale value of the property, and valuation guidelines are approved by the regulator in line with general Mortgage Business valuation approvals (i.e. in IRB approval).

V. ASSET - LIABILITY MANAGEMENT

All Austrian Covered Bond laws enshrine the matching principle whereby the total volume of assets in the cover pool must at least cover the total nominal amount of covered bonds in issuance. The cover pool assets must also cover the outstanding bonds in terms of interest income. In addition, a mandatory overcollateralization level of 2% is in place, which must be held in highly liquid substitute cover assets.

As well as these rules, banks may make additional voluntary provision in their articles of association which can strengthen the overcollateralization or asset- and liability management. An example of this would be to extend the matching principle to a net present value instead of nominal value and apply interest rate shocks, which is used by many of the international benchmark issuers.

The legislation also contains some maturity matching requirements to the extent that bonds cannot be issued if their maturity is considerably greater than the maturity of assets in the cover pool.

VI. TRANSPARENCY

The Austrian issuer banks of the Austrian Covered Bond Forum have set up a working group developing and analysing the CBIC Template guidelines. As a result, Austrian issuer banks have already developed a National Transparency Template –available on the Covered Bond Forum website; quarterly updates – based on the CBIC European Transparency Standards. The issuer cover pool reports can be found at:

One central website of Austrian Covered Bond Forum: http://www.pfandbriefforum.at/downloads.html

The National Transparency Template includes the following information:

> Program and Issuer Senior ratings;

> Overcollateralization values (based on nominal and net present values);

> The total volume of Pfandbrief outstanding as well as the related cover pools in terms of nominal, net present and stressed net present value;

> The share of further cover assets;

- The maturity structure of the Pfandbrief and cover assets;
- Information on the size of the cover assets;
- Information on the mortgages by property type/type of use, region and state;
- Information on the claims against the public sector by state and type of issuer;
- Information on the mortgages registered liens by register country;
- Summary tables including LTV, currency, interest and maturity profile

Furthermore, the members of the CB Forum aim to develop and expand the existing template with the General Issuer Detail and Key Concept Explanations Sections based on the CBIC transparency template.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The cover pool is monitored by a trustee ("Treuhänder"), who is appointed by the Minister of Finance, on suggestion of the issuer. The trustee is liable according to the Austrian civil code and has formal functions only. The monitor has to ensure that the prescribed cover for the Pfandbriefe exists at all times and that the cover assets are recorded correctly in the cover register. Without his approval, no assets may be removed from the cover pool.

For FBS the pool is monitored monthly by the government commissioner ("Regierungskommissar"), who works for the Ministry of Finance on behalf of the Banking Supervisory Authority (FMA).

Any disputes between the issuer and the trustee would be settled by the regulator. If a concern exists that the rights of the covered bond holders are being infringed, the court must appoint a joint special representative of the covered bond creditors.

VIII. SEGREGATION OF COVER ASSES AND BANKRUPTCY REMOTENESS OF COVERED BONDS

A cover register (Deckungsregister) permits the identification of the cover assets. All mortgages, public-sector loans, substitute cover assets and derivative contracts need to be registered in the cover register. Austrian Banks need to inform customers that loans will be introduced into the cover pool and state that loans in the cover pool are not subject to compensation. Set-off statements for derivative counterparties are admissible when they refer to claims and liabilities from the same Master Agreement.

The legal effect of registration is that in the case of insolvency of the issuer, the assets which form part of the separate legal estate (the so called "Sondervermögen") can be identified: All values contained in the register would be qualified as part of the separate legal estate.

While the bank carries out the daily administration of the cover register, it is the cover pool monitor who supervises the required cover und registration in the cover register.

Asset segregation

If the issuer becomes insolvent then the cover assets will be segregated from the remainder of the assets as a direct consequence of the insolvency proceedings. These assets shall form what is known as a 'Sondervermögen' (pool of special assets) and are earmarked for the claims of the covered bond holders. Any voluntary overcollateralization is also bankruptcy-remote and only covers assets that are evidently not needed to satisfy the claims of the covered bond holders are passed back to the insolvent issuer.

The cover assets will be managed by a special administrator, who is appointed by the bankruptcy court, after consultation with the FMA. The special administrator has the right to manage and dispose of the recorded assets.

Impact of insolvency proceedings on covered bonds and derivatives

Covered bonds do not automatically accelerate in case of insolvency of the issuer, but will be repaid at the time of their contractual maturity. The cover assets are administered in favour of the bond holders and any claims of the covered bond holders in respect of interest or principal repayments are to be paid from the cover assets. Consequently, in respect of derivatives, there is no legal consequence of insolvency and the counterparty claims as derivative transactions rank pari passu with the claims of the covered bond holders.

Preferential treatment of Covered Bond holders

Covered bond holders enjoy preferential treatment as the law stipulates the separation of the cover assets on the one hand and the insolvency estate on the other hand. To the extent that they are not satisfied from the cover assets, the Pfandbrief creditors may also participate in the insolvency proceedings with respect to the Pfandbrief bank's remaining (general) assets. Only if the cover assets do not suffice to satisfy the covered bond creditors, are the covered bonds accelerated.

Access to liquidity in case of insolvency

Once appointed, the special administrator for the cover pool has the right to manage the cover pool in order to satisfy the claims of the covered bond holders. The administrator may, for example, sell assets in the cover pool or enter into a bridging loan in order to create liquidity to service the bonds in issue.

The administrator also has access to any voluntary over collateralisation, which is also considered bankruptcy-remote. Any surplus collateral may only be transferred back to the insolvency estate to the extent that it is evident that it will not be needed to cover the claims of the covered bond holders.

Sale and transfer of mortgage assets to other issuers

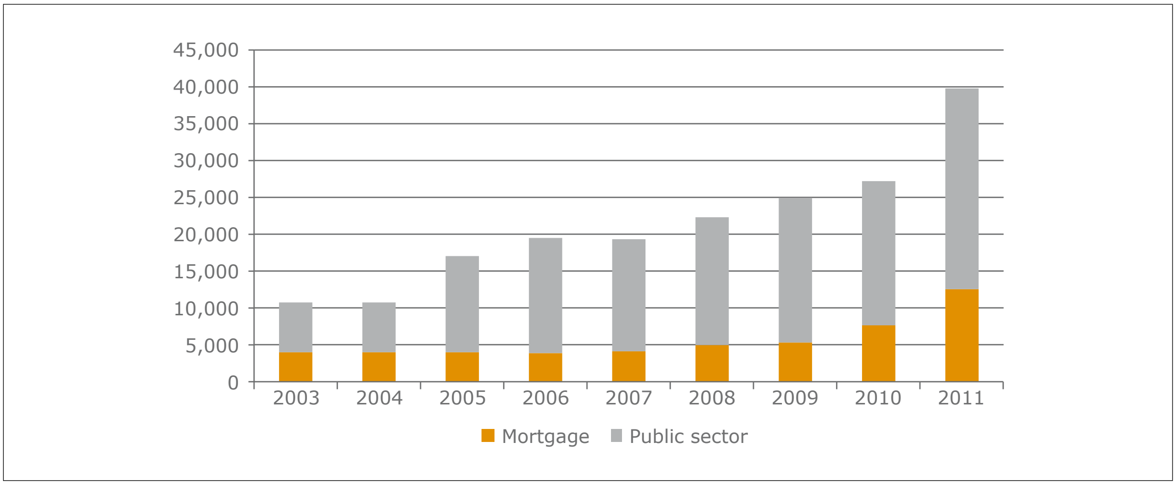
The covered bond administrator can also sell the assets collectively to a separate credit institution. This institution must then take over all liabilities with regard to the covered bonds. In fact, one of the tasks of the special administrator is to find a suitable credit institution that will buy the assets collectively.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Austrian Pfandbriefe as well as Austrian Covered Bonds (FBS) fulfil the criteria of the UCITS 52(4) directive, as well as those of the CRD Directive, Annex VI, Part I, Paragraph 68 a) to f). This results in a 10% risk weighting in Austria and other European jurisdictions where a 10% risk weighting is allowed.

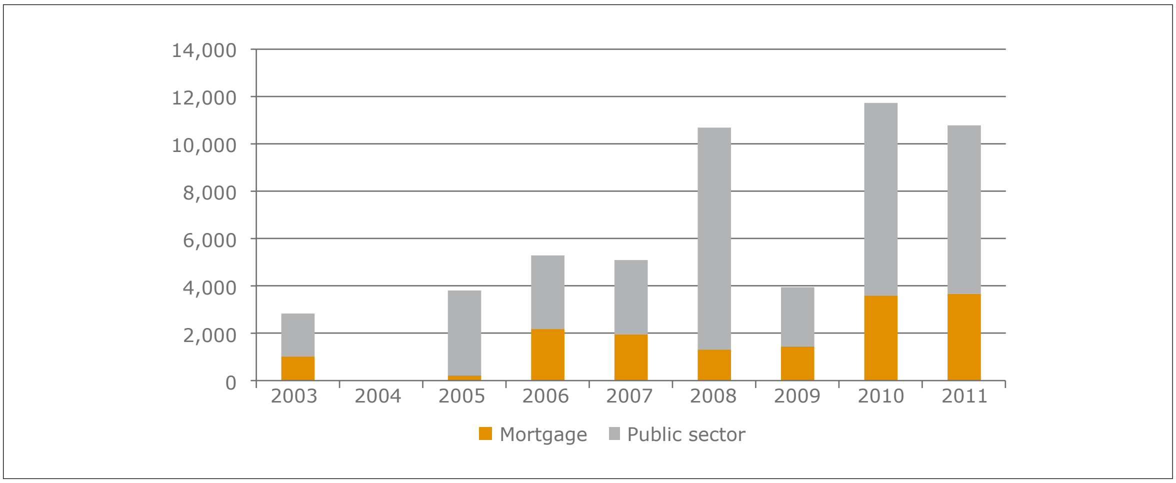
Austrian Covered Bonds are eligible in repo transactions with the national central bank.

> Figure 1: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://ecbc.eu/

3.3 BELGIUM

By Carol Wandels, Belfius Bank[1]

I. FRAMEWORK

"*Belgium is currently one of the few European countries that has no dedicated legal framework in place. However it should not take too long anymore before Belgian credit institutions can use covered bonds as an alternative funding tool knowing that the covered bond fundamentals are laid down in a draft legislation. This draft proposal, whereby the National Bank of Belgium (NBB) set pen to paper, is the result of ongoing discussions since 2009 between the Belgian banking sector, the NBB, the Belgian regulator (FSMA) and some law firms. It is expected that Belgium will join the dedicated legal framework countries by the end of 2011*".

This was the introduction of the 2011 Chapter. While we thought that by summer 2012 some Belgian banks would already have issued Belgian covered bonds, today (beginning of July 2012) Belgium can still not be considered as a covered bond legislative country. But one thing is sure, all necessary milestones have been achieved except the parliamentary voting process. At the moment of writing, the draft legislation was introduced in the Belgian Parliament and the urgency procedure is requested (which is quite often the case just before the summer break of politicians). Expectations are that after the summer break the covered bond law will be enacted. This would allow Belgian banks to issue somewhere in the fourth quarter of 2012.

The description of the forthcoming Belgian covered bond framework in the following sections is based on the draft legislation as it currently stands but it can not be excluded that amendments are made in the last phase of the process.

The legal basis for Belgian covered bonds will be incorporated into the Act of 22 March 1993 on the status and the supervision of credit institutions. This will be supplemented by a Royal Decree and several regulations.

II. STRUCTURE OF THE ISSUER

Belgian covered bonds can be issued by universal credit institutions[2] established in Belgium. However such institutions will first need to be licensed by the NBB as covered bond issuer (general authorisation as issuer) and also the covered bond program (specific program license) itself will need to get approval from the NBB. An extensive issuer license file detailing aspects like its strategy, solvency, risk management, asset encumbrance, IT systems, internal audit, etc. needs to be submitted. At program level the issuer will need to detail the impact of the covered bond issuance on its overall liquidity, the quality of the cover assets and maturity matching of assets/liabilities in the program. The statutory auditor of the issuer will need to report to the NBB on the organizational capacity of the credit institution to issue and follow up the covered bonds.

If all three files have been submitted to the NBB, a license can be obtained but it might be conditional upon respecting issuance limits that the NBB on a case-by-case basis might decide on. If licensed, the issuer and the program(s) will be added to specific lists that will be available for consultation on NBB's website.

[1] Special thanks to Sylvia Kierszenbaum from Allen&Overy for reviewing the text.

[2] Existing credit institutions could decide to issue themselves or to issue from a newly created credit institution. The latter would typically but not necessarily be a subsidiary or an affiliate of the mother company.

At program level a distinction is made between CRD-compliant covered bonds, i.e. "Belgian pandbrieven/ lettres de gage", and non CRD-compliant (but still UCITS compliant) covered bonds, i.e. "Belgian covered bonds". The denomination of both terms is protected by law. These distinct types of covered bonds will appear on two separate lists. Consultation of the NBB's website will hence give an overview of:

> Belgian credit institutions issuing covered bonds; and

> Belgian pandbrieven programs and its specific issuances

However the way that the law and the Royal Decree are stipulated, makes that in practice the Belgian credit institutions will only be able to issue CRD-compliant covered bonds. Therefore, in what follows, we will only concentrate on the Belgian pandbrieven.

When a credit institution issues Belgian pandbrieven, its assets will by operation of law consist of two distinct estates: its general estate on the one hand and a separate, ringfenced "segregated estate" ("patrimoine spécial") on the other hand (=balance sheet structure, no use of a special purpose vehicle). The general estate will comprise those assets of the issuing bank to which all its creditors have a direct recourse.

The Belgian pandbrieven investors will have a direct recourse to (i) the general estate of the issuing credit institution (i.e. repayment of the Belgian pandbrieven is an obligation of the issuing bank as a whole) and (ii) the segregated estate, that will comprise the cover pool that is exclusively reserved for the Belgian pandbrieven investors of a specific program and for the claims of other parties that are or can be identified in the issue conditions. Assets will become part of the cover pool upon registration in a register held by the issuer for that purpose. As of that moment those assets will form part of the segregated estate and are excluded from bankruptcy clawback risk.

When insolvency proceedings are opened, by operation of law, the assets recorded in the segregated legal estate do not form part of the insolvent general estate and hence will not be affected by the opening of the insolvency proceedings. Belgian pandbrieven investors will upon insolvency of the credit institution fall back on the cover pool assets for the timely payment of their bonds but at the same time holders will continue to have a claim against the insolvent general estate. Creditors that are not related to the segregated estate will not have any recourse to these cover pool assets. Any amounts left in the special estate can return to the insolvent general estate, upon the request of the bankruptcy receiver and after consultation of the NBB, once it is certain that the cover assets are no longer needed.

III. COVER ASSETS

All assets and instruments that will be legally segregated for the benefit of the Belgian pandbrieven investor in a separate estate constitute the cover pool. The cover pool can be composed of assets that are part of any of the following categories:

> Category 1: residential mortgage loans, and/or senior RMBS;

> Category 2: commercial mortgage loans, and/or senior CMBS;

> Category 3: exposure to the public sector, and/or senior public sector ABS;

> Category 4: risk on financial institutions; and

> Category 5: derivatives.

These five general categories are subject to further eligibility criteria:

- Geographical scope: Organisation for Economic Co-operation and Development (OECD), except for category 1 and 2 that are further restricted to EEA; for category 3 non-OECD public sector exposure will get a zero valuation, unless specified otherwise in Section IV.
- With respect to the MBS/ABS as mentioned in each of the first three categories: ABS/MBS are eligible provided that 90% of the underlying pool is directly eligible and is originated by a group related entity of the issuer of the Belgian pandbrieven. The senior ABS/MBS must qualify for credit quality step 1 (as set out in annex IX, part 4, 6 of the 2006/48/CE Directive). The securitization vehicle of the ABS/MBS must be located in the EU;
- For the mortgage loans mentioned in category 1 and 2: the loans need to be guaranteed by first lien (and subsequent lower ranking) mortgages on (residential or commercial) properties located in the EEA. Mortgage loans with properties under construction/in development can only be added to the cover pool if they do not represent more than 15% of all the mortgage loans taken up in the cover pool;
- For category 3: exposure to the public sector can only be (i) exposure to or guaranteed or insured by central governments, central banks, public sector entities, regional governments and local authorities or (ii) exposure to or guaranteed or insured by multilateral development banks or international organizations that qualify as a minimum for a 0% risk weighting as set out in annex VI, 20 of the 2006/48/CE Directive;
- For category 5: derivatives, of which the counterparty has a low default risk (to be further determined by NBB what can be understood by this), are only eligible if related to cover the interest rate/currency risk of the cover assets or Belgian pandbrieven. Moreover, a group related entity of the Belgian pandbrieven issuer is not eligible as derivative counterparty unless (i) it is a credit institution that benefits from a credit quality step 1 (as defined in Annex VI, points 29 to 32 of the 2006/48/CE Directive) and forms part of the EEA, and (ii) it has a (unilateral) credit support annex (CSA) in place. Note that any assets posted under the CSA would belong to the separate legal estate, but are not considered as a cover asset as described in this section III. Finally, the derivative contract needs to stipulate that suspension of payments or bankruptcy of the issuer does not constitute an event of default;
- For all of the categories: assets that are >[30]days delinquent may not be added to the cover pool.

The cover pool can be composed of assets out of each of the five categories. But per program that is set up, assets out of one of the first three categories (so either residential mortgage loans, commercial mortgage loans or exposure to public sector) need to represent a value of at least 85% of the nominal amount of Belgian pandbrieven. In practice this comes down to three types of Belgian pandbrieven programs that can be set up: residential mortgage covered bond program, commercial mortgage covered bond program or public covered bond program. How such value is determined, is explained in the following chapter.

IV. VALUATION AND LTV CRITERIA

The valuation rules of the cover assets determine the maximum amount of Belgian pandbrieven that can be issued. The value of the cover assets of each of the categories as mentioned in the section above, will be determined as follows:

- Category 1: minimum of [the outstanding loan amount, 80% of the value of the mortgaged property, the mortgage inscription amount[3]]
- Category 2: minimum of [the outstanding loan amount, 60% of the value of the mortgaged property, the mortgage inscription amount]
- Category 3: value is equal to the book value (nominal amount outstanding), except when the counterparties are not part of the EU in which case the value will be zero. There is however an exception to this zero valuation rule for non-EU counterparty exposure:

  a) in case the non-EU counterparties qualify for credit quality step 1, or

  b) in case the non-EU counterparties qualify for credit quality step 2 and do not exceed 20% of the nominal amount of Belgian pandbrieven issued

  in either case the value is equal to the book value.
- Category 4: no value can be given to this category unless:

  a) the counterparty must qualify for credit quality step 1, or

  b) in case the counterparty qualifies for a credit quality step 2, the maturity does not exceed 100 days as of the moment of registration in the cover pool

  in either case the value is equal to the book value.
- Category 5: no value is given to this category.
- Additional valuation rule applicable to any category: in case of delinquencies above 30 days, the value as determined per category is reduced by 50%. In case of default (> 90 days), no value can be given anymore.

When it comes to property valuation (applicable to category 1 and category 2), in general in Belgium every property is valued during the underwriting process based on either the notarial deed (that includes the property sale price) and/or in case of construction, the financial plan of the architects. It is rather rare in Belgium that the valuation is based on the report of an accredited third party appraiser. Specific regulation with respect to valuation of property is currently being drafted by the NBB.

Note that assets can be part of the cover pool without necessarily having a value attached to it, like is the case for the derivatives category but as well for example for risk on financial institutions with a maturity above 100 days and a rating below AA-.

V. ASSET-LIABILITY MANAGEMENT

Each issuer will be required to perform several asset cover tests. The first one has been already mentioned in section III and requires that the value of either category 1, 2 or 3 is at least 85% of the nominal amount of Belgian pandbrieven. Secondly, the value of the cover assets needs to exceed the nominal amount of Belgian pandbrieven by 5% at all times (5% overcollateralization). Finally, the sum of the interest, principal and other revenues needs to be sufficiently high to cover for the sum of interests, principal and other costs linked to the Belgian pandbrieven, as well as any other obligation of the Belgian pandbrieven program.

[3] This can include Belgian mortgage mandates but upon the condition that there is a first lien mortgage inscription of at least 60% related to one and the same property.

Next to the asset cover tests, a liquidity test will have to be performed whereby the issuer will calculate its maximum liquidity need within the next 180 days. This amount has to be covered by liquid cover assets. A liquidity facility could be used to cover liquidity needs, as long as it is not provided by a group related entity of the issuer. What can be included as other liquid cover asset still needs to be determined by the NBB.

The issuer will also be required to manage and limit its interest and currency risk related to the program and be able to sustain severe & averse interest/exchange rate movements. Although it is the issuer's sole discretion to determine how this will be managed (e.g. adding derivatives to the cover pool is a possibility (subject to eligibility criteria) but not an obligation) it needs to be documented in the license application.

At last it is important to highlight that the tests have to be met on a daily basis. It is the task of the cover pool monitor to verify at least once a month if the issuer is compliant with all the tests.

Other safeguard mechanism that will be foreseen:

> Issuer will have the possibility to retain its own Belgian pandbrieven for liquidity purposes.

> Commingling risk:

a) Collections received from cover assets as of the date of bankruptcy or beginning of liquidation will by law be excluded from the insolvent general estate

b) Registered collections received from the cover assets before the date of bankruptcy or beginning of liquidation, are part of the separate estate and legally protected via the right of "revindication". This is a special mechanism that has been created to protect cash held by the issuer on account of the special estate. Pursuant to this mechanism, the ownership rights of the special estate as regards cash that cannot be identified in the general estate, will be transferred to unencumbered assets in the general estate that will be selected by taking into account criteria specified in the issue conditions.

> Set-off and claw back risk: separate legislation in progress (same timing expectations for enactment as the covered bond law itself) to legally solve this.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

In its capacity as a Belgian credit institution licensed to issue Belgian pandbrieven, the issuer is subject to special supervision by the NBB as well as the supervision of a cover pool monitor.

The cover pool monitor:

> Is chosen by the issuer from those persons appearing on the official list of certified/statutory auditors established by the NBB;

> Shall be appointed subject to prior approval from the NBB (however, such appointment should be able to be revoked by the NBB in case of objective reasons);

> Can not be the certified/statutory auditor of the issuer.

The main tasks of a cover pool monitor consist of ensuring compliance with legal and regulatory requirements, e.g. are the cover assets duly recorded in the register, do the cover assets fulfil the eligibility criteria, is the value correctly registered, etc. Next to that the cover pool monitor has a reporting obligation towards the NBB on several aspects such as level of overcollateralization and results of the different tests that have to be performed. The issuer is obliged to provide full cooperation to the cover pool monitor and shall give the cover pool monitor the right to review the register, loan documents, accounting book, or any other document. The frequency and detailed procedures of any of the tasks of the cover pool monitor still need to be worked out by the NBB in its regulations.

The NBB at its discretion can ask the cover pool monitor to perform other tasks and verifications.

If the NBB considers that a category of Belgian pandbrieven no longer fulfills the criteria or the issuer no longer fulfills its obligations, it can withdraw the license of the issuer and consequently withdraw the issuer from the list. Such a deletion from the list will be reported to the European Commission but does not have consequences for existing Belgian pandbrieven holders.

VII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Assets need to be registered before they form part of the segregated estate. The law protects these registered assets (including all collateral and guarantees related to such assets) in the segregated estate from the creditors of the insolvent general estate, so they are therefore not affected by the start of insolvency proceedings against the issuer. Also any assets that would be posted via the CSA that is in place, would be protected from insolvency proceedings as it is required to register these type of assets as well, although as explained before one cannot consider those as pure cover assets.

The cover assets once registered are exclusively and by operation of law reserved for the benefit of the Belgian pandbrieven investors and other creditors that might be linked to the program (e.g. a swap counterparty of which the derivative is included in the cover pool). These creditors also have a claim on the general estate. Only when all obligations at program level have been satisfied, will any remainder of assets of the separate legal estate return to the general estate of the issuer. The bankruptcy receiver of the credit institution, in consultation with the NBB, could ask the restitution of cover assets if and when there is certainty that not all assets will be necessary to satisfy the obligations under the Belgian pandbrieven program.

At the moment of the opening of insolvency procedures of the credit institution, or even before whenever the NBB considers it to be necessary (e.g. at the moment the license is withdrawn), a portfolio manager ("gestionnaire de portefeuille") will be appointed that will take over the management of the Belgian pandbrieven program from the credit institution. The portfolio manager (appointed by the NBB) will have the authority to dispose of assets and will, in consultation with/upon approval of both the NBB and the representative of the noteholders, take all such actions required to fulfill in a timely manner the obligations under the Belgian pandbrieven. Such actions could consist in (partial) sale of the underlying cover assets, taking out a loan, issuance of new bonds to use for ECB purposes or any other action that might be needed to fulfill the obligations. Acceleration of the Belgian pandbrieven is not possible, unless:

> Noteholders would decide otherwise;

> It is clear that further deterioration of the cover assets would lead to a situation whereby it is impossible to satisfy the obligations under the Belgian pandbrieven (i.e. in a situation of insolvency of the cover pool).

The bankruptcy receiver has a legal obligation to cooperate with the NBB and the portfolio manager in order to enable them to manage the special estate in accordance with the law.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Belgian pandbrieven will comply with the requirements of Art. 52(4) UCITS Directive and of the CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f) if and to the extent they are listed by the NBB as such.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/100/Draft_Belgian_CB_Framework

3.4 BULGARIA

By Yolanda Hristova, UniCredit Bulbank
and Franz Rudolf, UniCredit

I. FRAMEWORK

In Bulgaria, the legal basis for the issue of covered bonds is the Mortgage-backed Bonds Law issued by 38th National Assembly on 27 September 2000, published in the State Gazette (Darzhaven vestnik) issue 83 of 10 October 2000[1].

Ordinance No 8 of Bulgarian National Bank on the Capital Adequacy of Credit Institutions[2] treats the risk weighting of other types of covered bonds.

II. STRUCTURE OF THE ISSUER

Pursuant to the Mortgage-backed Bonds Law, the Mortgage-backed bonds shall be securities issued by banks on the basis of their loan portfolio and secured by one or more first in rank mortgages on real estate in favour of banks (mortgage loans). Only banks may issue bonds called mortgage-backed bonds.

The real estate under the previous paragraph shall be insured against destruction and shall be of the following type:

> housing units, including leased out;

> villas, seasonal and holiday housing;

> commercial and administrative office spaces, hotels, restaurants and other similar real estate; and

> industrial and warehousing premises.

The issuing bank shall adopt internal rules on conducting and documenting mortgage appraisals of real estate which shall comply with the requirements of Article 73, paragraph 4 of the Bulgarian Law on Credit Institutions.

Securities issued under procedures other than the one laid down by the Mortgage-backed Bonds Law may not referred to with, or include in their appellation, the extension "mortgage-backed bond", or any combination of these words.

III. COVER ASSETS

The outstanding mortgage–backed bonds shall be covered by mortgage loans of the issuing bank (principal cover). To substitute loans from the principal cover that have been repaid in full or in part, the issuing bank may include the following of its assets in the cover of mortgage-backed bonds (substitution cover):

> cash or funds on account with the Bulgarian National Bank (BNB) and/or commercial banks;

> claims on the Government of the Republic of Bulgaria or the Bulgarian National Bank, and claims fully secured by them;

> claims on governments or central banks of states as determined by the Bulgarian National Bank;

[1] Amended; issue 59 of 2006; in force on the date of entry into force of the Treaty of Accession of the Republic of Bulgaria to the European Union; amended; issues 52 and 59 of 2007; amended; issue 24 of 2009; effective as of 31 March 2009

[2] Adopted by the Bulgarian National Bank, published in the Darjaven Vestnik, issue 106 of 27 December 2006, in force as of 1 January 2007; amended, issue 62 of 2007; amended, issue 38 of 2008, effective as of 11April 2008; amended, issue 21 of 2009; amended, issues 20, 85 and 102 of 2010; amended, issue 95 of 2011 (http://www.bnb.bg/bnbweb/groups/public/documents/bnb_law/regulations_8_credit_instit_en.pdf)

> claims on international institutions as determined by the Bulgarian National Bank;

> claims fully backed by government securities issued by the Government of the Republic of Bulgaria, the Bulgarian National Bank, the Governments, Central Banks or international institutions;

> claims secured by gold; and

> claims fully backed by bank deposits denominated in Bulgarian levs or in a foreign currency for which the BNB quotes daily a central exchange rate.

The substitution cover of mortgage-backed securities shall not exceed 30% of the total amount of liabilities of the issuing bank under that issue. Mortgage-backed Bonds cover from any issue (the sum total of the principal cover and the substitution cover) may not be less than the total amount of liabilities towards the principals of Mortgage-backed Bonds from that issue which are outstanding and in circulation outside the issuing bank.

The claims of the bondholders under mortgage-backed bonds from each issue shall be secured by a first pledge on the assets of the issuing bank included in the cover of that issue. The pledge is a subject of entrance in the Central Registers of Special Pledges, with the respective issue of mortgage-backed bonds being indicated as a pledge creditor.

The issuing bank shall request an entry and submit to the Central Register of Special Pledges all data required for the entry of the pledge within one month after executing a Mortgage-backed Bonds Issue and shall update that data at least once every six months thereafter. The pledge shall remain in force until the full redemption of the liabilities of the issuing bank under the respective issue of Mortgage-backed Bonds without the need for any renewal. Deletion of the pledge entry shall be made upon the full redemption of the issuing bank's liabilities under the respective issue of Mortgage-backed Bonds on the basis of a document issued by the bank's auditors.

IV. VALUATION AND LTV CRITERIA

Valuation

Mortgage appraisals of property shall be performed by officers of the issuing bank or by physical persons designated by it having the relevant qualifications and experience.

For appraisals of the property the comparative method, the revenue method and the cost-to-make method shall be used for the purposes of the law.

The mortgage appraisal shall explicitly specify the method or combination of the above methods used with the relative weight of each method in the appraisal, as well as the sources of data used in the analysis and calculations.

Subsequent mortgage appraisals of property used as collateral on the loans recorded in the register of mortgage-backed bonds cover shall be made at least once every twelve months for loans which:

> have outstanding liabilities exceeding 1% of the issuing bank's own funds; or

> have not been consistently classified as standard risk exposures throughout that period.

LTV criteria

LTV criteria are generally defined in the banks own lending policies depending on their risk appetite and other internal rules. No specific legal requirements are imposed by the local banking law.

V. ASSET-LIABILITY MANAGEMENT

Art.6 of the Law on Mortgage-backed Bonds stipulates that mortgage loans shall be included into the calculation of the principal cover at the value of their outstanding principal but at no more than 80% of the mortgage appraisal value of the real estate as housing units, including leased ones, and at no more than 60% of the mortgage appraisal value of the real estate as villas, seasonal and holiday housing units used as collateral on mortgage loans.

Substitution cover of mortgage-backed bonds from any issue may not exceed 30% of the total amount of liabilities of the issuing bank under that issue.

Mortgage-backed bonds cover from any issue (the sum total of the principal cover and the substitution cover) may not be less than the total amount of liabilities towards the principals of mortgage-backed bonds from that issue which are outstanding and in circulation outside the issuing bank.

In making calculations under the previous paragraph for Mortgage-backed Bonds and assets constituting their cover denominated in different currencies, the official foreign exchange rate for the Bulgarian lev to the respective currency quoted by the Bulgarian National Bank of the day of the calculation shall apply.

A loan recorded in the register of the cover of Mortgage-backed Bonds from a particular issue may be repaid at any time by bonds of the same issue at their face value.

VI. TRANSPARENCY

Banks (the only eligible issuers of mortgage bonds) produce regular reporting to Banking Supervision and provide and publish financial information on a monthly basis. No additional specific measures in respect to the mortgage bonds are currently announced.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Cover pool is managed by the issuing bank which should have adopted internal rules for maintaining the cover pool, the rules for access to the cover pool data base and the regularity of the update of the cover.

Bulgarian National Bank carries out general assessment of the banks, including issued mortgage bonds as part of general banking supervision.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

After the record of the assets in the register as a cover of mortgage-backed bonds of a particular issue may be used as collateral solely for the liabilities of the issuing bank on that issue. The issuing bank may not allow any encumbrances on its assets constituting the cover of outstanding mortgage-backed bonds. The issuing bank accounts assets recorded in the register of mortgage-backed bonds cover separately from the rest of its assets.

The issuing bank shall keep a public register of the cover of mortgage-backed bonds issued by it as the register is kept separately by mortgage-backed bonds issue.

In case of declaring the issuing bank bankrupt, the assets recorded as of the date of declaring the bank bankrupt in the register of the mortgage-backed bonds cover shall not be included in the bankruptcy estate. Proceeds from the liquidation of assets recorded in the register as a cover on a particular issue of mortgage-backed bonds are distributed among the bondholders from that issue in proportion to the rights under their bond holdings. Any funds remaining after settling the claims under mortgage-backed bonds from a particular issue is included in the bankruptcy estate.

The asset pool under the above mentioned paragraphs are managed by a holders' trustee of mortgage-backed bonds which is appointed by the bankruptcy court when it has been established that the bank has outstanding liabilities under mortgage-backed bonds. The trustee is managing the assets by individual mortgage-backed bonds issue.

The Trustee shall be a person who meets the requirements of Article 217, para. 1 and para. 2, items 1-3 of the Public Offering of Securities Act and is not engaged in any relationship with the issuing bank or any of the holders of mortgage-backed bonds which give reasonable doubt as to the former's impartiality. The Trustee shall have the powers of an assignee in bankruptcy in respect of the asset pool described above, as well as in respect of any outstanding liabilities of the issuing bank under mortgage backed bonds.

The Trustee shall manage the above mentioned assets separately for any mortgage-backed bond issue. The Trustee shall sell the above described assets under the procedure set forth in Articles 486-501 of the Civil Procedure Code and shall account any proceeds to an escrow account opened for each issue with commercial banks as determined by the Bulgarian National Bank. The Trustee shall publish in the State Gazette (*Darzhaven vestnik*) and in at least two national daily newspapers the place and time for the tender for the sale of assets under the procedures of previous sentence not later than one month prior to the date of the tender.

The bondholders of any issue of mortgage-backed bonds of a bank which has been declared bankrupt shall have the right to obligate the Trustee to sell loans included in the issue cover to a buyer specified by them and the Trustee shall follow precisely the decision of the Bondholders' General Meeting under the previous sentence.

The liabilities of the issuing bank under a Mortgage-backed Bonds issue shall be deemed repaid when the amount of outstanding principals of the sold loans becomes equal to the total amount of liabilities on principals and interest accrued on the bonds prior to the sales.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Risk weighting

Exposures in the form of covered bonds are treated in article 41 of Ordinance No.8 of Bulgarian National Bank on the Capital Adaquacy of Credit Institutions.

Exposures in covered bonds shall receive a risk weight one step more favourable than a senior unsecured exposure to the issuing bank in accordance with the *Standardised Approach to Credit Risk*.

Risk weights for exposures to covered bonds under Standardised approach:

- Risk weight of the issuer's first-rate unsecured debt 20% 50% 100% 150%
- Risk weight of the exposure 10% 20% 50% 100%

Risk weights for exposures to covered bonds under Foundation IRB (Internal Rating Base approach):

Loss Given Default (LGD) values for Exposures to Central Governments, Central Banks, Corporates and Institutions:

- senior exposures without eligible collateral: 45%;
- subordinated exposures without eligible collateral: 75%;
- covered bonds as specified in Article 41, paragraphs 2–4 (where mortgage bonds fall): 11.25%

Covered bonds shall be secured by any of the following eligible assets:

- exposures to or guaranteed by central governments, central banks, public sector entities, regional governments and local authorities in the EU Member States;
- exposures to or guaranteed by non-EU central governments, non-EU central banks, multilateral development banks, international organisations that qualify for the credit quality step 1 and step 2 as set out below:

Credit quality step	1	2	3	4	5	6
Risk weight	0%	20%	50%	100%	100%	150%

  and exposures to or guaranteed by non-EU public sector entities, non-EU regional governments and non-EU local authorities that are risk weighted as exposures to institutions or central governments; where these exposures qualify for the credit quality step 2, the exposure shall not exceed 20% of the current nominal amount of issued covered bonds of the issuing credit institution;
- exposures to institutions that qualify for credit quality step 1. The exposure shall not exceed 15% of the current nominal amount of the issued covered bonds of the issuing credit institution; exposures to EU-institutions that meet the step-2 credit quality requirement shall be included provided their residual maturity is less than 100 days;
- loans secured by mortgage on a residential property, to the lower of the amount of the pledge or 80% of the value of the property;
- senior shares in a special purpose (securitisation) entities governed by the laws of a Member State, securitising residential real estate exposures provided that at least 90% of the assets of such entities are composed of a mortgage of residential real estate and to the lower of:

  a) nominal value of the shares;

  b) value of the pledge;

  c) 80% of the value of the property pledged.

The shares under item 5 above shall have an assigned credit quality step one and not exceed 10% of the nominal amount of the outstanding issue. Exposures caused by transmission and management of payments of the obligors of, or liquidation proceeds in respect of, loans secured by pledged properties of the senior units or debt securities shall not be comprised in calculating the 90% limit from items 5 and 7. The covered bondholders' claims shall take priority over all other claims on the collateral.

Compliance with European Legislation

Mortgage-backed Bonds Law is compliant with the requirements of Article 52(4) UCITS Directive as well as with those of the CRD Directive, Annex VI, Part 1, Paragraph 68.

X. ADDITIONAL INFORMATION

Minimum information requirements for issuance prospectuses

The offering or the draft prospectus for an issue of mortgage-backed bonds consists of data valid at the time of their preparation, such as:

> the Rules of the issuing bank concerning the contents, the entry and deletion procedures as well as the terms and procedures authorizing access to the register and its internal rules of conducting and documenting mortgage appraisals;

> data on mortgage loans held in the issuing bank's portfolio on the basis of which an issue is being made, including for each loan:

a) the size of the outstanding principal at the time of extending the loan and by the end of the most recent full quarter;

b) loan life at the time of extending the loan and the remaining term to maturity;

c) interest rates, fees and commissions on the loan;

d) risk classification of the loan by the end of each calendar year from the time it was extended and by the end of the most recent full quarter;

e) type of real estate mortgaged as collateral, their mortgage appraisal value and the ratio between the outstanding principal and the mortgage appraisal value at the time of extending the loan and by the end of the most recent full quarter;

> characteristics of the mortgage loan portfolio on the basis of which the issue is made, including a distribution of loans by:

a) the size of the outstanding principal;

b) the residual term to the final repayment of the loan;

c) interest rate level;

d) their risk classification by the end of the most recent full quarter; and

e) the ratio between the outstanding principal and the most recent mortgage appraisal value of the real estate pledged as collateral.

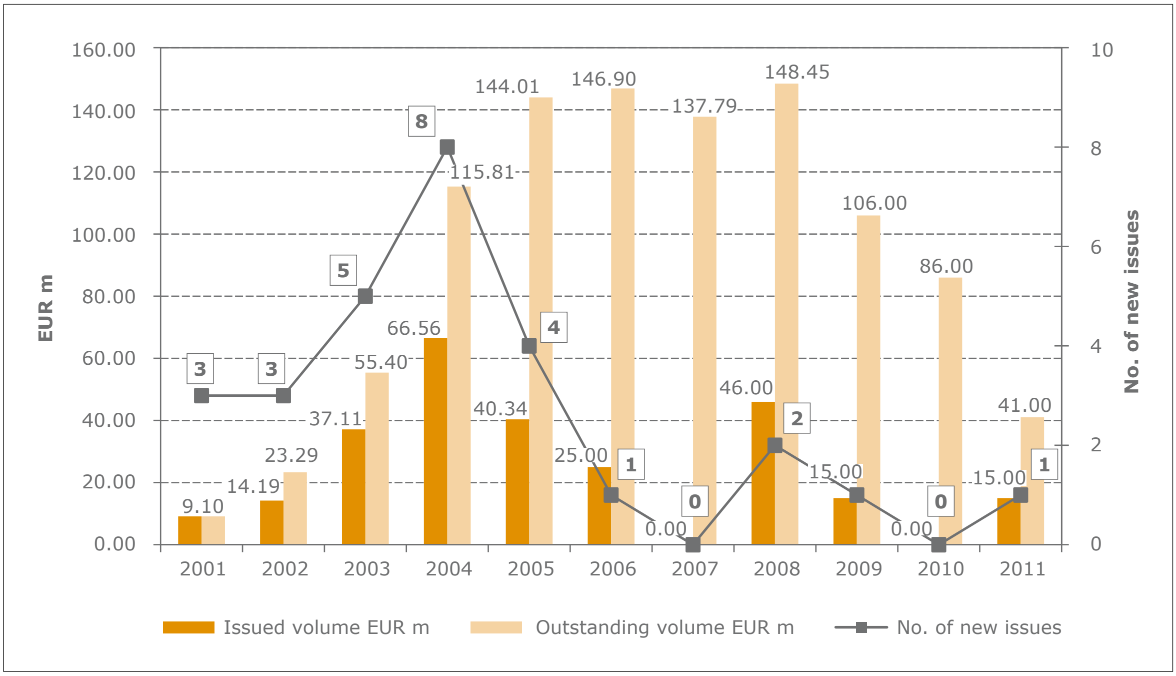
In public offerings of Mortgage-backed Bonds the provisions of the Public Offering of Securities Act (POSA) and the Ordinances on its enactment shall apply. In non-public offerings of Mortgage-backed bonds the provisions of Commerce Law shall apply.

Bulgarian Mortgage Bond Market Information

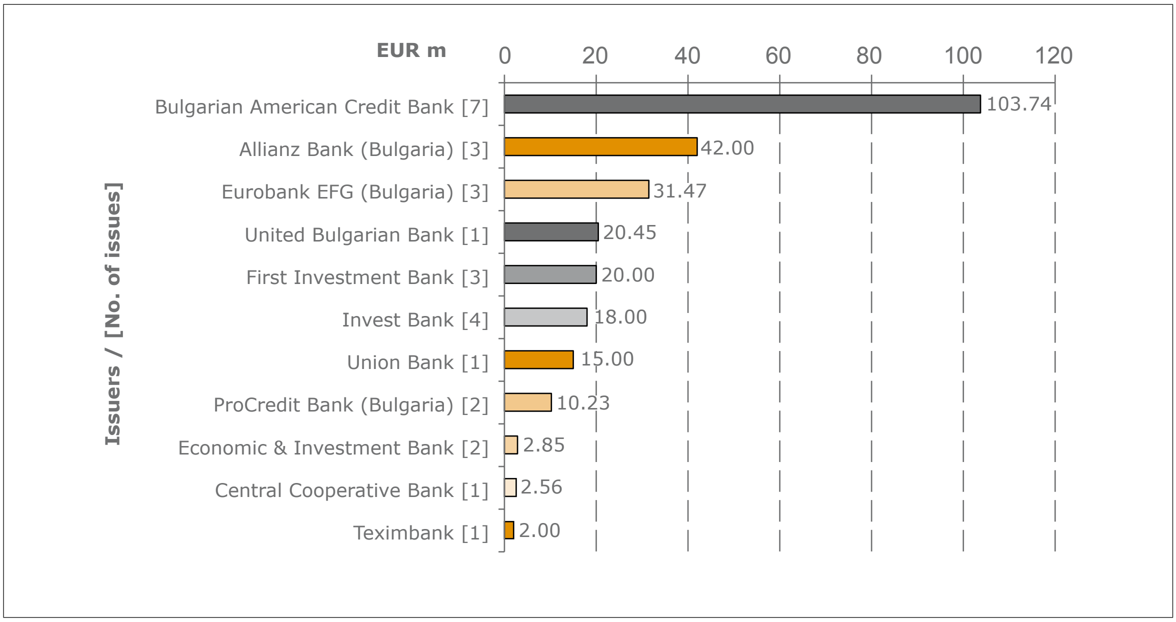
Since the adoption of the Bulgarian Law on Mortgage-backed Bonds in 2000 the Mortgage Bond Issues in Bulgaria total 28. There were one new issue in 2011. The volume of issued mortgage-backed bonds is EUR 268.3 m originated by 11 issuing banks. As of 31 December 2011 the outstanding Mortgage Bonds amount to EUR 41 m[3].

[3] Source: Central Depository, UniCredit Bulbank's own database

> Figure 1: Mortgage Bond Issues in Bulgaria



> Figure 2: Mortgage Bond Issuers in Bulgaria (2001 - 2011)



ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/72/Bulgaria

3.5 CANADA

By Anne Caris, Bank of America Merrill Lynch

I. FRAMEWORK

There is currently no dedicated legislation in respect of the issuance of covered bonds in Canada. Canadian covered bonds are based on contractual agreements and the program characteristics of the banks are self-imposed except for the issuance limit. A covered bond issuance limit of 4% of total assets was established in June 2007 by the Office of the Superintendent of Financial Institutions (OSFI) and remains unchanged to this day. OSFI regulates Canadian financial institutions.

Major steps have, nonetheless, been achieved since last year's Consultation Paper (May 2011). A draft law was proposed to Parliament in April 2012 and the Canadian covered bond legal framework is expected to be implemented by year-end. For the most part, the proposed framework aims to codify the terms within the existing Canadian covered bond programs – except for one major amendment. Under the new law, Canadian insured mortgages will no longer be eligible (only covered bonds by Royal Bank of Canada are backed by non-insured residential mortgages). To comply with the new law, Canadian banks will need to set up new programs for future issuance. New covered bond issuance is to be restricted to registered covered bonds.

In a nutshell, the key elements of Canada's new proposed covered bond legislation are as follows:

> Structure – an SPV model whereby asset segregation occurs via legal sale to a bankruptcy-remote Special Purpose Vehicle (SPV). This is in line with existing Canadian structures.

> Priority of claim – clarifications in the law to ensure that, in the event of issuer insolvency, the covered bondholders have a priority claim on assets held by the SPV.

> Eligible assets – uninsured mortgages for residential properties located in Canada only and with no more than four residential units. Loan-to-values (LTVs) cannot exceed 80%.

> Substitute assets – Canadian government securities and any prescribed assets to be eligible as substitute assets up to 10% of cover assets.

> Maximum over-collateralisation (OC) – no explicit level defined in the law but issuers will need to specify a minimum and maximum OC level for their respective programs.

> Registration – specific process to be registered and able to issue covered bonds. The Registrar (namely Canada Mortgage and Housing Corporation [CMHC] i.e., Canada's national housing agency) to ensure that all requirements have been met. CMCH may at anytime establish conditions or restrictions applicable to registered issuers and registered programs. It may also suspend the right of a registered issuer to issue further covered bonds under a registered program (written notice of a minimum 30 days, specifying the reasons).

> Type of issuer – registration process only open to federal financial institutions or cooperative credit societies incorporated and regulated by or under an Act of the legislature of a province.

> Additional regulation – Minister of Finance able to make further regulations including in terms of book keeping and reporting for which minimum disclosure requirements can be expected for transparency / standardisation.

> Cover pool audit – regular auditing from time to time and, at least once a year, by OSFI or persons acting under their directions. In this context access to any book/record or party (management, auditors).

Other items not covered by the current law proposal but mentioned in the consultation paper include:

> The proposal to standardise the approach to valuing the collateral within the cover pool for the purpose of the coverage tests and the frequency with which these tests are run.

> Demand loans to be callable at any time following a breach of certain triggers and default of the issuer (size of the Demand Loan defined as the value of the excess collateral within the Guarantor that is not required as collateral for the outstanding covered bonds).

> Counterparty criteria with issuers being permitted to act as swap counterparty and service provider (account bank, cash manager, etc.) within their programs, conditional to back-up/contingency plans if they breach certain triggers.

II. STRUCTURE OF THE ISSUER

To date, seven covered bond programs have been established by large Canadian financial institutions, namely Royal Bank of Canada (RBC), Bank of Montreal (BMO), Bank of Nova Scotia (BNS), Canadian Imperial Bank of Commerce (CIBC), Toronto-Dominion Bank (TD), National Bank of Canada (NBC) and Caisse centrale Desjardins (CCD). Covered bonds have been issued under all seven programs to date.

Canadian covered bond programs are all based on a similar structure. They are direct and unconditional obligations of the issuer. In the event of issuer insolvency or default, investors have a claim over the pool of cover assets. The cover assets are held in a bankruptcy-remote special purpose entity, the Guarantor, which provides a direct, unconditional and irrevocable guarantee in respect of due interest and principal payments under the covered bonds that would otherwise be unpaid by the respective issuer. In Canada, the Guarantor is either structured as a limited liability partnership or a trust, subject to accounting and tax considerations of the issuer. A bond / security trustee holds security over the cover assets on behalf of the investors.

Following an Issuer Event of Default, the Guarantor is required to meet the covered bond obligations using the cash flows generated from the cover assets. The Guarantor is permitted to sell the cover assets to meet these obligations, as required. The entire pool of cover assets is available as security for all the outstanding covered bonds issued under the program so there is no direct link between particular assets and a specific series of covered bonds. Payments made by the Guarantor under the covered bond guarantee are made in accordance with the applicable order of priority of payments. Preferential rights are limited to the Guarantor's assets although, if cover assets were to be insufficient, covered bond holders have recourse to the assets of the issuing entity ranking pari passu with unsecured debt holders.

Cover assets are segregated from the issuer through a legal true sale between the issuer and the Guarantor. The issuer grants the Guarantor a loan (the inter-company loan), the proceeds of which are used by the Guarantor to purchase the cover assets from the issuer. Legal title to the mortgages typically remains with the issuer and is only transferred to the Guarantor following the breach of a ratings trigger and subsequent replacement of the issuer as servicer. Borrowers are notified of the sale of the mortgages to the Guarantor upon breach of the trigger. Typically, additional cover assets are sold to the Guarantor to either meet the asset coverage requirements on an ongoing basis or to issue additional covered bonds under the program.

Importantly, the inter-company loan in Canada is split into a Demand loan and a Guarantee (or Term) loan. The Guarantee (or Term) loan represents the portion of the cover assets required as collateral for the outstanding covered bonds, as determined by the Asset Coverage Test (ACT). The balance of the inter-company loan constitutes the Demand loan, which represents the surplus assets held by the Guarantor. The issuer can call the Demand loan at any time, which would result in the excess assets being sold back to the issuer or a third party to repay the outstanding Demand loan. As such, covered bond investors only have access to the assets that are required as collateral for the covered bonds so that voluntary over-collateralisation beyond legal requirements is not protected.

III. COVER ASSETS

Cover assets in Canada's existing covered bond programs consist mainly of insured residential mortgages, with the exception of Royal Bank of Canada where mortgages are uninsured. The cover pool may also include National Housing Association Mortgage Backed Securities[1] (NHA MBS). Residential mortgages are typically amortising although few programs include home equity lines of credit (HELOCs). However, these loans are full recourse – similar to amortising mortgages with strict origination terms, in line with covered bond minimum requirements, e.g., in terms of LTVs (see below). Furthermore, HELOCs were insured like any other loan until 18 April 2011. While this is no longer the case, HELOCs outstanding prior to this date are grandfathered. Mortgages are backed by Canadian properties only.

Substitute assets can also be included in the cover pool. Being tailor-made covered bond programs, the eligibility criteria are self-imposed. There are, however, some similarities in the substitute collateral: 1) substitute collateral must not exceed 10% of the CAD-equivalent of the aggregate principal amount outstanding of the covered bonds; 2) substitute collateral may be exposures to institutions that are 10% or 20% risk-weighted (RSA) and CAD-denominated RMBS; 3) at any time that an Asset Coverage Test Breach Notice is outstanding or a Covered Bond Guarantee Activation Event has occurred, all substitute collateral must be sold as quickly as reasonably practicable and the proceeds credited to the GIC account and/or invested in authorised investments.

In terms of mortgage products, it is worth noting the following elements specific to the Canadian market:

> **Insured vs uninsured mortgages:** there are two types of mortgage loan in Canada – the so-called low ratio and high ratio loans. The latter are characterised by a loan-to-value (LTV) above 80% and require default insurance by CMHC (Canada Mortgage and Housing Corporation, i.e., Canada's national housing agency) or private insurers. The system was put in place to facilitate access to the property market while safeguarding financial stability. Insured mortgages currently account for approximately two-thirds of outstanding mortgages and are thus an important asset class that has traditionally been used to secure covered bonds in Canada since they were first issued in 2007.

> **Amortising loans vs HELOCS:** certain Canadian mortgage products are structured to provide the borrower with flexibility. This enables the borrower to split the mortgage into various separate amortising tranches with different terms as well as a non-amortising HELOC or a secured credit card, backed by the same property. These various facilities are subject to a maximum LTV for each bor-

[1] NHA MBS are backed by insured mortgages and carry a timely payment guarantee from the Canada Mortgage and Housing Corporation ("CMHC"), which is a Canadian crown corporation wholly owned by the Government of Canada, whose obligations carry the full faith and credit of the Government of Canada.

rower determined during the underwriting process. HELOCs are secured loans that do not have a fixed maturity term. Borrowers are only required to pay outstanding principal on demand. Payments are required at least monthly and can be as low as the interest due on the outstanding amount.

IV. VALUATION AND LTV CRITERIA

In Canada, a property value has to be assessed during the underwriting process. The valuation is either performed by an accredited third-party property appraiser or information on the property value is obtained from an independently maintained valuation model based on the value of similar properties recently sold in the same area. Upon loan origination there is no indexed property valuation. In addition, properties are usually not reappraised once a loan is granted, unless a borrower asks for a loan increase leading to a rise of the formerly approved LTV or if there is reason to believe the property value has depreciated substantially.

LTV criteria are self-imposed and are typically the following: (1) 80% for uninsured loans that are less than three months in arrears or not in arrears (i.e., performing); (2) 90% for insured loans; (3) 0% for loans that are three months or more in arrears (i.e., non-performing).

V. HEDGING AND ASSET - LIABILITY MANAGEMENT

ALM risks are fully hedged in the current existing Canadian covered bond programs. The Guarantor enters into interest rate swap(s) to hedge risk arising from interest rate mismatches between the covered bond collateral and the Inter-Company Loan and, upon the occurrence of a Covered Bond Guarantee Activation Event, the amounts payable to the covered bond swap provider(s). The Guarantor also enters into covered bond swap(s) to hedge risks arising from currency. The swap counterparties of the Guarantor rank senior or pari passu to the covered bondholders in the order of priority of payments. Swaps are intra-group due to current high rating levels. However, rating triggers are in place to ensure collateral posting and/or replacement in the event of future downgrades.

Within the Canadian covered bond programs, there is an inherent liquidity mismatch due to the bullet payment nature of the covered bonds and the cash flows generated from the cover assets. Following a default by the issuer, the principal cash flows generated from the cover assets may not be sufficient to ensure timely repayment of the outstanding covered bonds. To mitigate this credit and liquidity risk, each program incorporates over-collateralisation based on the type of assets in the cover pool. In addition, a reserve fund is required to be built up for the benefit of the Guarantor if the issuer’s ratings fall below a stipulated level (below P-1 (Moody’s), F1+ (Fitch), A-1 (S&P) or R-1M/AH (DBRS)). This required reserve amount is sized to cover permitted third-party expenses, servicing fees, interest due on the covered bonds and, if applicable, non-termination swap payments due over a specific period of time as noted in the program documents. It is retained in a GIC account and, following an Issuer Event of Default, the balance of the Reserve Fund will form part of available revenue receipts to be used by the Guarantor to meet its obligations under the covered bond guarantee.

Furthermore, typical of SPV structures, Canadian issuers must meet the following tests aimed at preventing any significant mismatches:

> **Pre-Maturity Test (PMT):** in the event that an issuer fails to be rated at least P-1 (Moody’s), F1+ (Fitch), A-1 (S&P) or AL (or AH) (DBRS) on any business day six or twelve months (as set in the specific program terms) prior to the redemption of any hard bullet covered bond series, a PMT is deemed to be breached.

In the event of a breach, the Guarantor or cash manager must promptly notify the seller(s) and the bond trustee and has to fund a pre-maturity ledger up to an amount at least equal to the principal amount of the hard bullet covered bond series to allow the issuer to meet such payment when it falls due. Failure to do so constitutes an Issuer Event of Default.

> **Asset Coverage Test (ACT):** the ACT tests whether the adjusted aggregate loan amount is at least equal to the CAD-equivalent of the aggregate principal amount outstanding on covered bonds on each calculation date. It also requires the issuer to ensure that there is a pre-determined asset percentage, which must not be above 97% and not less than 90% without the consent of the issuer (thus, there is a minimum but also a maximum over-collateralisation). Tests are conducted on a monthly basis by a cash manager. An asset monitor tests the arithmetic accuracy of the ACT calculation yearly, or more frequently under specific circumstances. Loans that are three months or more in arrears are given no weight in the ACT.
>
> If the ACT is breached and not cured on the next calculation date, an ACT Breach Notice is served to the issuer – which must not issue any further covered bond. If the issuer fails to cure the ACT breach by transferring additional cover assets or cash to the Guarantor by the calculation date following the delivery of the ACT Breach Notice, an Issuer Event of Default occurs.

Other events that result in an Issuer Event of Default include:

- The issuer failing within a stipulated period to meet any interest and principal payment related to the covered bonds outstanding when due.
- The issuer is, or is deemed or declared to be, insolvent or bankrupt.
- The liquidator, receiver or any other similar officer is appointed in relation to an issuer or its assets.
- The Superintendent of Financial Institutions Canada has taken control of the issuer or its assets.

Following an Issuer Event of Default, the covered bonds are not automatically accelerated. The trustee will serve a Notice to Pay on the Guarantor, following which the unconditional and irrevocable guarantee becomes effective and the Guarantor is responsible for the amounts due under the covered bond. After the activation of the guarantee, an *Amortisation Test* (AT) is run on a monthly basis to ensure that the Guarantor has sufficient assets to meet these obligations. If the aggregate asset amount is less than the outstanding balance of the covered bond, the AT is failed resulting in a Guarantor Event of Default. Other events that result in a Guarantor Event of Default include:

- The Guarantor failing within a stipulated period to meet any interest or principal payment under the covered bond guarantee when due.
- An order is made or resolution passed for the winding-up or liquidation of a Guarantor.
- The Guarantor ceases to carry on all or a material part of its business.
- The Guarantor is, or is deemed or declared to be, insolvent or bankrupt, or admits its inability to pay its debts as they fall due.
- Proceedings being initiated against a Guarantor under any applicable liquidation, winding-up, insolvency or other similar laws.
- Receiver, administrator, trustee or other similar official is appointed in relation to the Guarantor or in relation to its assets.

- The Guarantor initiating or consenting to judicial proceedings relating to its liquidation, insolvency or similar proceedings under applicable laws.
- The Guarantor making a conveyance for, assignment for the benefit of, or entering into any composition with, its creditors.
- Covered bond guarantee is not, or is claimed by the Guarantor not to be, in full force and effect.

Following a Guarantor Event of Default, the Security Trustee serves a Guarantor Acceleration Notice on the Guarantor. At this point, the covered bonds are accelerated and the Guarantor disposes of the cover assets as quickly as is practical to meet the covered bond payments.

Most of the Canadian programs permit the issuance of both soft-bullet and hard-bullet covered bonds. With the soft-bullet bonds, if the issuer is unable to repay all the amounts due under the covered bonds at maturity (after any applicable grace periods), a Notice to Pay will be served on the Guarantor. If the Guarantor has insufficient funds to pay the outstanding covered bonds in full, the Legal Final Maturity Date will be extended to the Extended Maturity Date. Under the existing Canadian covered bond programs the extension period is twelve months.

VI. TRANSPARENCY

The proposed law specifically states that books, records and information prescribed by regulation shall be made available to the public. Furthermore, it adds that a a specific format on how to retain and publish such information might be established under additional regulation. Canadian covered bond issuers have been transparent in providing information in line with ECBC’s overall label requirement.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The issuer prepares investor reports on a monthly basis. In addition, a quarterly submission is made to the rating agencies, including an updated cover pool, which is used to confirm / recalculate the asset percentage used in the ACT. Furthermore, an independent audit firm (the Asset Monitor) tests the calculation of the ACT performed by the issuer (as Cash Manager) on an annual basis. However, if the rating of the Cash Manager has been downgraded below the trigger level stipulated by the rating agencies or if an ACT Breach Notice has been served on the issuer and not yet revoked, the Asset Monitor tests the calculation on a monthly basis, until the situation is resolved. If the test reveals an error in the ACT calculation, the Asset Monitor tests the calculation monthly for a period of six months.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Under the Canadian covered bond programs, the issuer sells the cover assets to the Guarantor pursuant to a mortgage sale agreement. The sale of the assets constitutes a legal true sale. As there is no dedicated legal framework for the issuance of covered bonds in Canada, all contractual agreements are structured within the general legislation.

Assets are flagged on the issuer’s computer/IT systems and the cash flows are segregated in favour of the Guarantor. The Guarantor also owns other assets, including substitute assets, the GIC, and benefits, under the swap agreements. The Guarantor is structured as a bankruptcy-remote, special purpose entity and as such, following insolvency of the issuer, all the assets of the Guarantor are segregated from those of the bankruptcy estate of the issuer. True sale and bankruptcy remoteness opinions provided by counsel form part of the transaction documents. The issuer is responsible for ensuring that the collateral restrictions are met.

Title to the cover assets is retained by the issuer until breach of certain trigger events, following which the issuer is required to notify the borrowers of the mortgage sale, thereby perfecting the legal assignment of the mortgage loans and their related security to the Guarantor.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

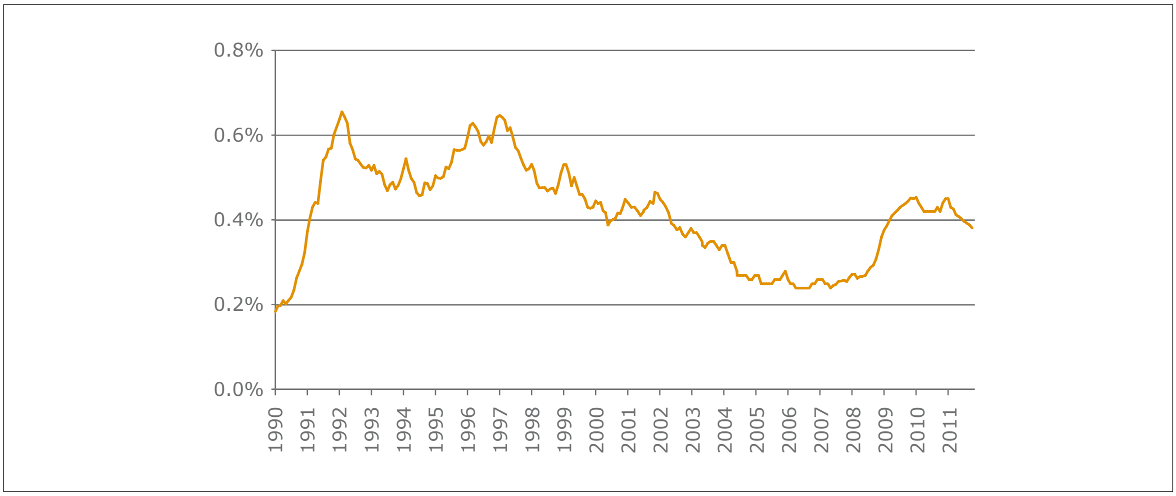
Canadian covered bonds are not UCITS 52(4)-compliant or CRD-compliant as Canada is not a Member State of the European Union (compliance also requires, among other things, the existence of a national covered bond legislation). Therefore, they do not benefit from a preferred risk-weighting for regulatory capital purposes. Under the Standardised Approach, they are treated similarly to senior unsecured bank debt.

That said, if EUR-denominated, Canadian covered bonds are eligible for the European Central Bank repo operations conditional on an investment grade rating. Specific haircuts are applied depending on the rating and characteristics of the covered bond.

X. ADDITIONAL INFORMATION: COMPARING INSURED VS UNINSURED MORTGAGES/ COVERED BONDS

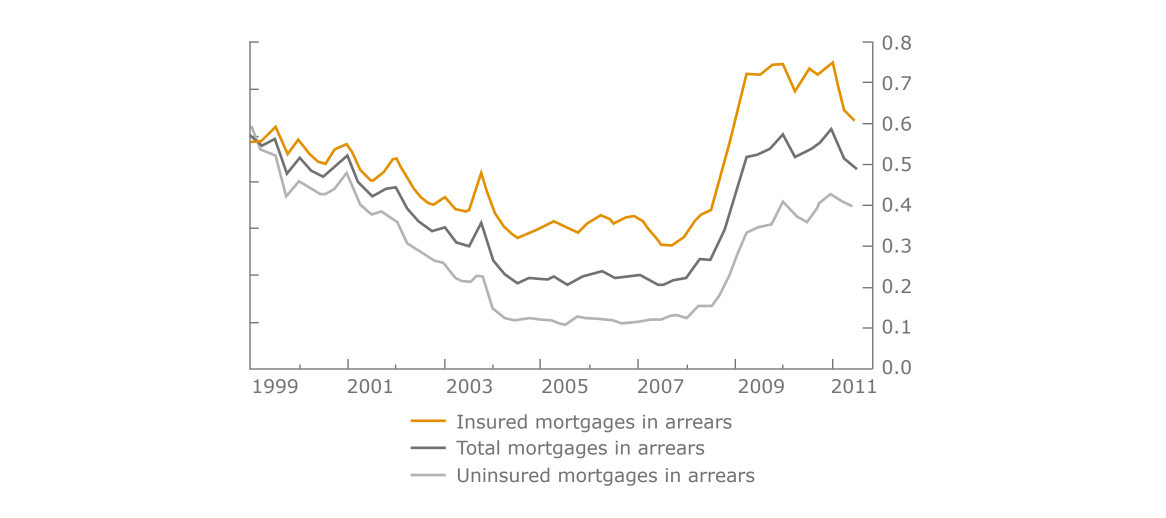
A major change for the Canadian covered bond market is that insured mortgage loans will be excluded from cover pools thus entailing a shift in the risk profile from public sector-like to traditional mortgage covered bonds. In that respect, it is worth noting the solid track record of the Canadian mortgage market through the cycle. Although at higher levels than in the years preceding the crisis, residential mortgage arrears are low at 0.38% at YE11 and below their historical peak. Arrears in Canada have not risen above 0.65% in the past 20 years and been at similar levels for both insured and uninsured mortgages (see Figure 1 and Figure 2). While mortgage arrears could rise as a result of negative macroeconomic factors, Canada's experience and relatively conservative mortgage framework suggest some degree of resilience.

> Figure 1: Residential mortgages in arrears %



Source: Canadian Bankers Association

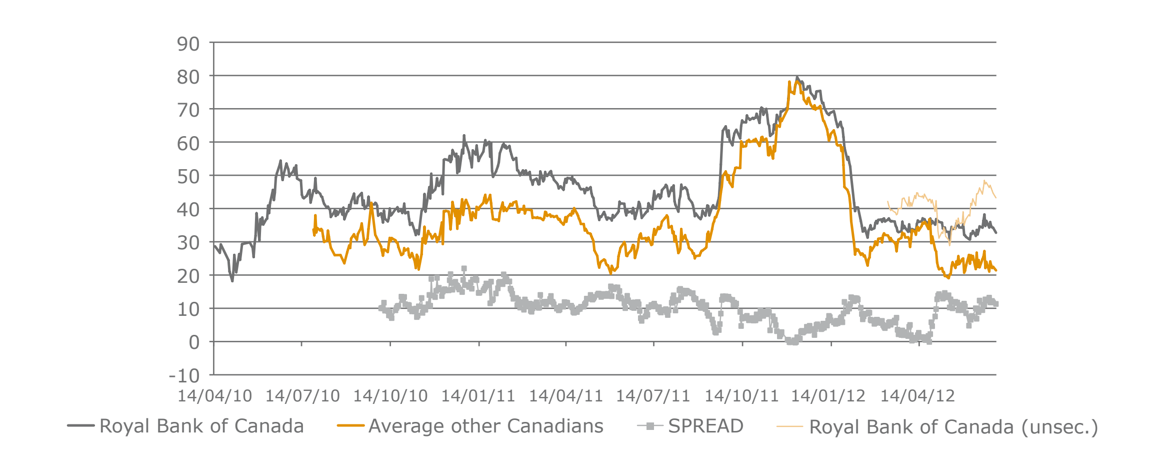
> Figure 2: Insured vs uninsured arrear levels (%)



Source: Canadian Bankers Association

Another key question is whether covered bonds backed by uninsured mortgages would price significantly higher than their "insured counterparts". Looking at Figure 3 which compares the ASW spreads of Royal Bank of Canada's US$-covered bonds (the only program in Canada to include exclusively uninsured mortgages) with the average ASW spread of other Canadian covered bonds (backed by insured mortgages), the differential between the two types of covered bond has been 10bp on average, with a maximum of 22bp and a minimum of 0bp. This is in line with what we see in other covered bond markets where the spread differential between public sector and mortgage-covered bonds in core markets for prime collateral is typically limited. The main driver of ASW spreads remains the issuer itself. Royal Bank of Canada's covered bonds also trade much tighter than senior unsecured bank debt with similar characteristics.

> Figure 3: Historical ASW spreads for US$ Canadian covered bonds & senior unsecured (bp)



Source: Bloomberg

Furthermore, the exclusion of insured loans from cover pools in the future should not impair Canadian banks' issuance capacity. Canadian banks disclosing the information show that they are not short of uninsured loans (see Table below). For example, insured mortgages at Royal Bank of Canada represent only 20% of the total compared with c.50% for Bank of Montreal and 60% for Canada Imperial Bank of Commerce and Toronto-Dominion Bank. The real hurdle for Canadian banks in terms of future issuance capacity is the maximum limit imposed by regulators, fixed at 4% of banks' total assets – one of the strictest across covered bond geographical markets.

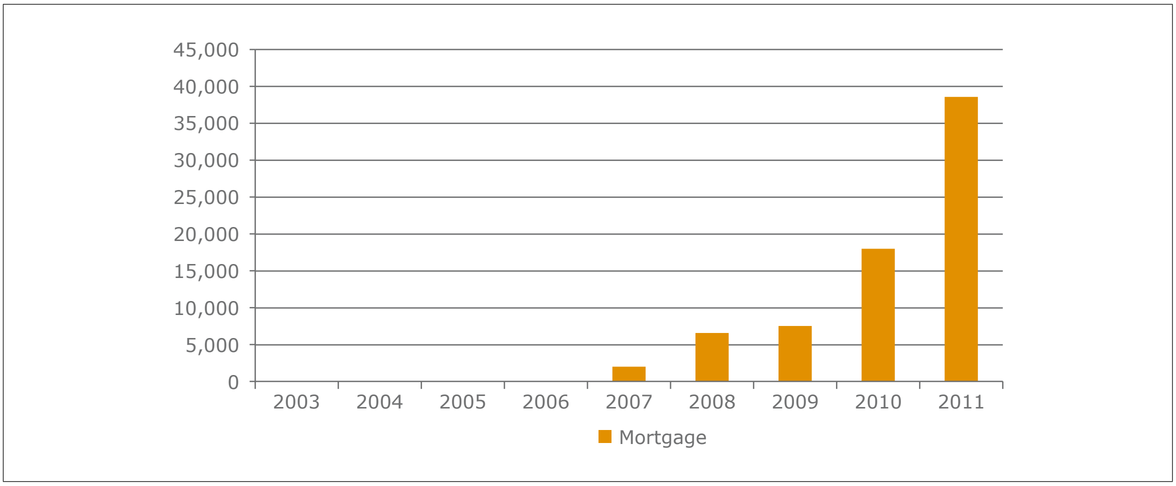
Figure 4: Uninsured Loans

YE2011 (C$ bn)	Royal Bank of Canada	Bank of Montreal	Bank of Scotia	Canadian Imperial Bank of Commerce	Caisse Centrale Desjardins	National Bank of Canada	Toronto-Dominion Bank
Max. covered bond issuance limit[1]	30	19	23	14	8	6	27
Outstanding Covered Bonds	9	7	10	13	1	2	7
Remaining issuance capacity (gross)	**21**	**12**	**13**	**1**	**7**	**4**	**20**
Total mortgages	132	54	123	100	78	18	87
Outstanding uninsured mortgages	**107**	**29**	**n/a**	**36**	**n/a**	**n/a**	**35**

[1]: 4% of total assets
Source: BofA Merrill Lynch Global Research

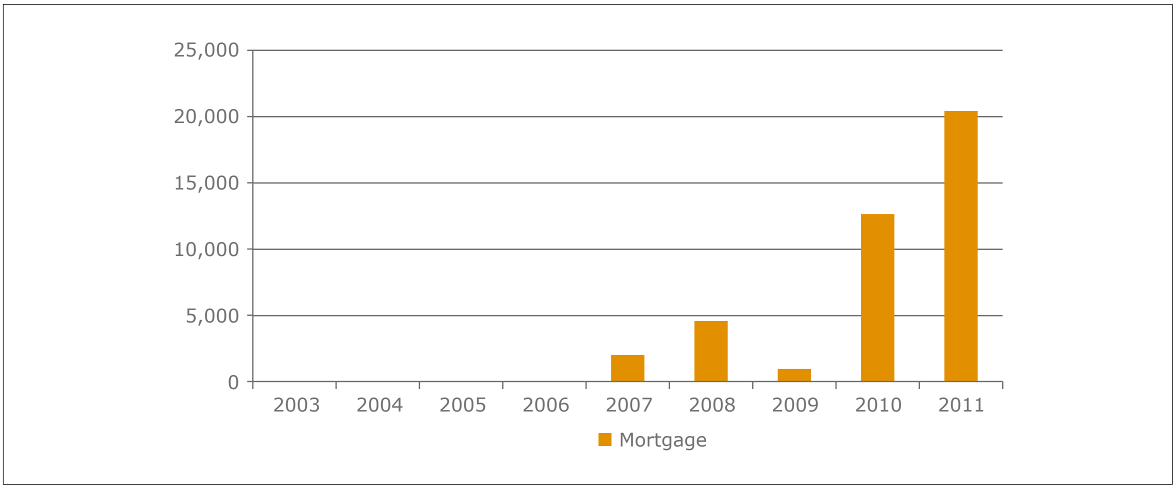
Issuers: Canadian Issuers as at July 31, 2011 were Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, Royal Bank of Canada, Toronto Dominion Bank National Bank of Canada and Caisse centrale Desjardins.

> Figure 5: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC

> Figure 6: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/12/Canada

3.6 CYPRUS

By Doros Theodorou and Dimitrios Spathakis, Cyprus Popular Bank

I. FRAMEWORK

Following on to an extensive and fruitful consultation process, which lasted over a year and involved the Central Bank of Cyprus (CBC), the Ministry of Finance, the Cooperative Societies Supervision and Development Authority and the banking industry, Cyprus has been the latest entrant to the covered bond universe in December 2010.

The primary legislation governing the issuance of covered bonds (Kalimmena Axiografa) is the Covered Bond Law of 2010, (130 (I)/2010), which came into force on December 23, 2010 (the "Law").

On the same day, the CBC issued a directive (526/2010) under the provisions of the Law, which constitutes the regulatory framework for the issue of covered bonds (the "Directive").

The Law and the Directive (the "Cypriot Legal Framework") are further supplemented by other laws (e.g. the Bankruptcy Law, the Banking Business Law, the Companies Law etc.) as referenced by the Law.

The Cypriot Legal Framework has been finalized in consultation with and following the positive opinion of the ECB, dated 14 October 2010 and 23 March 2011 (related links are: http://www.ecb.int/ecb/legal/pdf/en_con_2011_27_f_sign.pdf and http://www.ecb.int/ecb/legal/pdf/en_con_2010_73__f_sign.pdf)

II. STRUCTURE OF THE ISSUER

Under the Cypriot Legal Framework, Credit Institutions which have been approved by the Competent Authority (i.e. the CBC or the CSSDA), are only allowed to issue covered bonds using the direct issuance route.

Credit Institutions are defined, under the Law, to be:

> Banks (as defined in the Banking Laws);

> Cooperative Credit Institutions (as defined in the Cooperative Societies Law); and

> The Housing Finance Corporation (established under the Housing Finance Corporation Laws).

In accordance with Parts II and III of the Law, only Approved Institutions are eligible to issue covered bonds. Approved Institutions, are those Cypriot Credit Institutions which have been registered in the Register of Approved Institutions, (publicly available at the following link: http://www.centralbank.gov.cy/media/xls/ENG_2_Register_of_Approved_Inst.xls) following a relevant application to the Competent Authority.

Approval of such application is granted within 1 month from submission, and only after the Credit Institution has successfully demonstrated its ability to carry out the legal obligations of an Approved Institution, and that it fulfills the criteria and conditions determined by the Competent Authority.

Indicative minimum requirements set out in the Directive, for the registration of a Credit Institution in the Register of Approved Institutions, are:

> Core Tier 1 capital of at least EUR 50 m and capital adequacy ratio as required by the CBC under Pillar I and Pillar II of the Capital Requirements Directive;

> Establishment of an automated system for the support of the covered bonds business;

- Established risk management procedures for the recognition, management, monitoring and control of risks that may arise during the conduct of the covered bonds business;
- Procedures, policies and systems in place for the support of the covered bonds business; and
- Compliance with the provisions of the Law and the Directive, to be represented by a written confirmation by the Board of Directors of the Credit Institution.

With respect to individual covered bond issuance, Approved Institutions must subsequently apply to the Competent Authority for registration of such new issue in the Covered Bonds Register (publicly available at the following link: http://www.centralbank.gov.cy/media//xls/EN_register_9.04.2012.xls). Approval of such application is granted within 10 days from submission, and it is only following such approval that a newly issued bond becomes a covered bond.

III. COVER ASSETS

Primary cover assets are:

- Residential property backed loans (i.e. any kind of credit facility, secured on immovable property, provided that the property is used or intended to be used for residential purposes;)
- Commercial property backed loans;
- Public claims;
- Maritime loans; and
- Any other type that may be determined by the Competent Authority.

The criteria, terms and conditions in relation to cover assets are determined by the regulator in Art.13, 14 and 15 of the Directive. The main criteria indicatively include:

- Residential and commercial loans should be secured by a mortgage (or an equivalent security over a property if the property is not located in Cyprus) created in accordance with the Laws of Cyprus or the law of other Member States[1];
- The mortgage or the equivalent charge on immovable property, securing the credit facility, is created for an amount, at least, equal to the value of the loan;
- The immovable property securing the credit facility must be situated on the territory of the Republic or on the territory of other Member States;
- A residential or commercial loan secured by buildings under construction may be included in the cover pool, provided that the total value in each cover pool of the loans secured by buildings under construction does not exceed 10% of the cover pool value;
- Rescheduled loans may be included in the cover pool, only after the lapse of six months from the payment date of the first rescheduled loan instalment;
- Hedging contracts may also be included in the cover pool, only to the extent that they are used exclusively for the purpose of hedging any type of risk that may adversely affect the value of the cover assets.

[1] Member State means a member state of the European Union or other state which is party to the Agreement for the European Economic Area, which was signed in Oporto on 2 May 1992, and adapted by the Protocol signed in Brussels on 17 May 1993

a) It is noted, that in accordance with Art.33(b) of the Directive, the counterparty in a hedging contract must "*have a credit rating assigned to the first credit quality step as determined in Annex VI of the Directive 2006/48/EC or a guarantee by a connected entity of the counterparty whose credit rating is assigned to the first credit quality step*"

Finally, apart for the Primary Cover Assets, Complementary Assets may also be included in the cover pool, as prescribed under Art.16, 17 and 18 of the Directive (e.g. deposits with central banks and other highly rated institutions, traded debt securities, etc.).

Limitations and guidelines on the above are specified in the Directive (e.g. total value of Complementary Assets included in the cover pool and counted in the measurement of the Basic Collateralisation, not to exceed 15% of the total value of covered bonds, etc.).

IV. VALUATION AND LTV CRITERIA

For **residential loans**, the LTV is not allowed to exceed 75%, provided that if the LTV is above 75% but below 100%, such loans may be included in the cover pool on the condition that:

> They do not exceed 25% of the value of the covered bonds secured by the cover pool; and

> Such inclusion would not cause the weighted LTV of the cover pool to exceed 80%

For **commercial loans**, the LTV is not allowed to exceed 60%, provided that if the LTV is above 60% but below 80%, such loans may be included in the cover pool on the condition that:

> They do not exceed 25% of the value of the covered bonds secured by the cover pool, and

> Such inclusion would not cause the weighted LTV of the cover pool to exceed 65%

For **maritime loans**, the LTV is not allowed to exceed 60%, provided that if the LTV is above 60% but below 70%, such loans may be included in the cover pool on the condition that:

> They do not exceed 25% of the value of the covered bonds secured by the cover pool, and

> Such inclusion would not cause the weighted LTV of the cover pool to exceed 65%

In accordance with Art.13(10) and Art.15(10) of the Directive, the valuation of residential and commercial properties and the valuation of ships (Art.15(10) of the Directive) should be carried out by an independent valuer; i.e. a person who possesses the necessary qualifications, ability and experience to produce a valuation and is independent from the credit decision process.

For the monitoring and review of the value of the residential and commercial properties, the provisions of paragraph 8 (b) of Part 2 of Appendix VIII of the Directive of the Central Bank to banks for the Calculation of the Capital Requirements and Large Exposures shall apply. The provisions of the Directive dictate the following:

> The revaluations of the properties may be carried out by applying statistical methodologies.

a) For commercial properties, according to the aforementioned Directive, the value of the property is reviewed regularly and at least once a year;

b) For residential properties, according to the aforementioned Directive, the value of the property is reviewed regularly and at least once every three years; and

c) In situations where the market is subject to significant changes in conditions, a more frequent review of the property value is required.

- When information indicates that the value of the property may have declined materially relative to general market prices, the property valuation must be reviewed by an independent valuer
- Also when the balance of the financing exceeds €3million or 5% of the own funds of the credit institution, the valuation of the property will be reviewed by an independent valuer at least every 3 years

Additionally, and pursuant to Art.46(b) of the Directive, the Covered Bond Monitor ("CBM"), appointed in accordance with Art.49 of the Law, has a duty to examine the valuation process in relation to the valuation of the cover assets.

V. ASSETS - LIABILITY MANAGEMENT

The Directive provides for the following statutory tests:

- **Nominal Value Test**

  The adjusted[2] nominal value[3] of the Basic Cover (i.e. the Basic Collateralisation as defined under Art.24 of the Directive) must be at least equal to the total value of covered bonds issued under the programme.

- **Net Present Value Test**

  The adjusted net present value of the Basic Cover must be at least equal to 105% of the total net present value of covered bonds issued under the programme. All cover pool assets, including loans, Complementary Assets and hedging instruments must be included in the calculation of net present value of the Basic Cover.

  The above 105% condition must also be met in the following scenarios:

  a) Parallel interest rate shift of +200 and -200 basis points;

  b) Interest rate shifts determined by a 99% 6-month confidence interval using daily changes for the last 365 days;

  c) Exchange rate changes:

  - Euro and member-state currencies: 10%;
  - Currencies of the United States, Canada, Japan, Switzerland, Australia: 15%; and
  - Other currencies: 25%.

  d) Exchange rate shifts determined by a 99% 6-month confidence interval using daily changes for the last 365 days.

- **Weighted Average Life Test**

  The weighted average life of cover assets counted in the measurement of Basic Cover and Supervisory Overcollateralisation (as defined under Art.25 of the Directive), must be longer than the weighted average life of the covered bonds.

[2] Adjusted, refers to the set-off and LTV adjustments, as outlined under Art.24 of the Directive

[3] "Value" is defined under the Directive to mean nominal value plus accrued interest

> **Interest Cover Test**

Interest inflows from cover pool assets in the Basic Cover and Supervisory Overcollateralisation for the next 180 days must be reconciled with interest due on the covered bonds for the next 180 days and the highest net interest shortfall must be covered by the Complementary Assets contained in the Basic Cover and Supervisory Overcollateralisation.

> **Prematurity Test**

In relation to the repayment of the principal amount of the covered bonds, liquidity must be maintained, in the form of Complementary Assets or outside the cover pool in the form of liquid assets, as follows:

a) For the period between 180 days to 30 days before the maturity date of the covered bonds, at least 50% of the principal amount due for repayment;

b) For the period between 30 days before the maturity date and the maturity date of the covered bonds, 100% of the principal amount due for repayment.

Liquidity maintained for the purpose of meeting the prematurity test is not subject to the 15% limit of Complementary Assets in the cover pool (set in Art.20 of the Directive).

Additionally to the above statutory tests, and with a view to protect the depositors and all other unsecured creditors in case of insolvency proceedings, and to potentially provide for a reserve of assets that may be used in the future to sustain further stresses, the Directive provides that an Approved Institution is not permitted to issue covered bonds, if such an issue would result in:

> the total value of the primary assets which are required to be included in the institution's cover pools for each cover bond category, to exceed 90% of total value of the institution's eligible primary assets for that cover bond category, or

> the total value of the cover assets included in all cover pools and counted in the cover pool adequacy, to exceed 25% of the total value of the institution's assets.

VI. TRANSPARENCY

Transparency, in the Cypriot Legal Framework, is ensured through a series of reporting and registers that need to be maintained, updated and monitored by the covered bond Issuers as well as by the Competent Authority.

In accordance with Art.23 of the Law, covered bond Issuers are required to maintain a cover pool register for each covered bond Issue or Programme outstanding. Specific conditions for maintaining such Cover Pool Register (e.g. form, content, entry recording etc.) are outlined in Art.34-38 of the Directive. The Cover Pool Register is to be updated whenever an asset is included or excluded from the cover pool (and at least on a monthly basis) and shared with the Competent Authority and the CBM.

Specifically, Art.39-42 of the Directive set further transparency obligations to the covered bond issuers, requiring them to disclose, on a quarterly basis and in a publicly accessible area (e.g. their websites), specific statistical information relating to their outstanding covered bonds, in the form determined therein. The above information is also submitted to the Competent Authority and the CBM on a quarterly basis, in the form of Appendix 5 of the Directive.

With respect to the covered bond issuers and the covered bonds issued and outstanding in Cyprus, transparency is ensured through the maintenance of a Register of Approved Institutions (Art.5 of the Law) as a well as a Covered Bonds Register (Art.12 Law) by the Competent Authority. Both registers are kept in an electronic form and are publicly accessible in the website of the Competent Authority.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The Cypriot Legal Framework is structured in a manner which ensures very vigilant regulatory supervision of covered bond issuers. In accordance with Art.49 of the Law, each institution applying for registration in the Register of Approved Institutions, is required to appoint a qualified entity (e.g. an audit firm not associated with the covered bond issuer) as a Covered Bond Monitor (the "CBM"), such appointment being subject to the approval of the Competent Authority. The CBM must possess the necessary knowledge, experience and ability for the effective discharge of its functions and have the necessary qualifications outlined in Art.44 of the Directive. To the extent that, for any reason, the covered bond issuer has not managed to appoint a CBM, the Competent Authority is entitled to appoint one.

The duties of the CBM include a broad range of responsibilities, ranging from verifying to the Competent Authority, ahead of the application for the registration of bonds in the Covered Bonds Register, that the institution fulfils the conditions for registration as an approved institution, to submitting information and regular reports to the Competent Authority.

The main responsibilities of the CBM under the Cypriot Legal Framework, include:

> Overseeing the compliance of the Issuer with its obligations under the Cypriot covered bond Legislation;

> Prior to an application for the registration of any covered bonds in the Covered Bonds Register, verifying that the Issuer fulfils the conditions for registration as an approved institution and complies with the provisions of the Law in relation to every previous issue of covered bonds that are outstanding

> Where hedging contracts are included in a cover pool, verifying that these contracts fulfil the criteria set out in Art.26 of the Cypriot covered bond Legislation;

> Monitoring the cover pool assets included in a cover pool, including:

a) Verifying the accuracy and completeness of the information provided for the cover pool Assets included in the Cover Pool Register;

b) Examining the valuation process in relation to the valuation of the cover pool assets;

c) Monitoring compliance, on an on-going basis, with the Statutory Tests; and

d) Examining the entries in and removals from the Cover Pool Register and confirming the correct recording of the necessary information in the Cover Pool Register

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Following the registration of the covered bonds in the Covered Bonds Register, and in accordance with Art.16 of the Law, the cover pool is segregated from the covered bond issuer's insolvency estate, securing the claims of the Cover Pool Creditors[4] and constituting a form of charge over the cover pool assets.

[4] Cover Pool Creditors are defined in Art.2 of the Law to include, inter alia, the Covered Bond holders, the hedge counterparties, the Covered Bond Monitor and the Covered Bond Business Administrator

In accordance with the provisions of Art.28 of the Law and Art.21 of the Directive, covered bond issuers are required to maintain a Special Transaction Account, recording all inflows from the cover assets and the outflows from the account together with the details of such outflow. The balance of such Special Transaction Account is to be used solely for the servicing of the covered bonds as well as for the creation or acquisition of cover assets to be included in the cover pool, to ensure fulfillment of the cover pool adequacy criteria.

Furthermore, pursuant to Art.21(3) of the Directive, the covered bond issuer must have procedures in place which ensure, at any time, the ability to trace and calculate the cash inflows from the cover assets that have not been used. The operation of the Special Transaction Account is subject to the supervision of the CBM, in order to ensure that the covered bond issuer complies with the provisions of the Cypriot Legal Framework at all times.

In case of dissolution of the covered bond issuer, and until all legal claims of the Cover Pool Creditors are fully satisfied, the cover pool assets are not available to satisfy the claims of any other creditors of the Issuer in accordance with Art.40(5) of the Law.

By virtue of Art.40(7), 41 and 42 of the Law, the Covered Bond Business Administrator (the "CBBA") is empowered to dispose of the Cover Pool Assets, and use the proceeds of such disposal in order to satisfy the claims of the Cover Pool Creditors in priority over the claims of all other creditors.

To the extent that a covered bond issuer is subject to dissolution proceedings, in accordance with Art.40(5) and Art.40(6) of the Law, until the claims of the Cover Pool Creditors are satisfied in full, the cover pool assets will not be available to satisfy the claims of other creditors. Any surplus from the disposal of the cover pool, and only once the claims of the Cover Pool Creditors have been satisfied in full, shall be returned to the credit institution (Art. 44(1) of the Law).

Cover Pool Creditors enjoy a dual recourse, safeguarded under the Law. In accordance with Art.43(5) of the Law, to the extent that the claims of the Cover Pool Creditors are not fully satisfied from the disposal of the cover pool, then these creditors are, with respect to the unsatisfied part of their claims, unsecured creditors of the covered bond issuer.

In addition, where a covered bond Issuer is subject to dissolution proceedings, a Covered Bond Business Administrator (CBBA) is appointed by the Competent Authority (as per Art.59(1) of the Law), who takes all necessary measures to assume the control and the management of the cover pool and carries out the covered bond business. Any Cover assets not counted for the purposes of fulfilling the Statutory Tests shall be removed from the cover pool and the Cover Pool Register only by the CBBA.

The treatment of the cover pool following the commencement of dissolution proceedings is summarized below:

> Upon the initiation of dissolution proceedings, the CBBA assumes control of the cover pool (*according to the provisions of Art.40 of the Law*) and also of any liquid assets maintained outside the Register for the purposes of meeting the Prematurity Test, and is responsible to review the adequacy of the cover pool in accordance with Art.19 and Art.23 of the Directive;

> Cover pool adequacy assessment is being performed by the CBBA as per Art.18(6) of the Law, using solely those cover assets which are counted for the purposes of such assessment;

> To the extent that the above assessment has been successfully met, any assets which are not required to meet such assessment, including relevant requirements under a contractual OC, are being released and become available to satisfy the claims of all other creditors, members and investors of the credit institution;

> To the extent that the above assessment has not been successfully met, the CBBA (*according to the provisions of Art.29(2) of the Directive*) is entitled to use any assets included in the cover pool register that do not meet the criteria, terms and conditions for counting a cover asset in the cover pool adequacy. (*To the extent that such assessment is not met, the CBBA has the right to accelerate or transfer the CB business to another approved institution, in accordance with Art.62(1) of the Law*).

With respect to an automatic acceleration of the covered bonds, this is something that is not provided for by the Law, where a covered bond Issuer is subject to dissolution proceedings.

In accordance with Art.40(1) of the Law, all outstanding covered bonds will remain in force (subject to the terms and conditions under which they were issued), and the obligations of the covered bond Issuer under the covered bonds continue to be enforceable.

IX. RISK WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Cypriot covered bonds meet the criteria of UCITS 52(4) and also qualify under the CRD Directive, resulting in a 10% risk weighting assigned by the CBC. covered bonds issued under the Cypriot Legal Framework form acceptable collateral for refinancing purposes with the ECB, following the typical ECB eligibility assessment and their inclusion on the ECB Eligible Assets Database (EADB).

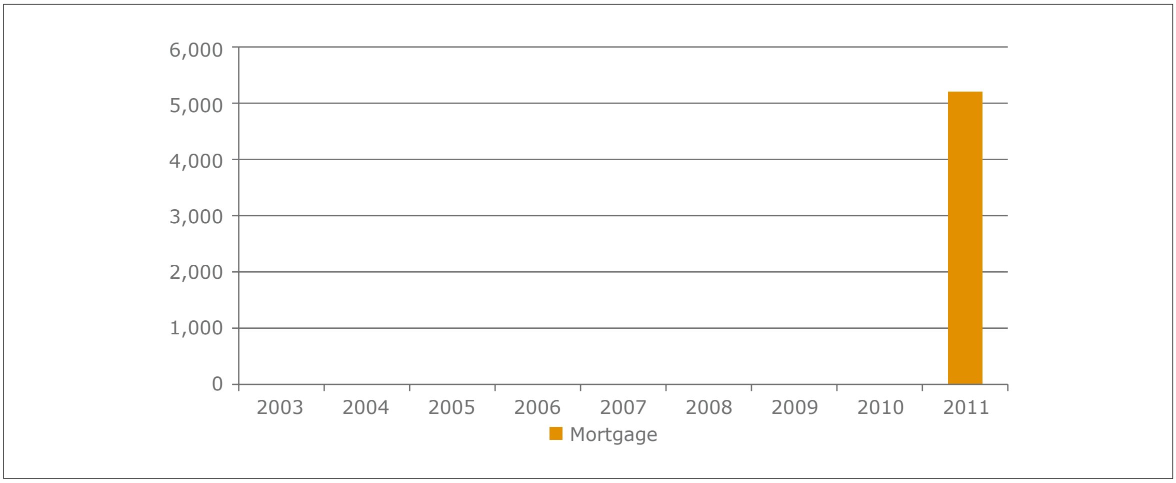
X. ADDITIONAL INFORMATION

Covered bond issuers are, in accordance with Art.20 of the Law, required to maintain, throughout the life of the covered bonds, a set-off reserve in connection with cover assets that are subject to set-off.

The Directive provides for the maintenance of such a set-off reserve, in the form of additional assets which are included in the cover pool (Art.22, 24 and 25 of the Directive).

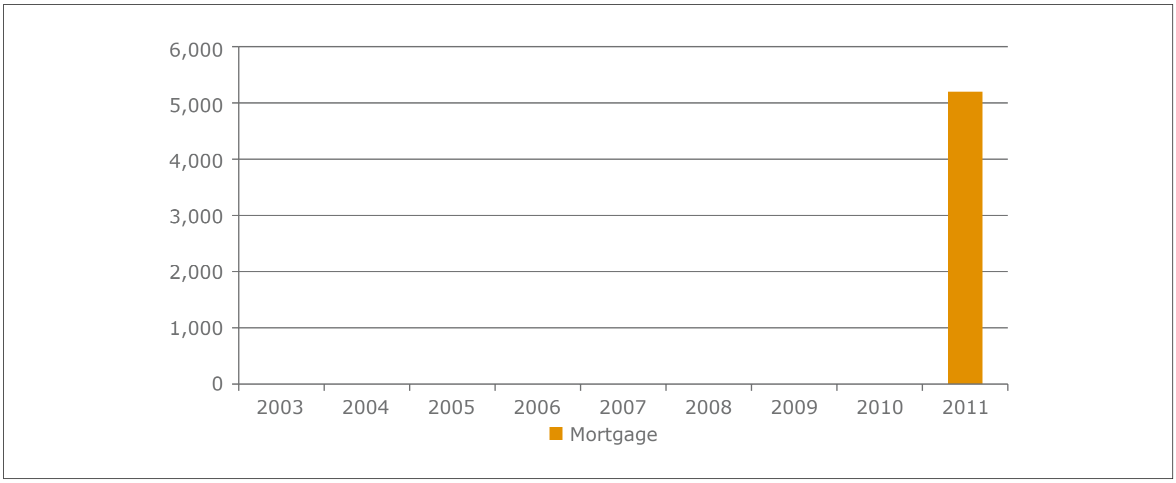
The set-off reserve is quantified by the Issuer and such calculation is subject to the monitoring of the CBM. The set-off reserve is segregated from the Issuer's other assets, forming part of the cover pool where Cover Pool Creditors have a priority claim over amounts in such reserve.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2011, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2011, EUR M



Source: EMF/ECBC

Issuers: There are two issuers in Cyprus: Cyprus Popular Bank Public Co Ltd and Bank of Cyprus Public Co Ltd.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/93/Cyprus_CBs

3.7 CZECH REPUBLIC

By Pavel Kühn, Ceska Sporitelna a.s.

I. LEGAL REGULATIONS

It has been possible to issue the mortgage Covered Bonds ("Hypotecni zastavni list" - hereinafter referred to as "MCB") in the Czech Republic from January 1, 1992 on the basis of the general regulation contained in the Commercial Code.

At present, the MCBs, the mortgage credits (hereinafter referred to as "MC") and the other terms and conditions of mortgage financing are regulated in detail in the Covered Bond Act (hereinafter referred to as "DBA") which entered into force on 1 July 1995. Since, the DBA was amended on 1 April 2004.[1]

Mortgage Covered Bonds may be issued by any bank complying with the terms and conditions of the Act on Banks. However, the right to issue MCBs is subject to a specific license granted by the Czech National Bank.

II. COVERAGE OF MCBS

Pursuant to the DBA, the MCBs are such covered notes the nominal value of and revenue from which are fully covered with (i) receivables from mortgage credits or parts of these receivables (the so-called "regular coverage") and (ii) possibly also in an alternative manner specified in the Act (the so-called "substitutive coverage"). The text "mortgage Covered Bond" has to make a part of the name of this covered bond. No other securities and/or covered bonds are allowed to use this name. The Czech legal framework does not provide the possibility to create public sector cover assets.

III. MORTGAGE RIGHT

The repayment of the MC including accessories has to be secured with the mortgage to a real estate, even to a real estate under construction. The real estate under the mortgage right has to be located on the territory of the Czech Republic, a member state of the European Union or another country making a part of the European Economic Area. The credit is considered to be the mortgage credit on the day of origin of legal effects of the mortgage right registration.

The mortgage right ensuring the MC used to cover the MCBs has to be in the first position in the Real Estate Register. There are two exceptions to this rule: the real estate under mortgage may have a priority mortgage right securing a credit which:

> Is extended by a construction savings bank or a credit extended for a cooperative housing construction supported by the State. The precondition for this is that the construction savings bank or the creditor of the cooperative housing construction credit that have the priority sequence of the mortgage right have given a written consent to the issuer of MCBs to establish the mortgage right in the following sequence. The receivable from the MC secured with a mortgage right not in the first position may not be used to cover the MCBs without such consent.

> Will be repaid so that the mortgage right related to the MC will move from the second position to the first position of registration in the Real Estate Register.

[1] CBA is currently being amended. Key attributes of the amendment are: new issues will be allowed to be governed by other than the Czech laws, covered bonds issued abroad will be recognized as covered bonds, issue terms will not need to be made public for private placements. The new amendment should become effective as of 1st of August, 2012.

The sum of all the liabilities from all the MCBs in circulation issued by one issuer has to be fully covered with the receivables or their parts from the MC (regular coverage) or possibly in a substitutive manner (substitutive coverage).

IV. REGULAR COVERAGE OF MCB

Only such receivables from the MC or their parts may be used for regular coverage of the liabilities from all the MCBs in circulation that do not exceed 70% of the mortgage value of the real estate under mortgage.

If any mortgage rights in priority sequence are attached at the same time to any real estate that serve to secure the construction savings credit and the housing construction credit, only the receivable from the mortgage credit or its part in the maximum amount of the difference between 70% of the mortgage value of the real estate under mortgage and the sum of the receivables from the credit extended by the construction savings company and the cooperative housing construction credit may be used for the purposes of coverage of the MCBs.

V. SUBSTITUTIVE COVERAGE

Substitution cover assets are restricted to 10% of the nominal amount of MCBs outstanding. The following substitution assets are eligible:

> Cash;

> Deposits of the issuer at the Czech National Bank (hereinafter referred to as "CNB");

> Deposits at the Central Bank (National Bank) of a member state of the European Union or another country making a part of the European Economic Area or at the European Central Bank;

> Government bonds and/or securities issued by the Czech National Bank;

> Government bonds and/or securities issued by the member states of the European Union or by other countries making a part of the European Economic Area, their Central (National) Banks and the European Central Bank; and

> Government bonds issued by the financial institutions established with an international agreement the contracting party of which is the Czech Republic, or the financial institutions with which the Czech Republic entered into an international agreement.

VI. MORTGAGE VALUE

The issuer of the MCBs determines the mortgage value of the real estate under mortgage, and namely as the customary price, taking into consideration:

> The permanent and long-term sustainable characteristics of the real estate under mortgage;

> The revenues attainable by a third party at regular management of the real estate;

> The rights and defects associated with the real estate; and

> The local real estate market conditions and impacts and presumed development of this market.

The customary price is considered to be such price that could be achieved in the event of the sale of the same or similar real estate as at the valuation date and in dependence on its condition and quality. The customary price should not reflect the extraordinary market circumstances, the personal relations between the participants and the subjective assessment of the interest of one of the parties. The mortgage value shall not exceed the customary price of the real estates.

The conditions allowing the use of the receivable from the MC to cover the MCBs have to be complied with throughout the period for which the receivable from the MC is included in the MCB coverage.

VII. RECORDS

The issuer of the MCBs is obligated to keep separate and conclusive records on the summary of all of its liabilities from the MCBs in circulation issued by it and on its coverage. The content of the records is defined in an obligatory regulation by the CNB. Pursuant to this regulation, the issuer of the MCBs shall keep the Coverage Register and the Coverage Ledger.

The Coverage Register contains a summary of how the liabilities of the issuer of MCBs are covered – with both the regular coverage (i.e. the list of the receivables from the MCs used to cover the MCBs) and with the substitutive coverage, if applicable. The records in the Coverage Register shall be updated by the issuer continuously as the changes occur.

The Coverage Ledger contains the full summary of the liabilities of the issuer from its MCBs in circulation and the valuation of the assets of the Coverage Register.

The records shall be kept in CZK in paper form or in electronic form. The recordkeeping including the insertion of the MCs for coverage and elimination of the MCs from the coverage shall be made by the departments independent of the departments responsible both for the extension of MCs and for issuance of the MCBs and namely up to the managing Board member.

VIII. POSITION OF THE HOLDER OF THE MORTGAGE COVERED BOND IN THE BANKRUPTCY PROCEEDING OF THE ISSUER

In the event of bankruptcy or bankruptcy proceedings of the issuer of the MCBs, the receivables from the MCBs in circulation issued by it have a priority rank for satisfaction. The assets (the receivables from the MC) serving to cover the MCBs of the bankrupt issuer constitute the mortgage substance. A special administrator may be appointed to administer the mortgage substance and to satisfy the claims resulting from the MCBs in circulation. The yield from the encashment of the mortgage substance shall be first used to satisfy the costs of administration and encashment of the mortgage substance and then immediately to satisfy the receivables of the MCBs without limitation of their amount. Only the rest shall be used to satisfy the other receivables from the bankrupt.

IX. ISSUER AS MORTGAGE CREDITOR

In the event of default of the MC, the issuer may enforce its mortgage right by selling the real estate in a judicial sale pursuant to the rules of civic court proceedings, in a voluntary or non-voluntary public auction pursuant to a special law or by selling the real estate in an execution proceeding via an executor and pursuant to the rules of execution.

The receivables from the mortgage credits or their parts that serve to cover the nominal value of the mortgage covered bonds enjoy an elevated protection in the enforcement of the mortgage right by the issuer. After the sale of the real estate under mortgage, the receivables from the mortgage credits that serve to cover the nominal value of the mortgage Covered Bonds are satisfied from the auction yield immediately after the costs of the auction and before the other receivables secured with the mortgage right.

Upon the bankruptcy order against the debtor from the MC, the issuer gets the position of a separate creditor that has the right that its receivable is satisfied from the encashment of the subject of mortgage (real estate) after deduction of the costs related to the maintenance, administration and sale of the real estate (encashment yield) at any time during the bankruptcy proceeding. The separate creditors are satisfied up to 70 per cent of the encashment yield falling on them. The non-satisfied portion may be satisfied within a distribution and in the class the receivable belongs to as per its nature.

X. STATE SUBSIDIES

The debtor from the MC may reduce his income tax base with the interests he has paid to the issuer from the MC used to finance his housing needs.

The interest revenues from such MCBs issued before 2008 are exempt from the income tax.

XI. SUPERVISION OF THE ISSUER (BANK)

The activities of the issuer of MCBs are regulated by the law and are subject to the supervision by CNB.

The issuer of MCBs is obligated to require prior approval from the CNB for a number of important decisions, for example the sale of the enterprise or its part, cancellation or merger of the issuer, decrease in the issuer´s registered capital, etc.

The issuer has a number of information obligations towards the CNB. For example, it is obligated to inform the CNB on presumed modifications of any of the provisions of its Articles of Association, on the proposals for personal changes in its statutory body and in the managing staff, on the intention to open a branch office or an agency abroad, or on the intention to establish a legal entity abroad or to participate in such entity with its assets. Besides, the issuer in the capacity of the bank is obligated to prepare and to submit information on its business activities in the extent and within the dates determined by the CNB.

The CNB has integrated and continuously integrates to the domestic regulations binding on the issuers any and all regulations, directives, rules, normative, principles and recommendations by the EU and the European Commission that regulate the activities of the issuers – banks, in particular in relation to their cautious business (including, for example, the BASEL II rules). Such regulation applies for example to (a) the standards of liquidity management and creation of minimum obligatory reserves, (b) capital adequacy and credit involvement, or (c) classification of receivables from credits and creation of reserves and adjustments to such receivables.

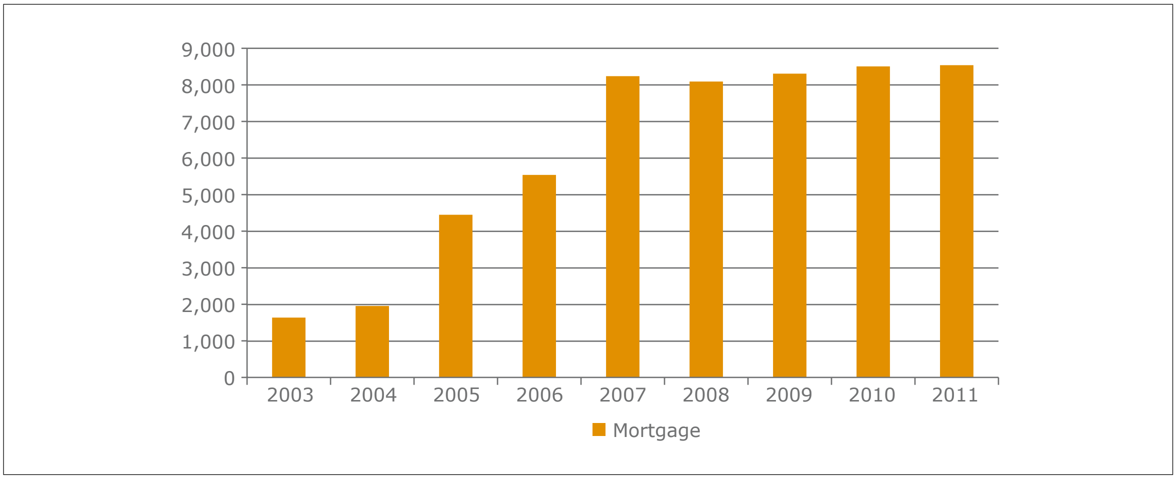
The CNB also supervises the issuer activities from the position of a Government supervisory body over the capital market. Each issuer having its MCBs in circulation is obligated to send to the CNB the reports showing its economic results and its financial situations in the determined intervals and to immediately notify of the changes in its financial situation and of other matters.

A breach by the issuer of the obligations supervised by the CNB is considered to be the so-called deficiency in bank activities. If a deficiency in bank activities is identified, the CNB may assume any of the measures pursuant to the Act on Banks. For example, it may require the issuer to make good, it may change the license of the issuer, impose a fine upon the issuer, suspend (for a maximum of one year) the right of the issuer to issue covered bonds, prohibit the issuer to issue the covered bonds or order the issuer to repay prematurely the nominal value of the MCBs issued by it, including the aliquot revenue.

XII. COMPLIANCE WITH EUROPEAN LEGISLATION

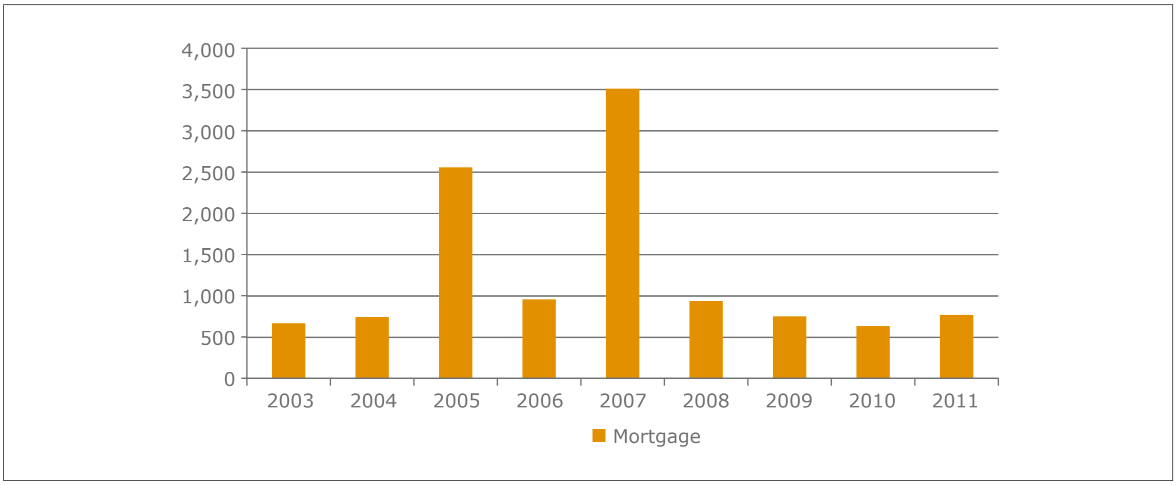
The Czech MCB legislation complies with the requirements of Art. 52 par. IV UCITS Directive.

> Figure 1: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

Issuers: Česká Sporitelna, Ceskoslovenská Obchodní Banka, Hypotecni Banka, Komercni Banka AS, Raiffeisen Bank AS, UniCredit Bank Czech Republic, Volksbank CZ AS and Wüstenrot Hypotecni Banka.

3.8 DENMARK

By Mette Saaby Pedersen, Association of Danish Mortgage Banks
and Svend Bondorf, Nykredit

I. FRAMEWORK

The Danish Act on covered bonds (SDOs) came into force on 1 July 2007. It was passed to implement the new set of rules on covered bonds from the EU (capital requirements directive- CRD l). At the same time, it met the political objective of giving both mortgage banks and commercial banks the opportunity to issue SDOs.

Danish mortgage banks and commercial banks are regulated in detail by the Danish Financial Business Act (*Lov om finansiel virksomhed*). Danish mortgage banks are also governed by the Danish Mortgage-Credit Loans and Mortgage-Credit Bonds etc. Act (the "Mortgage Act") (*Lov om realkreditlån og realkreditobligationer mv.*). The mortgage banks are specialised banks.

Specific bankruptcy regulations laid down in the Financial Business Act and the Mortgage Act prevail over general bankruptcy regulations (sections 247a-247i of the Financial Business Act and sections 22-33 of the Mortgage Act).

II. STRUCTURE OF THE ISSUER

The Danish Financial Supervisory Authority (FSA) may license mortgage banks, commercial banks and ship financing institutions[1] to issue covered bonds.

Until 1 July 2007, only mortgage banks were allowed to issue mortgage bonds/covered bonds. Since this date, also commercial banks can obtain a license to issue covered bonds. This leads to the existence of three types of Danish mortgage bonds:

> the (traditional) mortgage bonds (*Realkreditobligationer*, ROs) issued exclusively by mortgage banks. ROs are UCITS compliant (article 52(4)).

> the (new) covered mortgage bonds (*Særligt Dækkede Realkreditobligationer*, SDROs) issued exclusively by mortgage banks, fulfilling the former as well as the new legal requirements. SDROs are both UCITS (article 52(4)) and CRD compliant (Annex VI, 68).

> the (new) covered bonds issued by either commercial or mortgage banks (*Særligt Dækkede Obligationer*, SDOs). SDOs are both UCITS (article 52(4)) and CRD compliant (Annex VI, 68).

In addition, all ROs issued before 1 January 2008 have maintained their covered bond status in accordance with the grandfathering option under the CRD.

The covered bond legislation in Denmark allows for joint funding, i.e. two or more institutions joining forces to issue covered bonds in order to achieve larger issues. The first issue of joint funding between non-affiliated institutions has taken place in 2012.

Danish mortgage banks operate subject to a specialist banking principle in accordance with Danish legislation, which confines the activities of issuers to the granting of mortgage loans funded by the issuance of mortgage bonds. The cover pool may include unsecured loans to public authorities and guarantees issued by public authorities. Mortgage banks may also carry on other business related to mortgage banking.

[1] Ship financing institutions are regulated by the Act on a Ship Financial Institute (Act no 1376 - 10 December 2007).

The specialist banking principle implies that mortgage banks are confined to granting loans that meet the requirements for cover assets imposed by legislation. Similarly, the funding sources are limited to ROs, SDOs and SDROs. This is due to the fact that Danish mortgage banks are not allowed to accept deposits, etc. as a source of funding, cf section 8 of the Financial Business Act.

The issuer (mortgage bank or commercial bank) holds the cover assets on its balance sheet as well as all rights under the cover assets. Bonds and cover assets are assigned to individual capital centres in mortgage banks and to registers in commercial banks. The individual bonds, however, are not linked to individual mortgage loans. In case of suspension of payments or bankruptcy proceedings, the assets of the capital centres and registers will be frozen, and no excess funds may be transferred from them. In a bankruptcy scenario, the assets of a/each capital centre/register constitute a separate cover pool, cf section 27 of the Mortgage Act and section 247d of the Financial Business Act.

Issuers have their own employees. Outsourcing of activities is allowed if control measures are deemed satisfactory by the FSA, and consumer protection regulations are observed. The valuation of property may be outsourced provided that the issuer conducts sample valuations on a regular basis. The loan origination process may be outsourced, whereas the final approval process related to loan applicants is not subject to outsourcing. Loan administration activities may be outsourced.

III. COVER ASSETS

Assets eligible as the basis for bond issuance:

Covered bonds – SDO	Covered mortgage bonds – SDRO	Mortgage bonds – RO
> Loans secured by real property > Exposures to public authorities > Exposures to credit institutions (up to a maximum of 15 %) > Collateral in ships (not an option for mortgage banks)	> Loans secured by real property > Exposures to public authorities	> Loans secured by real property > Exposures to public authorities

To serve as cover assets, mortgages must be entered in the Danish land register, which is kept by the Danish district courts. Digital land and loan registration was launched in September 2009 and crowns several years of cooperation in the Danish financial sector aimed at handling customers’ loans faster and more efficiently.

With respect to SDO the cover pool may include exposures to credit institutions up to a statutory maximum limit of 15% of the nominal value of the outstanding amount of SDOs. Owing to various technical aspects regarding the lending activities of mortgage banks or commercial banks, a number of investments are not subject to this limit.

The difference between funding and lending may be hedged through derivatives, which are included in the cover pool assets.

In a capital centre in a mortgage bank the cover pool is dynamic as a result of the current addition and disposal of loans in connection with the granting and repayment of loans. In most capital centres assets may exclusively be transferred to or from the cover pool upon new lending and (p)repayment. On (p)repayment, the corresponding amount of issued bonds will be transferred from the capital centre. Each mortgage loan (cover asset) refers to specific ISIN codes and both cover assets and ISIN codes are assigned to specific capital centres. It is therefore not possible for the issuer to (i) change the cover pool unless in connection with new lending and (p)repayment nor (ii) transfer cover assets between different cover pools. Such cover pools are thus less dynamic than cover pools where existing mortgages can be transferred into and out of the cover pools. Cover assets must be identifiable, and the FSA supervises cover asset identification.

IV. VALUATION AND LTV CRITERIA

The Financial Business Act and the Mortgage Act contain provisions on property valuation.

Where loans are funded by the issuance of SDOs and SDROs, valuations are based on the open market value of a property. Where loans are funded by ROs, valuations are based on the mortgageable value. In Denmark, the mortgageable value will correspond to the open market value in the vast majority of cases, cf sections 10-15 of the Mortgage Act.

LTV limits - an overview

Loan Type Property category	Covered bond – SDO	Covered mortgage bond – SDRO	Mortgage bond – RO
Residential property	80% or 75%[1]	80% or 75%[1]	80%
Holiday property	60%	60%	60%
Agricultural property	60%[2]	60%[2]	70%
Commercial property	60%[2]	60%[2]	60%

Note: 1) 80% for loans issued with up to 30 years maturity and 10 years interest-only period and 75% for loans with an unlimited maturity and interest-only period.
2) The LTV can be raised to 70% if the bank adds additional collateral.

In connection with the issuance of SDOs and SDROs, mortgage banks and commercial banks must ensure continuous LTV compliance - ie not just at disbursement of the loan as is the case for ROs. Where an LTV ratio exceeds the statutory limits, the bank must add supplementary security to the capital centre/register. Otherwise, the issues may lose their status as SDOs or SDROs. Where the LTV limit of 80/75% for owner-occupied dwellings etc is exceeded, supplementary security will be required.

Mortgaged property is valued (on-site inspection) as part of the processing of loan applications. If the customer applies for a supplementary loan, a new valuation will be performed. When a loan is granted, the LTV thereof is assessed on a case-by-case basis. A basic principle of the valuation regulations is that valuations must be performed by a valuation officer of an issuer. Provided that a number of conditions are met, valuations may be outsourced. The detailed conditions are set out in the Financial Business Act and the Mortgage Act.

All valuations of mortgaged property by the Danish mortgage banks are reported to the FSA. The FSA performs random checks of mortgage banks' valuations by way of on-site inspections. In 2005 the FSA approved the use of an automated valuation model (AVM) for the valuation of mortgaged property. The AVM was approved for specific property categories only. AVM valuations are also supervised by the FSA.

V. ASSET - LIABILITY MANAGEMENT

The Financial Business Act, the Mortgage Act and the Executive Order on bond issuance, balance principle and risk management require mortgage banks and commercial banks to observe a balance principle and a set of rules on risk management in connection with the issuance of RO, SDRO and SDO.

The Executive Order provides limits to the scope of differences allowed between on the one hand the payments from borrowers and on the other hand the payments to the holders of the issued ROs, SDROs and SDOs. The limits are adjusted by loss limits to the interest rate, foreign exchange, option and liquidity risks that follow from cash flow differences in the balance sheet. The Executive Order also contains a number of other provisions limiting financial risk.

For commercial banks, the balance principle is applicable at register level. For mortgage banks, the balance principle is applicable at the level of the individual capital centres and the institutions in general.

For each register/capital centre, mortgage banks and commercial banks must choose whether to comply with either the *specific balance principle* or the general balance principle. The choice of balance principle does not depend on the choice of bond type (RO, SDRO or SDO) issued out of the register/capital centre. The differences between the two balance principles are as follows:

Types of risk	Specific balance principle	General balance principle
Interest rate risk	Stress test on level and structure + Loss limit of 1 per cent of capital base + Risks in different currencies cannot be set off	Stress test on level and structure Loss limit for **mortgage banks** dependent of stress test: 1 per cent/ 5 per cent of capital adequacy requirement + 2 per cent/10 per cent of the additional excess cover Loss limit for **commercial banks** dependent of stress test: 10 per cent/100 per cent of excess cover
Currency risk	Exchange rate indicator 2 (few currencies) + Loss limit of 0.1 per cent of capital base	Simple stress test Loss limit for **mortgage banks**: 10 per cent of capital adequacy requirement + 10 per cent of the additional excess cover for EUR and 1 per cent of capital adequacy requirement + 1 per cent of additional excess cover of other currencies Loss limit for **commercial banks** 10 per cent of excess cover
Option risk	Maximum term of 4 year + Structural limits on call options and index-linking	Stress test on volatility Loss limit for **mortgage banks**: 0,5 per cent of capital adequacy requirement + 1 per cent of the additional excess cover No maturity or structural limits Loss limit for **commercial banks** 5 per cent of excess cover No maturity or structural limits
Liquidity risk	Limitations on temporarily liquidity deficits 25 per cent (years 1-3) 50 per cent (years 4-10) 100 per cent (from year 11)	Limitations on interest payments: Interest (in) > Interest (out) (over a current period of 12 months) + Present value PV (in) > PV (out) (always)
Repayment of loans by bonds other than the underlying bonds	Max. 15 per cent Both own issued bonds and bonds from other credit institutions + Approximately same cash flow	Max. 15 per cent from other credit institutions - Own issued bonds unlimited

Despite the risk limits of the balance principle, Danish mortgage banks have in practice structured their mortgage lending business in such a way that they do not assume significant financial risks with respect to lending and the underlying funding activities. Thus, the mortgage banks have nearly eliminated interest rate risk, foreign exchange risk and prepayment risk.

Loans granted by the Danish mortgage banks are funded exclusively through mortgage bond issuance. Proceeds from issuance according to the loan amount must therefore be available on the date of loan disbursement. The mortgage bank commonly achieves this through tap issuance. Each loan disbursed is linked to certain amounts of bonds (not certain bonds) in one or several specific ISIN codes currently open for issuance. Knowing which loans to disburse, e.g. the following day, the mortgage bank pools the bond amounts necessary for these loans. Having done this, the total tap amount for each open ISIN code is issued and – subsequently – sold to investors. The tap issuance thus ensures that the following key criteria are maintained day by day:

> Provision of liquidity for actual disbursement;

> Balance of mortgages and bonds outstanding on capital centre level; and

> Balance of future payments on capital centre level.

The individual ISIN code can be open for issuance for an extended period of time. With tap issuance taking place virtually every day over a period of several years there is no strict distinction between primary and secondary markets in the Danish system. In other words: a liquid secondary market has a direct positive impact as a catalyst for smooth operation and tight pricing in the primary market.

The Danish commercial banks are also subject to the strict ALM rules. In practice the commercial banks operate under a general asset and liability management and do not offer pass-through products.

The FSA must be informed of any balance principle breaches without delay. Breaches are punishable by a fine imposed by the FSA. In case of severe or multiple breaches, the FSA may revoke the operating license and dismiss the management of the issuer.

According to the Financial Business Act, the capital base must represent at least 8% of risk-weighted assets and at least EUR 5m. Mortgage banks must observe the capital adequacy requirement both at individual capital centre level and at the level of the institution. Overcollateralisation forms part of the cover pool. If this requirement is not observed, the FSA must be informed without delay. In this case, the FSA will issue an order effecting suspension of payments and, if applicable, initiate bankruptcy proceedings against the issuer. The FSA may also grant the issuer time to secure an adequate capital base.

In addition, issuers are required to prepare comprehensive reports on asset-liability management for the FSA on a quarterly basis.

VI. TRANSPARENCY

A high level of transparency has always been an important characteristic of the Danish covered bond market. The Danish covered bond issuers publish information via many different platforms, such as prospectuses, investor reports, trading venues and issuers' investor relations web sites.

Transparency has always been a priority for Danish covered bond issuers and information is easily accessible. Until now, however, the information has been somewhat fragmented, requiring investors to seek and collect information from different sources and in different formats.

To complement the ECBC Label Initiative the Danish market participants have gathered available information and consolidated it in an intuitive and user-friendly structure in the national transparency template. With the introduction of the national transparency template investors are now offered a single point of entry for the extensive available information on covered bond issues – be it SDO, SDRO or RO. The transparency template helps investors obtain an extensive overview of a covered bond issue at a minimum effort.

Furthermore, establishing the national transparency templates provides the investors with means to compare key information across an array of issuers. The transparency template will make it easier for new investors to get an overview of covered bonds available for investment and will most certainly also prove a valuable tool to support covered bond investors' investment decisions.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The issuer monitors the cover pool continuously. Data from every single loan offer from the Danish mortgage banks and thus all property valuations for new lending purposes are reported to the FSA on a quarterly basis.

There is no cover pool monitor officer. Instead, in the mortgage banks the internal auditors are required to monitor the existence of the mortgages in the capital centre on a current basis. The commercial banks report on a quarterly basis to the FSA on the assets in the register. The statement of the registered assets must be verified by the external auditor of the bank.

Banking supervision is carried out by the FSA. The FSA has the authority to issue an order with which the issuer must comply. In case of severe or multiple breaches of Danish law or of such orders, the FSA may revoke the operating licence and dismiss the management of the issuer, cf sections 373-374 of the Financial Business Act.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Capital centres of mortgage banks (regardless of whether the issuer has issued ROs, SDROs or SDOs)

Cover assets, mortgages and eligible securities are assigned to specific capital centres which constitute the cover pools of the bonds issued in accordance with Danish legislation. A capital centre consists of a group of series with joint liability and a joint series reserve fund. To become eligible as collateral, mortgages must be entered in the Danish land register or filed for registration in the register (under certain conditions). Mortgages are registered at a specific level employing a property identification code. Eligible securities are registered on an accounting basis. The registration is legally binding and will form the basis of any bankruptcy proceedings.

The issuer - which is subject to the supervision of the FSA - keeps the cover register. The land register is kept by the Danish district courts.

Cover assets are assigned to cover pools on an ongoing basis in accordance with Danish legislation, and no further steps to secure a segregation of assets are therefore required.

If bankruptcy proceedings have been initiated, a trustee appointed by the bankruptcy court will administer the cover assets. As mortgage bank creditors are essentially bondholders, no separate administrator is appointed. Bond investors have a primary secured claim against all assets in the cover pool. Derivative counterparties have a corresponding primary preferential right provided that the derivatives contract stipulates that the suspension of payments or bankruptcy of the institution does not constitute an event of default. Bonds issued to secure assets as compensation for LTV excess (also referred to as junior covered bonds) have a secondary preferential right to all assets of the capital centre. The trustee may re-establish the issuer, if possible, and is not necessarily required to dissolve the enterprise.

When a mortgage bank becomes subject to bankruptcy proceedings, the assets of a capital centre will be segregated to satisfy bondholders, etc., in accordance with their legal position as secured creditors[2].

Any excess funds will form part of the assets available for distribution immediately or subsequently.

Any outstanding claims against the capital centres[3] - also referred to as residual claims – are payable out of the assets available for distribution. In this case, bondholders and derivative counterparties are secured creditors ranking before ordinary creditors, including holders of junior covered bonds. Junior covered bond holders are thus secondary secured creditors in relation to the capital centre but ordinary creditors as regards the assets available for distribution.

The bankruptcy proceedings against a mortgage bank cannot be closed until the last creditors have been paid or all funds have been distributed. Note that no Danish mortgage bank has ever been subject to bankruptcy proceedings.

The preferential position ensures that a bankruptcy scenario will only in exceptional cases affect bond investors and derivative counterparties, thereby rendering bonds bankruptcy remote.

Bankruptcy regulations applicable to Danish mortgage banks contain detailed guidelines which must be observed in a bankruptcy scenario. Key points of the guidelines are:

> A trustee will be appointed by the bankruptcy court to administer all financial transactions of the issuer;

> The trustee will be instructed to meet all payment obligations under bonds issued in due time despite any suspension of payments of the issuer;

> All new lending activities of the issuer will be suspended;

> The trustee may issue bonds to refinance maturing bonds and raise secured loans to obtain liquidity (cf below);

> The trustee may transfer an entire capital centre to another mortage bank;

> Payments on loans will not be accelerated, and therefore payments from borrowers will fall due according to the original payment schedule;

> The trustee will not meet the claims of other creditors until all payment obligations under the senior bonds have been met in full; and

> Derivative counterparties enjoy the same legal position as senior bonds.

[2] The same segregation of assets takes place in the "mortgage bank in general" as regards bonds issued outside capital centres at the level of the institution. However, the value of such assets may not exceed the value of the mortgages under the bonds plus an amount equal to 8% of the risk-weighted value of the mortgages.

[3] Including any claims by bondholders against the "mortgage bank in general".

Bonds do not accelerate automatically. Payments fall due according to the original payment schedule.

The trustee is ordered by law to meet all payment obligations under senior bonds and the derivative contracts as they fall due.

If payments from cover assets (mortgages and overcollateralisation of minimum 8%) are insufficient to meet the payment obligations, the trustee has the authority to raise additional loans. If this fails, the issuer will ultimately default on its payments. The trustee may raise loans to meet the payments for bondholders and derivative counterparties and provide security for such loans in the form of assets other than the cover pool mortgages, i.e. the reserve fund assets. Security can also be provided in the form of collateralized funds from the upcoming borrower instalment. The lender will have a first priority secured claim against the assets provided as security but not against the mortgages.

Cover assets are assets on the issuer's balance sheet, the issuer being the mortgagee of the mortgages. Cash flows from the cover assets must be used to meet the payment obligations under the bonds and the derivative contracts. Only the issuer as mortgagee, not investors, is entitled to foreclose on cover assets. Cash flows from cover assets must be used to meet firstly the payment obligations under senior bonds and the derivative contracts, secondly the obligations under junior covered bonds.

Commercial bank registers

A commercial bank sets up a register segregating assets, which exclusively serve as SDO cover assets.

As is the case with mortgage banks, derivative counterparties have a primary preferential right in line with the SDOs provided that the derivatives contract stipulates that the suspension of payments or bankruptcy of a commercial bank does not constitute an event of default. Bonds issued to secure assets as compensation for LTV excess (also referred to as junior covered bonds) have a secondary preferential right to all assets of the register.

The register is kept by the commercial bank and must at all times contain all assets, guarantees received and derivatives contracts, clearly individualised. The commercial bank must submit statements of the assets to the FSA. The external auditor must perform continuous regular control of the register and at least twice a year perform unannounced register audits.

Where the FSA suspends the licence of a commercial bank to carry on banking business, the FSA or the bank files a bankruptcy petition, or the bank is adjudicated bankrupt following the petition of a third party, the FSA will decide whether the register is to become subject to administration by an administrator as an estate in administration. The administrator (and not the ordinary trustee) will be in charge of the assets of the register.

Any unsatisfied residual claims by SDO holders and derivative counterparties against the register may be proved against the assets available for distribution of the commercial bank, but – contrary to the proceedings related to mortgage banks – exclusively as ordinary claims. Residual claims from junior covered bonds may also be proved as ordinary claims against the assets available for distribution.

The register is – contrary to the capital centres of mortgage banks – not subject to any specific statutory minimum requirement as to capital adequacy. The 8% capital adequacy requirement must only be fulfilled at the level of the commercial bank.

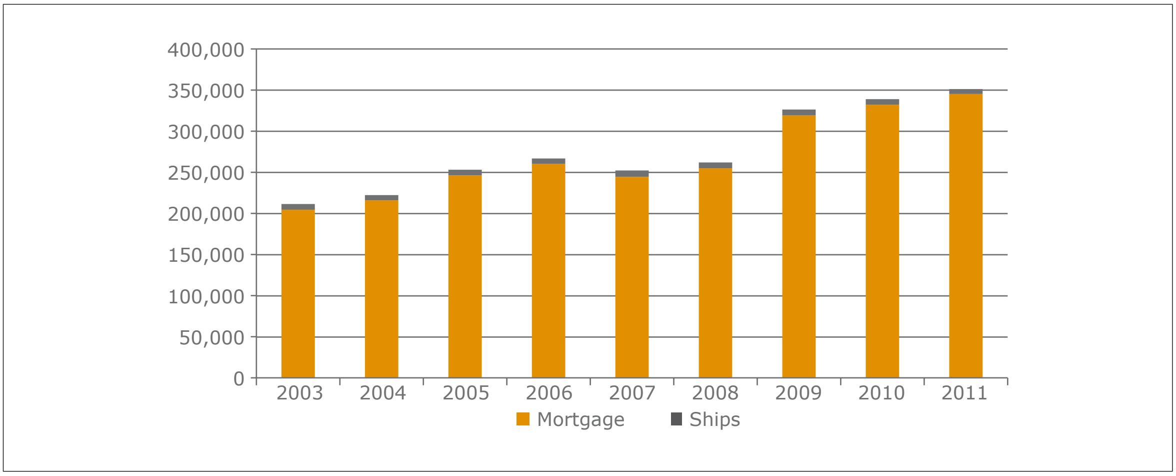
IX. RISK WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

SDOs and SDROs qualify as covered bonds under the CRD. ROs issued before 1 January 2008 will maintain the low risk weighting of 10% throughout the maturity of the bonds in accordance with the grandfathering option under the CRD. ROs issued after 1 January 2008 carry a risk weight of 20%. ROs, SDOs and SDROs are eligible for repo transactions and may be used as collateral for loans with the Danish central bank (Danmarks Nationalbank).

When investing in ROs, SDOs and SDROs, the Danish investment legislation allows pension funds, etc., to exceed the usual limits on exposures to a single issuer, thus acknowledging the reduced risk associated with covered bond assets (cf the Financial Business Act (for insurers) and the Act on Investment Associations and Special-Purpose Associations as well as other Collective Investment Schemes etc.).

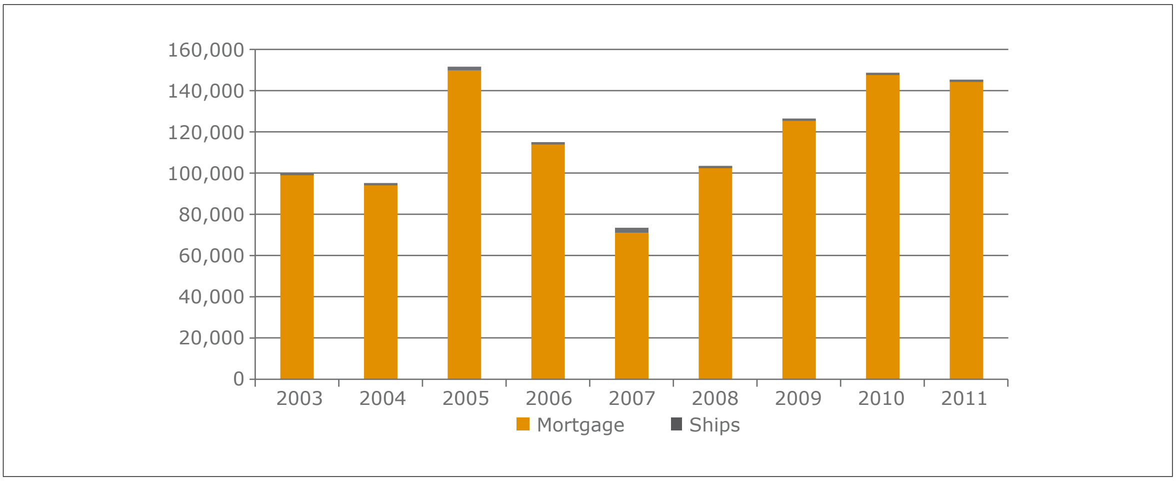
In the Danish legislation on large exposure limits in credit institutions a 100 % exemption is given to SDOs and SDROs. Exemptions for ROs issued after 31 December 2007 are either a 50 % (residential loans) or 25 % (commercial loans).

> Figure 1: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

Issuers: Covered Bonds backed by real estate collateral are primarily issued by the specialised mortgage banks: BRFkredit a/s, DLR Kredit A/S, LR Realkredit A/S, Nordea Kredit Realkreditaktieselskab, Nykredit Realkredit A/S (incl. Totalkredit A/S) and Realkredit Danmark A/S. FIH Realkredit A/S ceased new lending and issuance in 2004. At the end of 2011 the mortgage banks' outstanding volume of covered bonds was EUR 330 bn. Since the new Danish regulation on Covered Bonds entered into force on 1 July 2007, only one commercial bank, Danske Bank A/S, has utilised the possibility to issue covered bonds. Danske Bank has issued non-pass-through (euro-style) covered bonds of a value of around EUR 20 bn. Danish Ship Finance is the only Danish issuer of Covered Bonds backed by ship loans.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/87/S%C3%A6rligt_D%C3%A6kkede_Obligationer_-_SDO, http://ecbc.eu/framework/88/S%C3%A6rligt_D%C3%A6kkede_Realkreditobligationer_-_SDRO

3.9 FINLAND

By Timo Ruotsalainen, Aktia Real Estate Mortgage Bank
and Bernd Volk, Deutsche Bank

I. FRAMEWORK

In Finland, the legal basis for covered bond issuance is the Act on Mortgage Credit Bank Operations (HE 42/2010). The new legal framework replaced the old Act on Mortgage Credit Bank (1999) and entered into force on 1 August 2010. The new law overruled the special banking principle and gathered all Mortgage Credit Bank related legislation under same act. Besides, other technical changes, e.g. mixed pools, have been allowed.

The provisions of the new legal framework do not apply to covered bonds issued or derivatives contracts registered before the entering into force of the new act.

II. STRUCTURE OF THE ISSUER

The issuer of Finnish Covered Bonds can still be a specialised bank, but deposit banks or credit entities are entitled to apply for a licence to issue covered bonds. The existing specialised banks tend to stay in business in the way they have been operating since being established.

The issuer holds the cover assets on the balance sheet. A subsequent transfer of the cover assets to another legal entity is not taking place. A direct legal link between single cover asset and the covered bonds issued does not exist. All obligations from Finnish Covered Bonds are direct and unconditional obligations of the issuing bank as a whole. In the case of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved only for the claims of the holders of Finnish Covered Bonds.

Under the previous legal framework, only bonds covered by mortgages were issued by Finnish mortgage banks. A separate cover pool was to be established if these banks were to start the issuance of public-sector backed Finnish Covered Bonds. Under the new law, mixed pools comprising mortgage loans as well as eligible public sector assets are allowed.

III. COVER ASSETS

The geographical scope of cover assets is restricted to the European Economic Area (EEA).

Residential mortgage loans, shares in housing companies as well as commercial mortgage loans up to 10% of the total pool are eligible as cover assets.

Public sector loans in accordance with the CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f) criteria are also eligible.

A new feature in the law is that a specialised mortgage credit bank can grant an intermediate credit to a deposit bank or a credit entity. This intermediate credit must be covered with eligible cover assets as stated above. These assets must also be recorded into the cover register.

Up to 20% of the mortgage cover pool is allowed to consist of substitute cover assets; bonds and other debt obligations issued by the State, a municipality or another public-sector organisation or another credit institution than one belonging to the same consolidation group as the issuer; a guarantee as for own debt granted by a public-sector organisation or credit institution referred above; a credit insurance given by an insurance company other than one belonging to the same group, referred to in the Act on Supervision of Finance and Insurance Groups; cash assets of the issuer deposited in the Bank of Finland or a deposit bank with the restriction that if the issuer is a deposit bank the cash deposit may not be in a deposit bank belonging to the same consolidation group as the issuer.

ABS or MBS tranches are not eligible for the cover pool.

Derivatives are eligible for the cover pools only if they are used for hedging purposes.

The nature of the cover pool is dynamic. Currency risk is perfectly matched as the law requires cover assets to be in the same currency as the covered bonds.

IV. VALUATION AND LTV CRITERIA

The property valuation within the legal framework for covered bonds in Finland is based on market values. There are different LTV levels for residential and commercial mortgage loans: 70% of the value of the residential property and 60% of the value of the commercial property accepted. This LTV is a relative limit, i.e. when a loan exceeds the 60%/70% limit, the part of the loan up to 60%/70% LTV remains eligible to the cover pool. A loan placed as collateral for a covered bond may not exceed the current value of the property standing as collateral.

V. ASSET-LIABILITY MANAGEMENT

There are legal standards for Asset-Liability Matching in the Finnish Covered Bond System. For instance, the aggregate interest received on the cover assets in any 12-month period must exceed the interest paid on the outstanding covered bonds. This regulation takes derivatives for hedging purposes into account.

The total amount of collateral of covered bonds shall continuously exceed the remaining combined capital of the covered bonds.

The net present value of the total amount of collateral of covered bonds shall continuously exceed by at least 2% the total net present value of the payment liabilities resulting from the covered bonds.

In case of a breach of one of these rules mentioned, the issuer might face sanctions from the FSA. Ultimately, the issuer might face the loss if its licence.

VI. TRANSPARENCY

The annual and interim reports of the issuer indicates, in addition to that provided in the act on Credit Institutions, the basis of the valuation of the collateral and the amount of residential mortgage loans and possible intermediary loans and public sector loans issuer has granted, as well as the amount of covered bonds issued.

On top of the regulatory requirements all issuers provide additional information about the cover pools, ratings and other relevant topics on their websites. Please find the website information at section X, Additional information.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The issuer carries out the monitoring of the cover pool. Therefore, the issuer reports to the FSA on a monthly basis. With regard to UCITS 22(4), this supervision of a specialised bank as issuer of the covered bond is compliant to the “special supervision”. The FSA has the legal power to take appropriate measures. It is allowed to conduct inspections at the bank in question or to require documents. Also, the FSA could issue a public warning or admonition. Ultimately, it is up to the FSA to revoke the banking licence of the bank in question.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS REGULATED

A cover register allows identifying the cover assets. The legal effect of a registration of assets into the cover register is to create the priority claim of covered bond holders to these cover assets in case of an insolvency of the issuer. The cover register is managed by the corresponding bank, which in turn is supervised by the FSA.

The cover register contains information about the principle amount of covered bonds issued, the mortgages and substitute assets covering these bonds as well as derivative transactions hedging these bonds or funds placed as their collateral.

Asset segregation

The cover pool is a part of the general estate of the bank as long as the issuer is solvent. If the insolvency proceedings are opened, by operation of law, the assets recorded in the cover registers are excluded from the general insolvency's estate. When the insolvency proceedings are opened, the FSA appoints a special cover pool administrator. Within the insolvency procedure, the derivative counterparties rank pari passu to covered bond holders. The cover assets do form a separate legal estate, which is ring-fenced by law from other assets of the issuer.

Impact of insolvency proceedings on covered bonds and derivatives

Covered bonds do not automatically accelerate when the issuing institution becomes insolvent. The legal consequences for the derivatives in case of an insolvency of the issuing bank depend on the relevant contracts.

Preferential treatment of covered bond holders

Covered bond holders enjoy a preferential treatment as the law stipulates the separation of the cover assets on the one hand and the insolvency's estate on the other.

The satisfaction of the covered bond holders is not limited to the cover assets in the Finnish system. On the contrary, those creditors also participate in the insolvency proceedings in respect of the remaining assets of the bank.

A moratorium on the insolvency's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of covered bond holders.

Access to liquidity in case of insolvency

With the appointment of the cover pool administrator, this person acts on behalf of the covered bond holders. The pool administrator has access to the cover assets. Cover assets may only be disposed with the consent of the FSA. Additionally, the pool administrator has also the first access on cash flows generated by the cover assets. The law foresees a possibility for the pool administrator together with the bankruptcy trustee to take up a loan on behalf of the cover pool to create more liquidity.

Up to 20% of the cover pool may consist of liquid substitute cover assets. With the consent of the FSA, this limit may even be higher. As all cover assets entered into the cover register are ring-fenced in case of an insolvency of the issuer, this results also in the insolvency remoteness of voluntary over-collateralisation.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Finnish Covered Bonds comply with the requirements of Article 52(4) UCITS Directive as well as with those of the CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f). Therefore, these bonds are 10% risk weighted in Finland. Following the common practice in Europe, they accordingly enjoy a 10% risk weighting in most European countries.

Finnish Covered Bonds are also eligible in repo transaction with national central bank, i.e. within the Euro-zone.

As far as the domestic issuers are aware, there are no further specific investment regulations regarding Finnish Covered Bonds.

X. ADDITIONAL INFORMATION

Websites of Finnish Issuers:

Aktia Real Estate Mortgage Bank

> http://www.aktia.fi/aktia_real_estate_mortgage_bank

Danske Bank

> http://www.danskebank.com/en-uk/ir/Debt/Pages/Debt.aspx

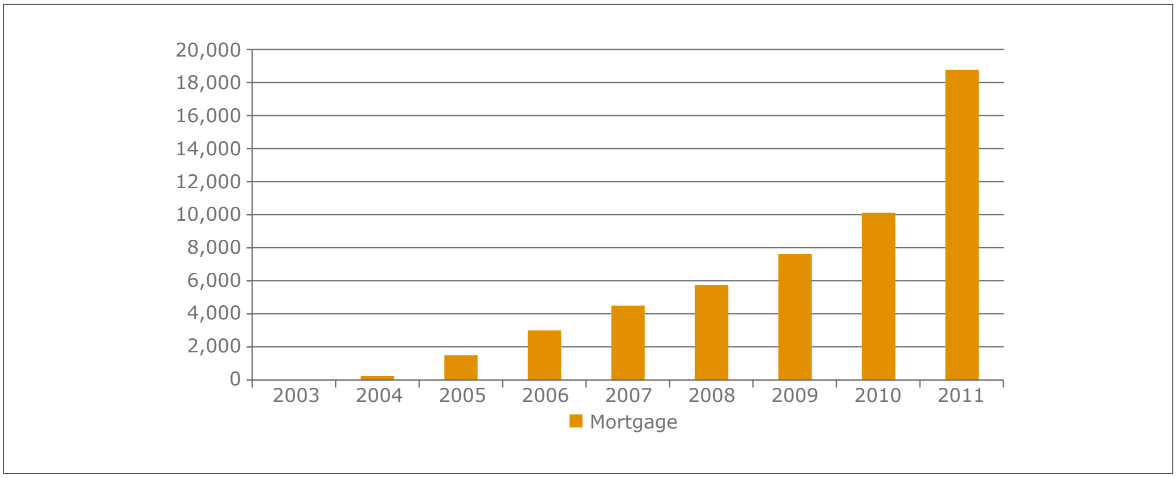
Nordea Bank Finland

> http://www.nordea.com/Investor+Relations/Debt+rating/Nordea+Bank+Finland/Cover+pool+data/1439622.html

OP Mortgage Bank

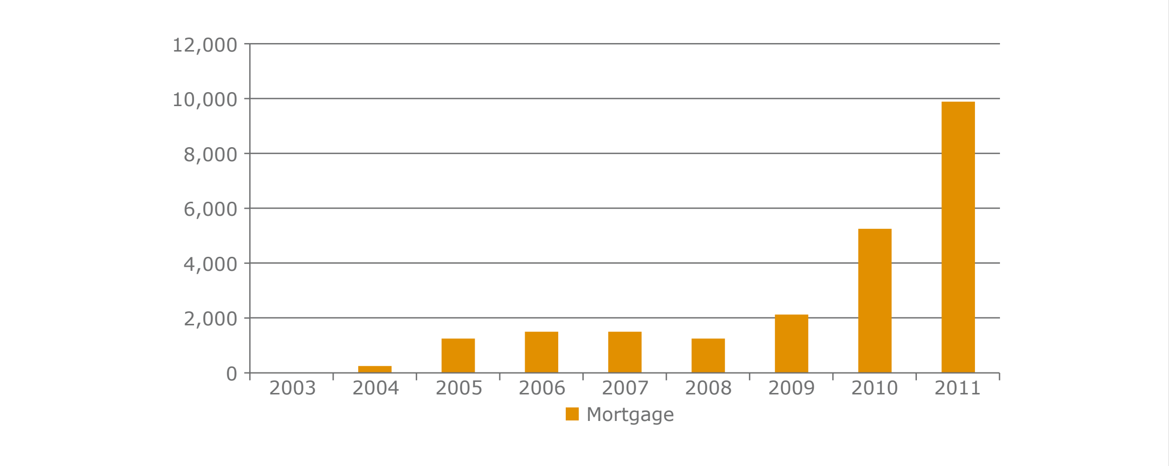
> https://www.pohjola.fi/pohjola/investor-relations/debt-investors/op-mortgage-bank?id=334200&srcpl=8&kielikoodi=en

> Figure 1: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

Issuers: Finnish issuers at the end of 2010were Aktia Real Estate Mortgage Bank, Nordea Bank Finland, OP Group Mortgage Bank and Sampo Housing Loan Bank.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/19/Finland

3.10 FRANCE

By Francis Gleyze, Caisse Centrale du Crédit Immobilier de France,
Henry Raymond, Caisse de Refinancement de l'Habitat – CRH,
Cristina Costa, Natixis
and Boudewijn Dierick, BNP Paribas

French covered bond regulation was significantly modified in 2010 and 2011 with the strengthening of the *société de crédit foncier* legal framework and the creation of *sociétés de financement de l'habitat*, giving a specific legal framework to the existing French structured covered bonds issuers based on the implementation of the European Collateral directive N° 2002/47.

Consequently, three main covered bonds issuing structures exist today in France:

> Sociétés de crédit foncier;

> Sociétés de financement de l'habitat; and

> Caisse de Refinancement de l'Habitat.

Could also continue their activities, the French structured covered bonds issuers that would not apply for their conversion into société de financement de l'habitat.

A - SOCIETES DE CREDIT FONCIER (SCF)

By Francis Gleyze, Caisse Centrale du Crédit Immobilier de France

While many States allow ordinary credit institutions to issue covered bond subject to the segregation of the cover pool in their balance sheet, France requires the set-up of an ad hoc company, the *société de crédit foncier* totally distinct from the other companies of the group to which it belongs and exclusively dedicated to the issuance of covered bonds named *obligations foncières*.

Sociétés de crédit foncier are credit institutions governed by a stringent legal framework designed to protect the holders of the *obligations foncières* they issue. They operate under the close scrutiny of the *Autorité de Contrôle Prudentiel*, the France's Banking Authority, which requires them to comply with strict management rules in order to ensure control over risks.

I. FRAMEWORK

Sociétés de crédit foncier are governed by articles L.515-13 and seq. and R.515- 2 and seq. of the French Monetary and Financial Code (the "Code"). Licensed by the French Banking Authority, they have a single purpose: to grant or acquire eligible cover assets, as defined by Law, and to finance them by issuing *obligations foncières*, which benefit from a special legal privilege (the "Privilege"). They may also issue or contract other debts benefiting or not from the Privilege.

The legal framework of the *société de crédit foncier* was lastly updated by Law N° 2010-1249 of 22 October 2010 and by Decrees n° 2011-244 dated 4 March 2011 and N° 2001-205 dated 23 February 2011.

II. COVER ASSETS

Only eligible assets, restrictively defined by Law, are authorized on the balance sheet of the *société de crédit foncier*. All assets on the balance sheet are part of the cover pool.

Assets eligible to the cover pool are:

> Loans guaranteed by a first-ranking mortgage or by an equivalent guarantee;

> Loans granted to finance real estate and guaranteed by a credit institution or an insurance company with shareholders' equity of at least € 12 million and that is not a member of the group to which the *société de crédit foncier* belongs. The amount of these loans cannot exceed 35% of the assets of the *société de crédit foncier*;

> Public exposures on:

a) Central administrations, central banks, public local entities and their grouping, belonging to a member State of the European Community or party to the European Economic Area, USA, Switzerland, Japan, Canada, Australia or New Zealand or - under ratings conditions - central administrations and central banks belonging to a non member State of the European Community or to an non adherent to the European Economic Area;

b) European Community, International Monetary Fund, Bank for international Settlements and multilateral developments banks registered by the French Ministry of Finance;

c) Others public sector entities and multilateral developments banks as described in Article L.515-15 of the Code;

> Senior securities issued by French securitisation vehicles or equivalent entities subject to the law of a Member State of the European Community or party to the European Economic Area, USA, Switzerland, Japan, Canada, Australia and New Zealand whose assets are composed, at a level of at least 90%, of loans and exposures directly eligible to the cover pool. The assets of the securitisation vehicles or equivalent entities may only consist of mortgage loans or public sector exposures, and under no circumstances, may be backed by assets created by consolidating or repackaging multiple securitisations. To be eligible to the cover pool, the senior securities issued by the securitisation vehicles or similar entity must qualify as a minimum for the credit quality assessment step 1 by a rating agency recognised by the French Banking Authority.

Such senior securities cannot exceed 10 % of the nominal amount of the outstanding issue. However, until 31 December 2013, the 10 % limit shall not apply, in accordance with Directive 2010/76/EU (CRD III) of the European Parliament, provided that:

> The loans carried by the securitisation vehicles were originated by a member of the same consolidated group of which the issuer of the covered bonds is also a member or by an entity affiliated to the same central body to which the issuer of the covered bonds is also affiliated (that common group membership or affiliation to be determined at the time the senior securities are made collateral for covered bonds; and

> A member of the same consolidated group of which the issuer of the covered bonds is also a member or an entity affiliated to the same central body to which the issuer of the covered bonds is also affiliated retains the whole first loss tranches supporting those senior securities.

By 31 December 2012, the European Commission shall review the appropriateness of the derogation set out in the third paragraph and, if relevant, the appropriateness of extending similar treatment to any other form of covered bond.

- Mortgage promissory notes representing loans that would be otherwise directly eligible to the cover pool and issued in accordance with Articles L.513-42 et seq. of the Code. The mortgage notes may not represent more than 10% of the assets of the *société de crédit foncier*;
- Replacement assets up to 15 % of the amount of the outstanding covered bonds issued by the *société de crédit foncier*. Replacement assets are defined as sufficiently secure and liquid assets: securities, assets and deposits for which the debtor is a credit institution or an investment company qualifying for the step 1 credit quality assessment (with a maturity up to 100 days for a credit institution or an investment company subject to the law of a Member State of the European Community or party to the European Economic Area and qualifying for the step 2 credit quality assessment).

Loans guaranteed by a first-ranking mortgage or by an equivalent guarantee and loans guaranteed by a credit institution or an insurance company are eligible for privileged debt financing up to a part of the financed or pledged real estate's value. Senior securities of securitisation vehicles are subject to similar rules.

III. PRIVILEGE

Pursuant to article L.515-19 of the Code, holders of obligations foncières and other privileged debts have preferred creditor status and the right to be paid prior to all other creditors who have no rights whatsoever to the assets of the *société de crédit foncier* until the claims of preferred creditors have been satisfied in full.

This legal Privilege which supersedes the ordinary French bankruptcy Law, has the following characteristics.

- The sums deriving from the loans, exposures, similar debts, securities, financial instruments, after settlement if applicable, and debts resulting from deposits made with credit institutions by the *société de crédit foncier* are allocated in priority to servicing payment of the covered bonds and other privileged debt;
- The judicial reorganisation or liquidation or amicable settlement of a *société de crédit foncier* does not accelerate the reimbursement of *obligations foncières* and other debt benefiting from the Privilege which continue to be paid at their contractual due dates and with priority over all other debts. Until the holders of privileged debts are fully paid off, no other creditor of the *société de crédit foncier* may avail itself of any right over that company's property and rights;
- The common provisions of French bankruptcy law affecting certain transactions entered into during the months prior to the insolvency proceedings (the *période suspecte*) are not applicable to *sociétés de crédit foncier*.

IV. BANKRUPTCY REMOTENESS

As an exception to the general French bankruptcy Law, bankruptcy proceedings or liquidation of a company holding share capital in a *société de crédit foncier* cannot be extended to the *société de crédit foncier*. As a result, sociétés de crédit foncier are totally bankruptcy remote and enjoy full protection from the risks of default by their parent company or the group to which they belong.

V. COVERAGE RATIO

The total value of the assets of a *société de crédit foncier* must at all times be greater than the total amount of liabilities benefiting from the Privilege, a condition that makes, initially, for a coverage ratio always greater than 100%, increased to 102% by decree N° 2011-205.

From a regulatory standpoint, the coverage ratio is calculated on the basis of the *société de crédit foncier* accounting data by applying different weights to classes of assets:

> Loans secured by a first-ranking mortgage or by an equivalent guarantee are weighted 100% up to their part eligible for privileged debt financing;

> Loans guaranteed by a credit institution or an insurance company are weighted 100% if the guarantor qualify, at least, for the step 2 credit quality assessment, weighted 80% if it qualify for the step 3 credit quality assessment, and weighted 0% in any other case;

> Public exposures and replacement assets are weighted 100%; and

> Senior securities of securitisation vehicles are weighted 100%, 80%, 50% or 0% subject to different criteria including, essentially, their rating.

The coverage ratio is reported and published at regular intervals, in accordance with applicable laws and regulations.

VI. COVER POOL MONITOR

Sociétés de crédit foncier must appoint a registered auditor, with the agreement of the French banking regulator, to act as a "Specific Controller". To ensure independence, the Specific Controller may not be an employee of either of the société de crédit foncier's independent auditors, of the company that controls the *société de crédit foncier*, or of any company directly or indirectly controlled by a company that controls the *société de crédit foncier*.

The mission of the Specific Controller involves the following verifications:

> That all assets granted or acquired by the *société de crédit foncier* are eligible to the cover pool, and in the case of mortgage assets, that they are properly valued;

> That the coverage ratio is, at any moment, at least, at 102%;

> That the *société de crédit foncier* comply with all the limits required by the regulation (i.e. the limit of the loans guaranteed by a credit institution or an insurance company, the limit of the mortgage promissory notes and the limit of the replacement assets);

> That the "congruence", i.e. the adequacy of maturities and interest rates of assets and liabilities, is at a satisfactory level; and

> And, more generally, that the *société de crédit foncier* complies with the law and regulations.

The Specific Controller certifies that the s*ociété de crédit foncier* complies with coverage ratio rules on the basis of a quarterly issuance program, and for any issue of privileged debt of an amount equal or above EUR 500 million. These coverage ratio affidavits are required to stipulate in issuance contracts that the debt benefits from the legal Privilege.

The Specific Controller reports to the French banking regulator. He attends shareholders' meetings, and may attend Board meetings.

Pursuant to article L.515-30, the Specific Controller is liable towards both the *société de crédit foncier* and third parties for the prejudicial consequences of any breach or negligence he may have committed in the course of his duties.

VII. ASSET/LIABILITY MANAGEMENT – LIQUIDITY

Sociétés de crédit foncier must manage and hedge market risks on their assets, liabilities and off-balance sheet items: interest rate risks, currency risks, liquidity and maturity mismatch between liabilities and assets. The surveillance of these points is part of the duties of the Specific Controller.

In order to give protection to the hedging system in place, article L.515-18 of the Code provides that financial instruments hedging the assets, *obligations foncières* and other debt benefiting from the Privilege, and financial instruments hedging the overall risk on assets, liabilities and off-balance sheet items, benefit from the Privilege. As a consequence, they are not to be terminated in the event of bankruptcy proceedings or liquidation.

Since Law N° 2010-1249 of 22 October 2010 and Decree N° 2011-205, *sociétés de crédit foncier* are required to ensure that their cash needs are constantly covered over a moving period of 180 days. The scope of this new obligation will extend to forecasted principal and interest flows involving the s*ociétés de crédit foncier'*s assets, as well as to flows related to its trading of financial futures stipulated in CMF § L.515-18. Cash needs may be covered, if necessary, by replacement securities, assets eligible for Bank of France refinancing, and repurchase agreements with credit institutions that have the highest short-term credit ratings or whose creditworthiness is guarantied by other credit institutions that have the highest short-term credit ratings.

As credit institutions, they are, more generally, subject to Comité de la Réglementation Bancaire et Financière (CRBF) regulation 97-02 on internal control. Accordingly, they must set up a system for monitoring transactions and internal procedures, a system for handling accounting processes and data processing, as well as risk management and monitoring systems.

VIII. ASSET VALUATION

Among his duties, the Specific Controller controls the eligibility, composition, and valuation of the assets. Real estate valuations must be based on their long-term characteristics. Under banking regulation n° 97-02, property values are considered part of the risks of *sociétés de crédit foncier*. The valuations are made by independent experts in compliance with banking regulation.

IX. TRANSPARENCY

As credit institutions and listed companies, sociétés de crédit foncier must issue periodic financial information and, in accordance with French Regulation 97.02, a report on risk management.

Moreover, *sociétés de crédit foncier* are also required to publish:

> A quarterly report relating to the nature and the quality of their assets. This report must be published in the *Bulletin des Annonces Légales Obligatoires*, in any newspaper enable to publish legal announcements or on their website;

> A semi-annual report, at 30 June and 31 December of each year relating to the amount of its coverage ratio, the compliance with the limits they are requested to respect i.e. the 35% limit of guaranteed loans, the 10% limit of mortgage promissory notes, etc. This report is certified by the Specific Controller and transmitted to the Banking Authority.

> An annual report describing (i) the nature and the quality of their assets describing the characteristics and breakdown of loans and guaranties, the amount of defaults, the breakdown of receivables by

amount and by class of debtors, the proportion of early redemptions, the list and characteristics of senior securitisation securities and RMBSs they hold, the volume and breakdown of replacement securities they hold and (ii) the extent and sensitivity of their interest-rate exposure. This report is published in the *Bulletin des Annonces Légales Obligatoires* after the annual shareholders' General Meeting;

> An annual report relating to the methods, process and results of the valuation and revaluation of the real estate.

X. BANKING SUPERVISION

Sociétés de crédit foncier operate under the constant supervision of the Banking Authority.

Their management, their Specific Controller and their Independent Auditors should be agreed by the Banking Authority.

All the above mentioned reports should be sent to the Banking Authority together with the annual report of the Specific Controller and the report of the annual reports of the Independent Auditors.

XI. COVERED BONDS LIQUIDITY

The French *sociétés de crédit foncier* which issue Jumbo obligations foncières have together signed with 23 banks a specific standardised market-making agreement, which has become a national agreement.

XII. RISK- WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

Obligations foncières comply with the requirements of article 52 par. 4 UCITS directive, and with the CRD directive, Appendix VI, Pact 1, Paragraph 65 a) to f).

Consequently, and subject to local regulations, the banking risk - weighting is 10% according to European solvency criteria.

B - CAISSE DE REFINANCEMENT DE L'HABITAT (CRH)

By Henry Raymond, Caisse de Refinancement de l'Habitat

I. FRAMEWORK

CRH was created in 1985 by French Government with State explicit guarantee as a central agency in order to refinance French banks in the specific legal framework of art 13 of law 85-685 of July 1985.

Up to SFEF 's creation in October 2008, no other agency of that type was created in France. Since January 1, 2010, CRH is appointed to control debt service and collateral administration of SFEF.

Today, instead of a State guarantee, the French law gives CRH's bondholders a very strong privilege on CRH's secured loans to banks.

The Caisse de Refinancement de l'Habitat (previously Caisse de Refinancement Hypothécaire) is a specialised credit institution of which the sole function is to fund French banks housing loans to individuals.

CRH issues bonds and lends the borrowed amount to banks in the same conditions of rate and duration.

CRH loans take the form of promissory notes issued by the borrowing banks and held by CRH.

CRH's bonds are strictly regulated in order to offer bondholders a very high credit quality and benefit from a legal privilege.

They are governed by the article 13 of act 1985-695 of July 11, 1985 as complemented by article 36 of act 2006-872 of July 13, 2006.

CRH received approval to issue bonds under article 13 of act 1985-695 by letter of September 17, 1985 from the Minister for the Economy, Finance and Budget.

CRH's operations are governed by the provisions of art L. 313-42 to L. 313-49 of Monetary and Financial Code. CRH's loans to banks, i. e. notes held by CRH, are covered by the pledge of housing loans to individuals. In the case of a borrowing bank default, CRH becomes owner of the portfolio of housing loans without any formality notwithstanding any provision to the contrary.

II. COVER ASSETS

Eligible loans are only home loans to individuals defined by law: first-ranking mortgages or guaranteed loans.

Guaranteed loans are loans granted to finance real estate with the guarantee of a credit institution or an insurance company (the total amount of these loans cannot exceed 35% of the covering portfolio).

The geographical area for eligible loans is the European Economic Area in the law but "de facto" only France and Overseas territories.

No replacement assets are allowed. RMBS and other loans are not eligible.

III. PRIVILEGE

Pursuant to article 13 of act 1985-695 (complemented), when the guarantee of the French government is not accorded (this guarantee is no longer granted), the sums or amounts generated by the promissory notes are allocated, as a matter of priority and under all circumstances, to the payment of the interest and principal on CRH bonds.

The provisions of Book VI of the French commercial code, or those governing all legal or equivalent amicable proceedings engaged on the basis of foreign laws, do not constitute an obstacle to the application of these provisions.

These provisions give to CRH's bondholders a preferred creditor status and the right to be paid prior to other creditors.

IV. BANKRUPTCY REMOTENESS

CRH is a company independent from borrowing banks. Bankruptcy proceedings or liquidation of a borrowing bank, holding CRH's equity, cannot be extended to CRH.

V. COVERAGE RATIO

In compliance with article 13 of act 1985-695, the only aim of CRH is to issue bonds to fund banks mortgage loans. Then, CRH's debt amount and CRH's loans to banks (represented by notes) must be equal.

According to the provisions of the law and of article R. 313-21 of Monetary and Financial code, CRH's statutes dictate that the covering portfolio amount (compound of home loans to individuals pledged to cover CRH's loans to banks) must exceed 125% of the amount of notes held by CRH, and then must exceed 125% of CRH's bonds.

VI. COVER POOL MONITOR

CRH is an independent credit institution that does not borrow for its own account but for the account of banks and does not charge any fee or interest margin on its refinancing transactions.

CRH regularly achieves, based on sampling, audits on the cover pool carried out at the borrowing banks. If necessary, CRH asks borrowing banks to increase the cover pool to compensate for the shortfall identified or to pay back CRH by delivering CRH's bonds.

VII. BANKING SUPERVISION

As a credit institution, CRH is under the general supervision of the French banking authority *l'Autorité de contrôle prudentiel*. Furthermore, its operations are under a specific supervision of *l'Autorité de contrôle prudentiel* because of the provisions of the article L. 313-49 of Monetary and Financial Code.

CRH is also subject to audit by its shareholder banks.

VIII. ASSET - LIABILITY MANAGEMENT

As explained above, CRH's debts and loans (represented by notes) have exactly the same characteristics. CRH is not submitted to an interest rate risk. CRH is not affected by early repayment of loans included in the portfolio.

According to CRH internal regulation, the cover pool must be congruent with rate and duration of CRH's debt to protect CRH in the case where it becomes owner of the cover pool.

IX. TRANSPARENCY, ASSET VALUATIONS AND LOAN TO VALUE

Every year, the annual report publishes the size of the cover pool. This report confirms the characteristics (nature and quality) of home loans pledged and that CRH is not exposed to interest rate risk.

The rules for real estate valuations are the same as those of *sociétés de crédit foncier*.

Loan to value must not exceed 80% (de facto 90% because of the over-sizing of the covering portfolio by 25%).

X. CRH BONDS LIQUIDITY

The size of CRH's bonds outstanding is very important. They are very liquid, listed on MTS and several banks are market makers for them .The average full CRH debt turnover ratio is very high. Two of CRH issues have a size of 5 euro billion.

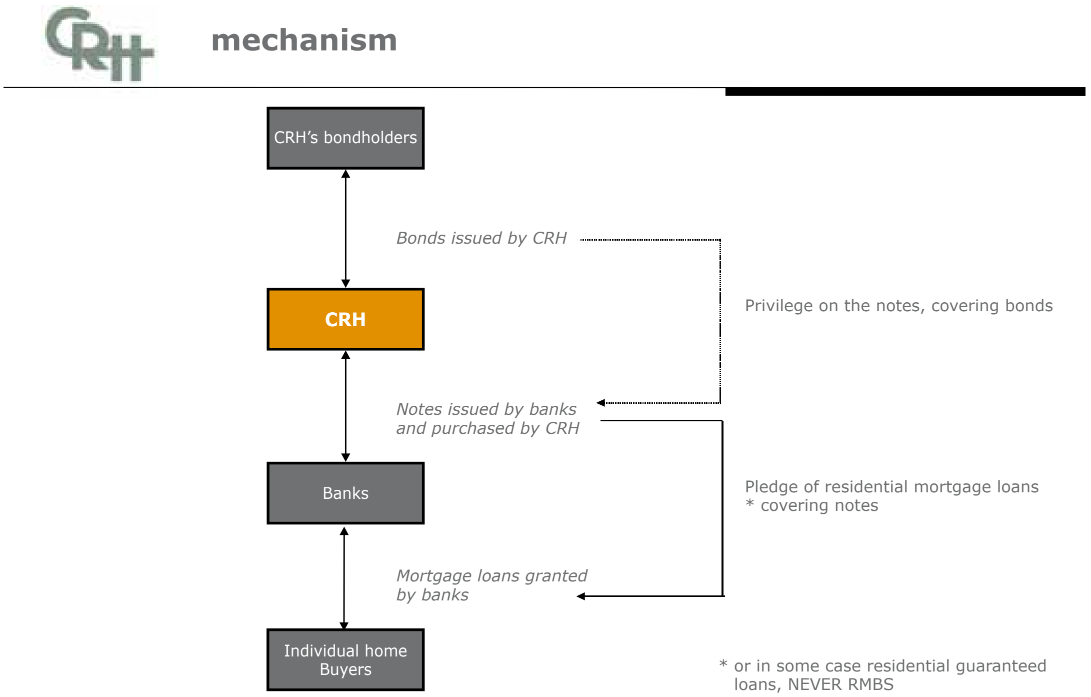
XI. RISK - WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

CRH's debt has been rated AAA and Aaa (senior unsecured) by Fitch and Moody's since 1999.

CRH's bonds are compliant with criteria of article 52 par. 4 UCITS directive and with the Capital Requirements Directive (CRD) requirements. They are 10% weighted in standard approach.

They are included in securities accepted for the European Central Bank (E.C.B.) open market operations.

Figure 1: Mechanism


CRH
mechanism
CRH's bondholders
Bonds issued by CRH
CRH
Privilege on the notes, covering bonds
Notes issued by banks
and purchased by CRH
Banks
Pledge of residential mortgage loans
* covering notes
Mortgage loans granted
by banks
Individual home
Buyers
* or in some case residential guaranteed
loans, NEVER RMBS

C - SOCIETES DE FINANCEMENT DE L'HABITAT (SFH)

By Cristina Costa, Natixis
and Boudewijn Dierick, BNP Paribas

The first structured covered bond was issued in late 2006 using contractual agreements instead of the existing Obligations Foncières framework. In order to provide a statutory framework for the growing number of French structured covered bond, a new law on banking and regulation was adopted in October 2010. The enactment of Law n°2010-1249 dated 22 October 2010 on the banking and financial regulation and of the Decree n° 2011-205 dated 23 February 2011, set up the new status of Société de Financement de l'Habitat (SFH). The SFH legislation is intended to give a specific legislative framework to French structured covered bonds backed by residential mortgages. The SFH and the 'Société de Crédit Foncier' (SCF) are now subject to the same law and regulations (specific controller, coverage ratio, liquidity ratio, etc.). Segregation of assets is based on the European Collateral Directive, which has been transposed into the French Monetary and Financial Code.

Under the SFH legislation, the holders of the Obligations de Financement de l'Habitat (OH) benefit from a legal privilege granted to these bonds holders over the SFH program's assets (article L. 515-19 of the Monetary and Financial Code). If the issuer becomes insolvent, the OHs and other privileged debts are paid in accordance with their payment schedule, and have priority over any of the program's other debts or non-privileged creditors in relation to the SFH's assets.

According to the SFH law a credit institution licensed as a finance company by the French supervisor (*Autorité de Contrôle Prudentiel*) may, if it complies with articles L.515-34 and seq. of the Monetary and Financial Code, opt for the status of a home financing company (*Société de Financement de l'Habitat*). In 2011, all French common-law based covered bond issuers except two (Banques Populaires Covered Bonds and Groupe Caisse d'Epargne Covered Bonds) have opted for the SFH status.

I. FRAMEWORK

Obligations de Financement de l'Habitat (OH) make use of the implementation of the EU Collateral Directive 2002/47/EC in French law, which allows for a segregation of the assets without an actual transfer (true sale) of assets to the issuer. This directive was implemented into the French Code Monétaire et Financier (Article L. 211-36 and seq.). Pursuant to the article L.211-38 of the French Monetary Code, the pledges shall be enforceable even when the relevant collateral provider is subject to an insolvency proceeding.

A bank pledges or assigns collateral to a subsidiary, which is a regulated French credit institution with limited purpose [SFH now] (e.g. issuing covered bonds for the purpose of providing financing to the sponsor bank). The covered bonds proceeds are used to fund advances to the respective sponsor bank(s). The covered bonds are secured by the legal privilege over the assets of the issuer, which are in turn secured by a pledge over cover assets which remain on the sponsor bank's balance sheet (and/or on the balance sheets of the respective subsidiaries, affiliates or group member banks). Upon a borrower enforcement notice (for example in case of default of the sponsor bank), the respective cover assets, including underlying securities, will be transferred to the covered bond issuer.

There are two types of structures of a SFH:

> Dual structure (structure used by all issuers until now):

a) Cover asset pool remains on the balance sheet of the sponsor bank

b) Cover assets and covered bonds are on different balance sheets;

c) Transfer of assets following insolvency of the participating bank

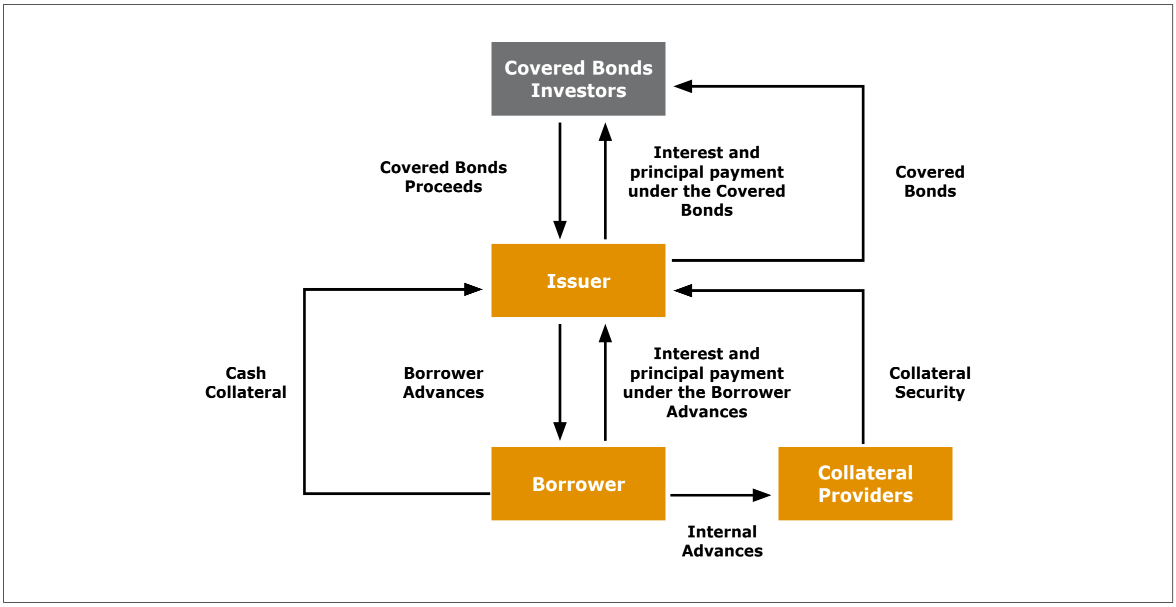
> Single structure:

a) Cover assets are on the balance sheet of the issuer

b) Cover assets and covered bonds are on the same balance sheet

c) The parent company (=lending institution) transfers loans to the issuer of covered bonds.

Figure 2: Structure of Obligation de Financement de l'Habitat


Covered Bonds Investors
Covered Bonds Proceeds
Interest and principal payment under the Covered Bonds
Covered Bonds
Issuer
Cash Collateral
Borrower Advances
Interest and principal payment under the Borrower Advances
Collateral Security
Borrower
Collateral Providers
Internal Advances

Sources: Moody's, Natixis

II. STRUCTURE OF THE ISSUER

Société de Financement de l'Habitat (SFH), or home financing companies, are credit institutions licensed as a finance company by the French *Autorité de Contrôle Prudentiel*. The sole purpose of home financing companies is to grant or to finance home loans and to hold securities or instruments under the conditions set out by the law and financial regulations. Under an SFH program, the issuer issues "Obligations de Financement de l'Habitat (OHs) which are unsubordinated senior secured obligations and rank *pari passu* among themselves.

These specialised credit institutions are usually an affiliate of the sponsor bank. There are currently seven SFH issuers: BNP Paribas Home Loan SFH (99.9%-owned by BNP Paribas), BPCE SFH (99.9% owned by BPCE S.A.), Crédit Mutuel Arkea Home Loans SFH (affiliate of the Crédit Mutuel Arkéa group), Crédit Mutuel-CIC Home Loan SFH (a subsidiary of Banque Fédérative du Crédit Mutuel), Crédit Agricole Home Loan SFH (99.9% owned by Crédit Agricole S.A.), HSBC SFH (France) (a subsidiary of HSBC France) and Société Générale SFH (a subsidiary of Société Génerale).

At the time of writing, all French common-law based covered bond issuers except two (Banques Populaires Covered Bonds and GCE Covered Bonds) have transferred their status to SFH. These two programmes will no longer issue – instead, BPCE Group issues Obligations de Financement de l'Habitat via BPCE SFH.

III. COVER ASSETS

Pursuant to SFH Law, the eligible assets of a Société de Financement de l'Habitat comprise, inter-alia:

> Home loans (prêts à l'habitat) which include (i) loans which are secured by a first-ranking mortgage or other real estate security interests that are equivalent to a first-ranking mortgage (*hypothèque de premier rang ou une surete immobiliere conferant une garantie au moins equivalente, Art. L515-35, II, 2°*) or (ii) loans that are guaranteed by a credit institution or an insurance company (*cautionnement consenti par un établissement de crédit ou une entreprise d'assurance*). The property must be located in France or in any other Member State of the European Union or the European Economic Area ("EEA") or in a State benefiting from the best credit level rating.

> Loans guaranteed by the *Fonds de Garantie à l'Accession Sociale à la Propriété* (*Guarantee Fund for Social Access to Home Ownership*)

> Loans secured by the remittance, the transfer or the pledge of the receivables arising from the home loans referred to above,

> Units or notes (other than subordinated units or subordinated notes) issued by French securitisation vehicles, or other similar vehicles governed by the laws of a Member State of the EU or the EEA if (i) their assets comprise at least 90% of secured loans or other receivables benefiting from the same level of guarantees; (ii) such units or notes benefit from the highest level of credit assessment ("*meilleur échelon de qualité de credit*") and (iii) the similar vehicles are governed by the laws of a Member State of the European Union or EEA.

> Promissory notes (*billets à ordre*), and

> Substitution assets, under certain conditions provided by SFH Law (their aggregate value can make up to a maximum of 15% of the cover pool).

Under the SFH Law, cover pool assets comprised of units or notes issued by securitization vehicles (*organismes de titrisation*) are only eligible to support covered bond issuance if they are rated Aa3/AA- or above (100% eligible) or A3/A- or above (50% eligible). ABS/MBS count as collateral within the pool depending on the originator, the rating of the securitization, and the time at which the securities were acquired by the issuer.The Sociétés de Financement de l'Habitat are not allowed to make any other investments, except investments in securities which are sufficiently secure and liquid to be held as so-called substitution assets.

Weightings of ABS/MBS for *Sociétés de Crédit Foncier and Sociétés de Financement de l'Habitat*

If the underlying assets of the ABS/MBS were originated by the group and they were acquired by the issuer before 31 December 2011, the securities count as collateral with the following ratings:

> 100% as long as they are rated Aaa/AAA;
> 80% if the rating is between Aa3/AA- and Aa1/AA+;
> 0% if the rating is below Aa3/AA-

If the underlying assets of the ABS/MBS were originated by the group and they were acquired by the issuer after 31 December 2011, the securities count as collateral with the following ratings:

> 100% as long as they are rated Aaa/AAA;
> 50% if the rating is between Aa3/AA- and Aa1/AA+;
> 0% if the rating is below Aa3/AA-

If the underlying assets of the ABS/MBS were transferred by an institute that is not a member of the same group as the covered bond issuer and they were acquired by the issuer before 31 December 2011, the securities count as collateral with the following ratings:

> 100% as long as they are rated Aaa/AAA;
> 50% if the rating is between Aa3/AA- and Aa1/AA+;
> 0% if the rating is below Aa3/AA-

If the underlying assets of the ABS/MBS were transferred by an institute that is not a member of the same group as the covered bond issuer and they were acquired by the issuer after 31 December 2011, the securities count as collateral with the following ratings:

> 100% as long as they are rated Aaa/AAA;
> 0% if the rating is below Aaa/AAA.

Source: Instruction 2011-I-06 of Autorité de Contrôle Prudentiel

The Sociétés de Financement de l'Habitat are not allowed to make any other investments, except investments in securities which are sufficiently secure and liquid to be held as so-called substitution assets (within the limit of 15% of the cover pool).

Under SFH Law, each issuer has to appoint a Specific Controller, who is responsible for verifying key aspects of the issuer, in particular the extent of the collateral (the legal cover ratio is 102%) for the covered bonds. He is independent from both the issuer and the sponsor bank. When home loans granted or financed by the SFH are backed by a guarantee from a credit institution or an insurance company falling within the scope of consolidation (as defined in article L.233-16 of the French commercial code) as the SFH (i.e. in-house guarantor), the specific controller shall be entitled to carry out all controls on documents or on-site to determine whether the methods used to evaluate risk by that credit institution or that insurance company are appropriate.

The new framework changes the treatment of guaranteed housing loans. In particular, the new regulation applies a haircut to in-house guarantors: i.e. if the guarantor is a group institution, only 80% of the loan may be included. In addition, a rating criterion/trigger has been introduced. If the credit rating is in the BBB region (i.e. below A-), the rate of inclusion drops to 80% for external guarantors and 60% for internal guarantors. If the rating of the guarantor is non-investment grade, the guarantee will no longer be recognized and the guaranteed loans may not be included in the cover pool. For more information please refer to the box below.

Weighting of guaranteed home loans for *Sociétés de Financement de l'Habitat*:

When the home loan guarantor is not part of the same consolidation scope as the SFH or the SCF, the weighting is as follows:

> 100% when the home loan guarantor has at least the second highest level awarded by a rating agency (≥A3/A-/A- by Moody's/S&P/Fitch);

> 80% when the home loan guarantor has at least the third highest level of quality awarded by a rating agency (≥Baa3/BBB-/BBB- by Moody's/S&P/Fitch);

> 0% in all other cases.

When the home loan guarantor is part of the same consolidation scope as the SFH, the guaranteed home loans are weighted as follows:

> 80% when the home loan guarantor has at least the second highest level of quality awarded by a rating agency (≥A3/A-/A- by Moody's/S&P/Fitch);

> 60% when the home loan guarantor has at least the third highest level of quality awarded by a rating agency (≥Baa3/BBB-/BBB- by Moody's/S&P/Fitch).

> 0% in all other cases.

IV. VALUATION AND LTV CRITERIA

The properties are valued according to the French mortgage market accepted practice. The property values are indexed to the French INSEE (*Institut National de la Statistique et des Etudes Economiques*) or PERVAL (Notaries) house price index on a quarterly basis. In most programmes, price decreases are fully reflected in the revaluation, while in the case of price increases, a 20% haircut is applied even though this is not required by law.

In order to ensure overcollateralization (above the 2% minimum required by law) compatible with the triple-A rating objective, the SFH programmes include a dynamic Asset Coverage Test (ACT) that requires the balance of the mortgages in the collateral pool to significantly exceed the balance of the outstanding covered bonds. The minimum level of OC will depend on the credit quality of the mortgages in the cover pool as assessed by the rating agencies. For all the existing programmes the maximum asset percentage applied in the ACT is 92.5%, which translates into a minimum overcollateralization of 8.1%. However, that being said all programmes currently exceed the minimum amount due to adjustments to the rating agency methodologies.

When calculating the appropriate loan balance within the asset coverage test (ACT), higher LTV loans are included in the pool, but loan amounts exceeding the respective cap do not get any value in the

ACT. For all programmes, the LTV ratio of the mortgage loans cannot be more than 100% (however, the portion that is above 80% will be disregarded in the ACT). In addition, the ACT gives no value to the loans in arrears or defaults.

V. ASSET-LIABILITY MANAGEMEMT

Overcollateralization: By law, the SFH framework must maintain a nominal overcollateralization ratio of 2% on the adjusted cover pool balance at all times.

Liquidity buffer: Also by law, the SFH framework requires the SFH to cover, at all times, its treasury needs over a period of 180 days, taking into account the forecasted flows of principal and interest on its assets and net flows related to derivative financial instruments.

Liquidity: The SFH framework provides further liquidity by allowing, as a last-recourse funding option, the SFH to subscribe to its own privileged covered bonds – up to 10% of total privileged liabilities – provided that the SFH uses these OH as collateral with the central bank or cancels them within 8 days.

The above requirements are also applicable to SCF.

In addition to the requirements specified by the SFH Law, all French OH programmes include a number of safeguards to hedge interest rate and currency risk, refinancing risk, commingling risk, market risk, etc. as follows:

> Interest rate and currency risks need to be neutralised (the hedging strategy);

> Liquidity is ensured through a pre-maturity test (designed to ensure that sufficient cash is available to repay the covered bonds in full, on the original maturity date in the event of the sponsor bank's insolvency) and possible maturity extension;

> Subject to certain rating triggers, swaps with suitable counterparties have to be entered to ensure that exposure to market risk is properly hedged;

> Cash flow adequacy is secured through the asset-coverage test and the contractual obligation to neutralise any exposure to interest rate and currency risk;

> Commingling risk is mitigated by the hedging strategy and the Collection Loss Reserve Amount;

> Minimum rating requirements in place for the various third parties that support the transaction, including the swap counterparties.

VI. TRANSPARENCY

As credit institutions, Sociétés de Financements de l'Habitat (SFH) must issue periodic financial information and, in accordance with French Regulation 97-02, publish a report on risk management.

In addition, SFH are governed by articles L515-17 to L.515-32-1 of the French Monetary and Financial Code (the same governing Sociétés de Crédit Foncier) and as such, are required to publish quarterly information regarding the nature, quality and duration of the assets to be financed, a semi-annual report relating to the amount of its coverage ratio, and an annual report describing the nature and quality of the assets (breakdown of loans and guarantees, amounts of defaults, redemptions…).

Beyond the regulatory requirements, SFH customarily publish monthly investor cover pool and contractual asset cover test reports, which can be found on their respective websites.

VII. COVER POOL MONITOR & BANKING SUPERVISION

The issuing bank is responsible for the monthly pool monitoring, with the asset coverage test calculation being checked by an independent Asset Monitor (and by the specific controller – some SFH do not have both): under the terms of the asset monitor agreement, the asset monitor tests the calculation of the asset coverage test annually. In case of non-compliance with the asset coverage test or in case the senior unsecured rating of the sponsor bank drops below a predefined trigger rating level, the test has to be performed on a monthly basis. In addition, rating agencies are involved in the programme and re-affirm the ratings of the program upon a pre-defined issuance volume. They also monitor the amount of overcollateralisation required to maintain the triple-A ratings.

Under SFH Law, each issuer has to appoint a Specific Controller (*Contrôleur Spécifique*), and a Substitute Specific Controller (*Contrôleur Spécifique Suppléant*), who are selected from an official list of auditors and are appointed subject to the prior approval of the ACP. Their role is (i) to ensure that the Issuer complies with the SFH Law (in particular, by verifying the quality and the eligibility of the assets and the cover ratios the Issuer has to comply with), (ii) monitor the balance between the Issuer's assets and liabilities in terms of rates and maturity (cash flow adequacy) and notifies the Issuer and the ACP if he considers such balance to be unsatisfactory. The Specific Controller remains liable, both as regards the Issuer and third parties, for any loss suffered by them which results from any misconduct or negligence arising in the performance of its duties. The Specific Controller verifies key financial aspects of the activities of the Issuer, in particular the extent of the collateral for the Covered Bonds. He is independent from both the Issuer and the Sponsor Bank. Furthermore, for every issuance with an amount exceeding EUR 500,000,000 the specific controller must attest the compliance of the cover ratio.

VIII. SEGREGATION OF COVER ASSETS & BANKRUPTCY REMOTENESS

Like the SCF law, the SFH Law provides for a regime which derogates in many ways from the French legal provisions relating to insolvency proceedings. Under the SFH legislation, the holders of the Obligations de Financement de l'Habitat benefit from the privilege granted to these bonds over the SFH programme's eligible assets. If the issuer becomes insolvent, the OHs and other privileged debts pay in accordance with their payment schedule, and have priority over any of the programme's other debts or non-privileged creditors in relation to the programme's assets. All privileged debts rank *pari passu*.

The Issuer may be subject to insolvency but SFH law provides for a regime which deviates in many ways from the French insolvency provisions:

> **Privilege / No acceleration of covered bonds as a result of insolvency of SFH:** in the event of an insolvency proceeding of the SFH (safeguard procedure, judicial reorganization or liquidation), all claims benefiting from the Privilège (including interest) must be paid on their due dates and in preference to all other claims. Until payment in full of all such preferred claims, no other creditors may take any action against the assets of the SFH.

> **No nullity during hardening period:** the provisions allowing an administration to render certain transactions entered into during the hardening period (*période suspecte*) null and void are not applicable for transactions entered into by a SFH (provided that such transactions are made in accordance with their exclusive legal purpose and without fraud). No, there are no such provisions in the SFH law. This only applies for assets transfers (article L.515-21)

- **Option to terminate ongoing contracts with insolvent counterparties:** in case of the opening of any insolvency procedure against the credit institution which is acting as manager and servicer of the SFH, any contract may be immediately terminated by the SFH notwithstanding any legal provisions to the contrary.
- **No Consolidation:** SFH law precludes the extension of any insolvency procedure in respect of the SFH's shareholders to the SFH itself.

IX. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

In France and abroad, French Obligations de Financement de l'Habitat have a 20% risk-weighting under the CRD Standard Approach. OH meet the requirements of Article 52(4) of the UCITS directive, but due to the unlimited eligibility of guaranteed home loans, they do not meet the CRD requirements. However, this could change if the final CRD IV text accepts unlimited eligibility of guaranteed home loans as collateral (Article 124 – paragraph 1 – subparagraph 1).

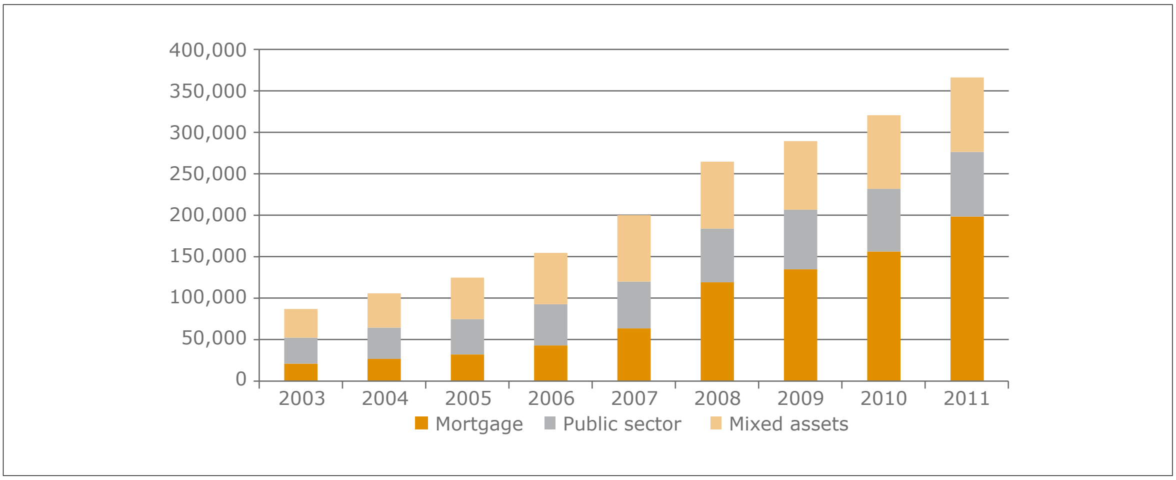
Figure 3: Comparison of French covered bonds

	Obligation de Financement de l'Habitat
Legal Framework	French Monetary and Financial Code, Articles L.515-34 to L.515-39, Decree no. 2011-205 of 23 February 2011 and the Banking and Financial Regulation Act no. 2010-1249 of 22 October 2010
Issuer	duly licensed credit institution - with the status of financial company - Société de Financement de l'Habitat (SFH)
Eligible cover pools	- Residential home without limitation for guaranteed home loans and residential mortgages (commercial real estate loans are not eligible) - Securitization of the above (subject to specific rules and criteria)
Collateralisation	102%
Legal Privilege	Yes
LTV ratio	- First-rank residential mortgage loans and guaranteed home loans: max. 80% LTV - State-guaranteed real-estate loans: max. 100% LTV
Substitution assets	Max. 15% of total OF and other
Liquidity	Requirement to cover all cash flows for a period of 180 days, taking on principal and interests on its assets, and cash flows pertaining
Investor protection	Overcollateralisation, 180-day liquidity needs coverage and ability
Issue's structure/Transfer of assets	True sale of cover assets or loans secured by financial guarantees (articles L.211-38 and seq French Monetary & Financial Code - transposition of "Collateral" Directives)
Supervision	Autorité de contrôle prudentiel (ACP) - one specific controler - two
UCITS Compliant	Yes
Risk-weighting according to EU Credit institutions	20%
ECB Label	Yes
Rating (Moody's/S&P/Fitch)	Aaa/AAA/AAA

Source: Natixis, French Monetary and Financial Code, Banking and Financial Regulation Act

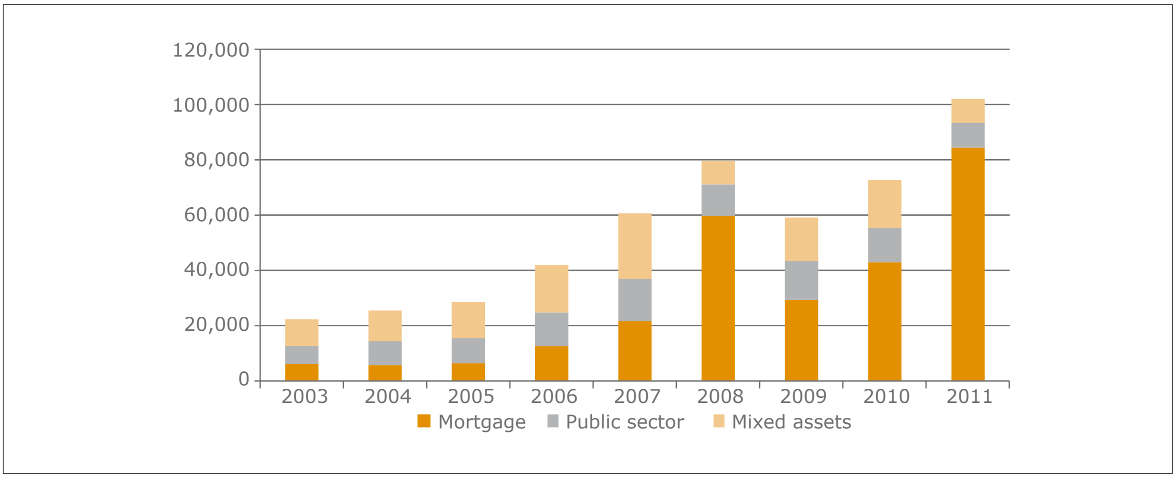
Obligations Foncières	Caisse de Refinancement de l'Habitat
French Monetary and Financial Code, Articles L.515-13 to L.515-33, regulation no. 99-10 of 9 July 1999. Amended by the Decree no. 2011-205 of 23 February 2011, Banking and Financial Regulation Act no. 1249 of 22 October 2010	French Monetary and Financial Code Articles L.313-42 to 313-49 and Art L.515-14-1, article 13 Law n°85-695 of 11 July 1985
duly licensed credit institution - with the status of financial company - Société de Crédit Foncier (SCF)	duly licensed credit institution - with the status of financial company -Caisse de Refinancement de l'Habitat (CRH)
- First-rank residential mortgage loans - First-rank commercial mortgage loans - State-guaranteed real-estate loans - Third party guaranteed real estate loans (max. 35% of total assets) - Public sector loans, bonds and leasing - Securitization of the above (subject to specific rules and criteria)	- First rank residential mortgage loans - State guaranteed mortgage loans - Third party guaranteed real estate loans (max. 35% of total assets) - No securitisation tranches, no RMBS - No loans with duration over 25 years - No loans with unit amount over €1m
102%	125%
Yes	Yes
- First-rank residential mortgage loans and guaranteed home loans: max. 80% LTV - First-rank commercial mortgage loans: max. 60% LTV - State-guaranteed real-estate loans: max. 100% LTV	- Residential mortgage loans: max 80% LTV, max 90 % LTV if overcollateralisation of 25% - State guaranteed mortgage loans: max 100% LTV
privileged resources.	Non eligible
into account all cash flows resulting of future payments to term instruments.	
to repo own issuances, controlled ALM	Overcollateralisation, full recourse to the participating banks in case of collateral shortfall
True sale nearly exclusively (but loans secured financial guarantee for "public exposures" legally possible)	ad hoc promissory notes exclusively secured by eligible cover pools
auditors - AMF (Autorité des Marchés Financiers)	Autorité de contrôle prudentiel (ACP) - two auditors - AMF (Autorité des Marchés Financiers)
Yes	Yes
10%	10%
Yes	Yes
Aaa/AAA/AAA	Aaa/-/AAA

> Figure 4: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC

> Figure 5: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

Note: For CFF, the mortgage and public sector assets are put in the same pool. As such, the cover pool acts as global coverage for privileged liabilities, i.e. no specific asset is linked to a specific bond issue. Therefore, CFF Covered Bonds are under the "mixed assets" category.

Issuers:

> **CRH :** Caisse de Refinancement de l'Habitat

> **Obligations Foncières :** AXA Bank Europe SCF, BNP Paribas Public Sector SCF, Cie Financement Fonciers (CFF), CIF EuroMortgage, Crédit Foncier et Communal d'Alsace et Lorraine (CFCAL), Crédit Mutuel Arkéa Public Sector SCF, Dexia Municipal Agency, General Electric SCF, Société Générale SCF

> **Obligations à l'Habitat :** BNP Paribas Home Loan SFH, BPCE SFH, Crédit Agricole Home Loan SFH, Crédit Mutuel Arkéa Home Loans SFH, Credit Mutuel-CIC Home Loan SFH, HSBC SFH (France), Société Générale SFH

> **General Law Based CBs:** Banques Populaires Covered Bonds, Groupe Caisse d'Epargne Covered Bond.

3.11 GERMANY

By Wolfgang Kälberer and Otmar Stöcker,
Association of German Pfandbrief Banks

I. FRAMEWORK

In Germany, the legal basis for covered bond issuance is the German Pfandbrief Act (PfandBG – Pfandbriefgesetz) dated 22 May 2005. It supersedes the general bankruptcy regulation (§§ 30-36 of the Pfandbrief Act).

In addition and for historic reasons, three further legal frameworks exist in German law for the issue of covered bonds (DZ-Bank covered bonds, DSL covered bonds and Landwirtschaftliche Rentenbank covered bonds). The range of cover assets is slightly different compared to Pfandbriefe (they may include for instance a much higher portion of claims against credit institutions), but their insolvency regime is rather similar to the Pfandbrief rules. For more details, see 'Das Pfandbriefgesetz', Textsammlung und Materialien, edited by the Association of German Pfandbriefbanks, Frankfurt a.M. 2005, page 277-280.

On 26 March 2009 amendments of the PfandBG came in force introducing a new Pfandbrief category, the Aircraft Pfandbrief, and furthermore enhancing the attractiveness of Pfandbriefe for investors. Among many improvements, a further liquidity safeguard has been implemented by introducing a special liquidity buffer of 180 days. Since spring 2010, further amendments have been discussed in Parliament in order to strengthen the position of the special cover pool administrator; they came into force on 25 November 2010 and on 1 January 2011. The forthcoming amendment of the PfandBG will introduce further transparency requirements and is scheduled for the end of 2012.

II. STRUCTURE OF THE ISSUER

Since 2005, the issuer of Pfandbriefe is no longer required to be a specialised bank. Instead, Pfandbrief issuers are allowed to exercise all activities of a credit institution, although a special licence for Pfandbrief issuance is required. The minimum requirements to obtain and keep the special licence are as follows:

- Core capital of at least EUR 25 million
- General banking licence which allows the issuer to carry out lending activities
- Suitable risk management procedures and instruments
- Business plan showing regular and sustainable issues as well as necessary organisational structure

Since the German outsourcing guidelines of the BaFin do not allow for the outsourcing of important and decision-making sections of the credit institution, the issuer is required to have its own employees. In addition, the PfandBG requires Pfandbrief banks to manage their own risk and take their own credit decisions on their own.

The issuer holds the cover assets on his balance sheet. A subsequent transfer of the cover assets to another legal entity does not take place. Given that a direct legal link between single cover assets and Pfandbriefe does not exist, all obligations relating to Pfandbriefe are obligations of the issuing bank as a whole, to be paid from all the cover assets of the issuer, recorded in the cover register. In the case of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved for the claims of the Pfandbrief holders. Even then, Pfandbrief holders still have a claim against the general insolvency estate.

III. COVER ASSETS

Cover assets are produced by mortgage lending, public sector lending, ship and aircraft financing activities. ABS/MBS are not eligible. A specific class of covered bonds corresponds to each of these cover asset classes: Hypothekenpfandbriefe, Öffentliche Pfandbriefe, Schiffspfandbriefe and Flugzeugpfandbriefe. The respective Pfandbrief must be fully secured by its specific cover asset class (§ 4 PfandBG). Detailed transparency requirements are regulated in § 28 PfandBG, enhanced by the amendments 2009 and 2010.

Up to 10% of the nominal volume of Pfandbriefe outstanding may consist of money claims against the European Central Bank, central banks in the European Union or against suitable credit institutions, which fulfil the requirements of credit quality step 1 according to Table 1 of the Annex VI of Directive 2006/48/EC.

The geographical scope of eligible mortgage assets is restricted to EU/EEA countries, to Switzerland, USA, Canada and Japan. Public sector loans to these countries are eligible for the cover of Öffentliche Pfandbriefe (§ 20 PfandBG). The total volume of loans granted in non-EU countries where it is not certain that the preferential right of the Pfandbrief creditors extends to the cover assets, may not exceed 10 % of the total volume of the cover loans (§§ 13 I 2, 20 I 2 PfandBG) and 20 % for ship and aircraft mortgages (§§ 22 V 2, 26b IV PfandBG).

Derivatives are eligible for cover pools under certain conditions. They must not exceed 12% of the cover assets when calculated on a net present value basis (§ 19 I 4. PfandBG).

IV. VALUATION AND LTV CRITERIA

Property valuation is regulated in § 16 PfandBG. This provision refers to the mortgage lending value (Beleihungswert) which is, in contrast to the market value, based on sustainable aspects of the property. Details about the valuation process and the qualifications of valuers are regulated in a specific statutory order on the mortgage lending value (Beleihungswertermittlungsverordnung, BelWertV), § 16 IV PfandBG.

Monitoring requirements result from the Capital Requirements Directive (once a year for commercial real estate and once every three years for residential real estate). In addition, § 27 BelWertV requires a review of the underlying assumptions when the market has declined substantially; a review of property values is also necessary when the loan has defaulted.

The BelWertV requires personal and organisational independence of the valuer (internal or external valuer)

For both commercial and residential property, the LTV limit is 60% of the mortgage lending value of the property. This LTV is a relative limit, i.e. when the loan exceeds the 60% limit, the part of the loan up to 60% LTV remains eligible for the cover pool.

V. ASSET - LIABILITY MANAGEMENT

§ 4 PfandBG stipulates that the total volume of Pfandbriefe outstanding must be covered at all times by assets of at least the same amount. Thus, the nominal value of the cover assets must permanently be higher than the respective total value of the Pfandbriefe.

In addition, the Pfandbrief Act requires that Pfandbriefe are covered on a net present value basis even in the event of severe interest rate changes or currency fluctuations. The issuer has to provide an overcollateralisation of at least 2% after stress tests which have to be carried out weekly. Both the maturity of outstanding Pfandbriefe and the fixed-interest periods of the cover pool are disclosed on a quarterly basis. Details about the calculation are regulated in a special statutory order Net Present Value (Barwertverordnung).

Furthermore, each day Pfandbriefbanks have to calculate the maximum liquidity need within the next 180 days. This amount has to be covered by liquid assets (§ 4 Ia PfandBG).

Every quarter, the stress-tested NPV of outstanding Pfandbriefe, the cover pool and the overcollateralisation have to be published (§ 28 I PfandBG). The stress tests apply not only to interest rate risks but also to foreign exchange risks.

Cash flow mismatch between cover assets and covered bonds is furthermore reduced by the prepayment rules applicable to fixed interest rate mortgage loans. Prepayments of mortgages during fixed rate periods are only permitted in cases of "legitimate interest" of the borrower or after a period of ten years. If the mortgage is prepaid, the borrower has to compensate the damage of the lender caused by the prepayment (§ 490 II German Civil Code).

VI. TRANSPARENCY

According to § 28 of the Pfandbrief Act (Pfandbriefgesetz, PfandBG), all Pfandbrief Banks are obliged to publish detailed information about their Pfandbrief outstanding and the pertaining cover pools on a quarterly basis. These include

- The total volume of Pfandbrief outstanding as well as the related cover pools in terms of nominal, net present and stressed net present value;
- The share of derivative financial instruments in the cover assets;
- The share of further cover assets;
- The maturity structure of the Pfandbrief and cover assets;
- Information on the size of the cover assets;
- Information on the mortgages by property type/type of use, region and state;
- Information on the claims against the public sector by state and type of issuer;
- Information on the ship mortgages/aircraft registered liens by register country; and
- Information on non-performing cover assets.

These transparency requirements offer investors a high level of security in terms of frequency and scope of the reports and investors are granted an enforceable right to receive clearly defined data relating to the cover assets and Pfandbriefe. However, given the ongoing changes in the capital markets, the requirements to be met by Pfandbrief issuers regarding the provision of up-to-date information on the asset pools are changing and rising constantly. Therefore, the legal transparency requirements are amended frequently. In 2009, for example, the Pfandbrief Banks pressed for a more detailed disclosure of maturities in order to ensure that investors are better informed about the short and medium-term maturities. The 2010 amendment of the Pfandbrief Act introduced a period of one month after the end of each quarter, in which the quarterly report must be published, except for the fourth quarter, where this period is extended to two months. The forthcoming amendment of the PfandBG will introduce inter alia further transparency requirements and is scheduled for the end of 2012.

Beside these legal requirements, the vdp member banks started the vdp Transparency Initiative in 2010. Within the scope of this initiative, transparency reports of vdp member institutions are published

> In a uniform format;

> That can be processed electronically;

> Using a uniform understanding of the legal requirements; and

> On one central website (the vdp's).[1]

Each report is available as a reading version in pdf format and, suitable for further direct processing, in xls (Excel) and csv formats as well. Automatic links to investor data bases are possible. The website offers sorting possibilities for the reports both by reporting date and bank name. All reports are published in English and German language versions. There is a data history available that goes back to 31 December 2008. Hence, the vdp Transparency Initiative provides investors with excellent resources to analyse Pfandbrief cover pools pursuant to their specific needs.

While transparency of cover pools is important for investors, information on covered bonds has to go far beyond cover assets. Another crucial element is transparency regarding the legal structure of covered bonds, which includes information on the legal nature of the cover pool, the segregation of cover assets, the insolvency remoteness of covered bonds, the timely payment in the case of the issuer's insolvency and on the question who actually issues the covered bond. Transparency of these aspects is of utmost importance for investors as covered bonds are designed to survive the issuer's insolvency. The best cover assets will be of no value for the investor if they disappear in the issuer's insolvency estate. The Pfandbrief Act contains detailed regulations of all these aspects, thus ensuring investors a high degree of product transparency.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

A cover pool monitor (Treuhänder) supervises the cover pool. He is appointed by the BaFin and must possess the expertise and experience necessary to fulfil all duties. A qualification as a certified auditor suggests that the necessary expertise is provided.

The monitor has to ensure that the prescribed cover for the Pfandbriefe exists at all times and that the cover assets are recorded correctly in the cover register, §§ 7, 8 PfandBG. Without his approval, no assets may be removed from the cover pool. The BaFin has published a specific statutory order on details of the form and the contents of this cover register (Deckungsregisterverordnung – DeckRegV), § 5 III PfandBG.

In addition, BaFin carries out a special supervision on Pfandbrief banks. The former division on mortgage banks (Referat Hypothekenbanken) was transformed into the divison "Pfandbriefkompetenzcenter I - Grundsatzfragen", which is responsible for all fundamental issues regarding the PfandBG. In January 2006, the BaFin set up a special division for cover pool audits ("Pfandbriefkompetenzcenter II – Deckungsprüfungen").

Furthermore, the BaFin has to monitor the cover pool on average every two years (§ 3 PfandBG) and to this end it may appoint auditors with special knowledge in this area. Finally, BaFin carries out the general banking supervision on German Pfandbrief banks.

[1] http://www.pfandbrief.de/cms/_internet.nsf/tindex/de_pub_pfandbg.htm

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

A cover register (Deckungsregister) permits the identification of the cover assets, § 5 PfandBG. The register records the cover assets being used to cover the Pfandbriefe as well as claims under derivatives (§ 5 I 1 PfandBG).

The legal effect of registration is that in the case of insolvency of the issuer, the assets which form part of the cover pool can be identified: All values contained in the register would not be part of the insolvency estate. § 30 I 1 PfandBG now calls them "insolvency-free assets".

While the bank carries out the daily administration of the cover register, it is the cover pool monitor who supervises the required cover und registration in the cover register, § 8 I, II PfandBG. Copies of the cover register shall be transmitted to the supervisory authority on a regular basis.

Asset segregation

The cover pool is a part of the general estate of the bank as long as the issuer is solvent. If insolvency proceedings are launched, by operation of law, the assets recorded in the cover registers are excluded from the insolvency estate (§ 30 I 1 PfandBG). Those assets will not be affected by the launching of the insolvency proceedings (§ 30 I 2 2. HS PfandBG).

After the launching of the insolvency proceedings, a special cover pool administrator (Sachwalter) carries out the administration of the cover assets (§ 30 II 1 PfandBG). Through the appointment of the cover pool administrator by the court, on proposal of the BaFin, the right to manage and dispose of the recorded assets will be transferred to him automatically by law (§ 30 II 2 PfandBG). Regarding cover assets and timely payment of Pfandbriefe, the cover pool administrator represents the Pfandbriefbank (§ 30 II 5, 6 PfandBG). He is allowed to use premises and staff of the Pfandbriefbank (§31 VIII PfandBG).

The cover pool administrator may even be appointed before the insolvency proceedings have been launched (§ 30 V PfandBG).

Impact of insolvency proceedings on covered bonds and derivatives

Covered bonds do not automatically accelerate when the issuing institution is insolvent, but will be repaid at the time of their contractual maturity. The same applies to derivatives which are registered in the cover register and form part of the cover pool. Accordingly, the German master agreements for cover derivatives stipulate that the bankruptcy of the Pfandbrief issuer does not signify a termination event. Article 13 N° 6 DeckregV stipulates that the collateral provided by the derivative counterpart or the Pfandbrief bank has to be registered in the cover register. The consequence of such registration is that the collateral belongs to the insolvency-free assets.

Preferential treatment of covered Bond holders

Covered bond holders enjoy preferential treatment as the law stipulates the separation of the cover assets on the one hand and the insolvency estate on the other, § 30 I PfandBG.

The satisfaction of the Pfandbrief creditors is not limited to the cover assets. On the contrary, these creditors also participate in the insolvency proceedings with respect to the Pfandbrief bank's remaining assets.

Only in the case of over-indebtedness or insolvency of the cover assets, the BaFin may apply for a special insolvency procedure relating to the cover pool and covered bonds (§ 30 VI PfandBG). Insolvency of the cover pool is the only reason, which might trigger acceleration of Pfandbriefe.

As long as the cover pool is solvent, a moratorium on the insolvency estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of covered bond holders.

Access to liquidity in case of insolvency

Through the appointment of the cover pool administrator, the right to manage and dispose of the recorded assets is transferred to him by law (§ 30 II 2 PfandBG). Thus, the cover pool administrator has first access to the cover assets and collects the cash flows according to their contractual maturity (§ 30 III 2 PfandBG).

No explicit regulation exists with respect to the insolvency remoteness of voluntary overcollateralisation (OC). However, the insolvency administrator may only demand that the overcollateralisation be surrendered to the insolvency estate if those amounts will obviously not be necessary as cover for the respective Pfandbrief category (§ 30 IV 1 PfandBG). The burden of proof that OC will never be necessary for the timely payment of the Pfandbriefe, lays with the insolvency administrator.

The cover pool administrator is entitled to contract loans in order to obtain liquidity. According to § 30 II, 5 PfandBG, the cover pool administrator may carry out legal transactions with regard to the cover pools in so far as this is necessary for an orderly settlement of the cover pools in the interest of the full and timely satisfaction of the Pfandbrief creditors.

Pfandbriefbank with limited business activities

The amendment of the PfandBG 2010 is focusing on the legal nature of cover pools in the event of a Pfandbrief bank's insolvency and on the access of a cover pool administrator to liquid funds during difficult times. A cover pool will be given the status of a non-insolvent part of the bank of the insolvent Pfandbrief bank. Thus, the cover pool administrator could act as head of a bank in respect of transactions with the Deutsche Bundesbank; he would also be entitled to issue Pfandbriefe.

More precisely, § 2 IV PfandBG stipulates that the banking license will be maintained with respect to the cover pools and the liabilities covered there from until the Pfandbrief liabilities have been fulfilled in their entirety and on time.

A revised version of § 30 PfandBG addressing the ring-fencing of the cover assets from the insolvency estate confirms this new approach by introducing the new heading 'segregation principle' and by referring to the cover assets as 'insolvency-free estates'. Consistently, the amended PfandBG incorporates the term 'Pfandbrief bank with limited business activities'.

Thus, the amendments ensure that the cover pool administrator acts on behalf of a solvent Pfandbrief bank that is in possession of a license to engage in banking business in general and in Pfandbrief business more specifically, even if the bank itself is insolvent and the general banking license withdrawn. Hence, the Pfandbrief bank with limited business activities is treated as a solvent bank in order to comply with the eligibility criterion "counterparty" for central bank open market operation with the perspective to satisfy its liquidity needs.

Sale and transfer of mortgage assets to other issuers

According to § 32 I PfandBG, the cover pool administrator may transfer all or a part of the assets recorded in the cover register as well as liabilities from Pfandbriefe as a whole to another Pfandbrief bank. This transfer requires the written approval of the supervisory authority.

According to § 35 I PfandBG, the cover pool administrator may also agree with another Pfandbrief bank that the assets recorded in the insolvent Pfandbrief bank's cover register may be managed in a fiduciary capacity by the insolvent Pfandbrief bank's cover pool administrator for the other Pfandbrief bank.

Thus, particular provisions allow for an easy "transfer" of mortgages outside of the common provisions of civil law, e.g. the management in a fiduciary capacity of registered land charges (so called "Buchgrundschulden") and foreign mortgages. Both forms require the written approval of the BaFin. Since 1 January 2011, § 36a PfandBG stipulates that the specific provisions of the PfandBG have priority during the restructuring of a Pfandbriefe issuing institution according to the new "Restrukturierungsgesetz".

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk weighting of covered bonds (German Pfandbriefe and foreign covered bonds) is regulated by Article 20a Kreditwesengesetz (KWG) and the Solvabilitätsverordnung (SolvV), transposing the Capital Requirements Directive into German law.

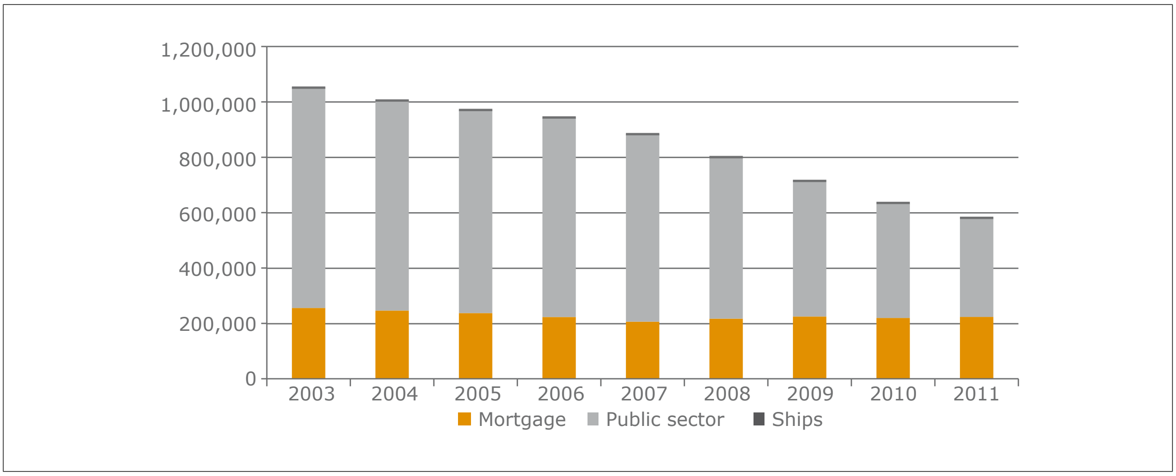
German Pfandbriefe comply with the requirements of Art. 52 par. 4 UCITS Directive as well as with those of the CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f). Therefore, they enjoy a 10% risk weighting. Foreign covered bonds enjoy a 10% risk weighting in Germany, provided that they comply with the requirements of § 20a KWG.

Derivatives which are part of the cover pool are now 10% risk weighted, granting the derivative partners the same risk weighting as Pfandbriefe (§ 25 VIII SolvV).

With the expected entry into force of the Capital Requirement Regulation (CRR) on 1.1.2013, the CRR rules will immediately be applicable at Member State level and therefore replace the national covered bond provisions contained in the KWG and SolvV. Material changes are not expected, although the range of eligible assets of the CRR is wider compared to the KWG. It is uncertain if the preferential treatment of derivative partners can be maintained.

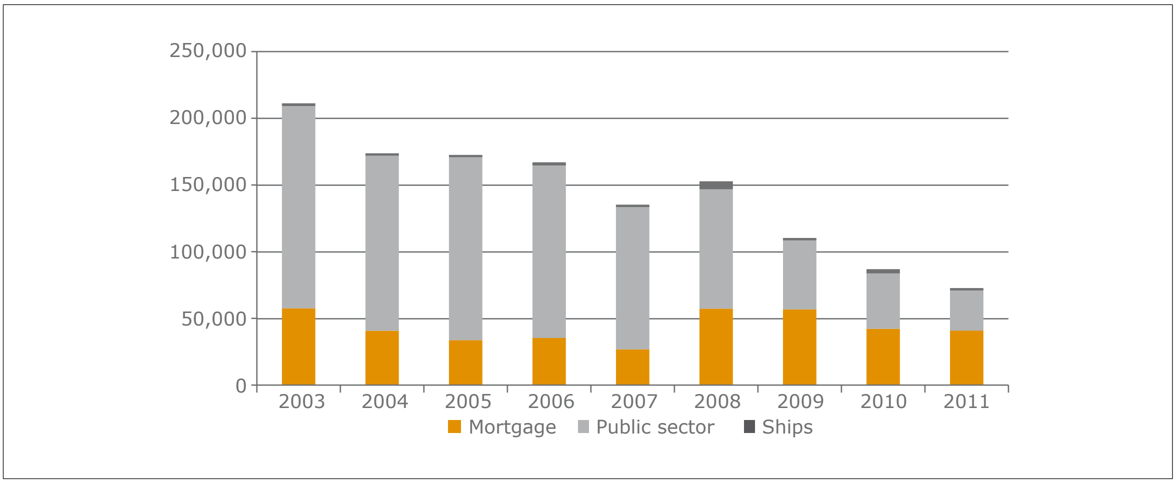
Finally, German investment legislation allows investment funds to invest up to 25% of the fund's assets in Pfandbriefe and furthermore in covered bonds issued by credit institutions complying with the requirements of Art. 52 par. 4 UCITS Directive (Article 60 par. 2 German Investment Act).

> Figure 1: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

Issuers: There are currently about 70 Pfandbrief banks in Germany, including banks from all three pillars of the German banking industry (private banks, public banks and co-operative banks). They include 18 former mortgage banks, 10 Landesbanks and circa 30 savings banks. Also, an increasing number of private universal banks became Pfandbrief banks within the last years."

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/23/Pfandbriefe

3.12 GREECE

By Alexander Metallinos, Karatzas & Partners Law Firm

I. FRAMEWORK

In Greece, the primary legal basis for Covered Bond issuance is article 91 of Law 3601/2007 "On the Undertaking and Exercise of Activities by Credit Institutions, Sufficiency of Own Funds of Credit Institutions and Investment Services Undertakings and Other Provisions", which entered into force on 1 August 2007 (the "Primary Legislation"). The Primary Legislation supersedes general provisions of law contained in the Civil Code, the Code of Civil Procedure and the Bankruptcy Code. By way of implementation of the Primary Legislation and, pursuant to an authorization provided by the latter, the Governor of the Bank of Greece has issued Act nr. 2598/2.11.2007, which was replaced by the Bank of Greece Act nr. 2620/28.8.2009 (the "Secondary Legislation"). Finally, the legislative framework in Greece is supplemented by Law 3156/2003 "On Bond Loans, Securitization of Claims and of Claims from Real Estate" (the "Bond Loan and Securitization Law"), to the extent that the Primary Legislation cross-refers to it.

II. STRUCTURE OF THE ISSUER

The Greek legislative framework permits the issuance of covered bonds in two ways, either directly by a credit institution, or indirectly by a subsidiary of a credit institution. In the direct issuance structure the covered bonds are issued by a credit institution and the segregation of the cover pool is achieved through a statutory pledge over the cover pool assets.

By virtue of law 3716/2009, a new paragraph 13 introduced into the Primary Legislation a variation to the direct issuance. Under this structure the covered bonds are issued by the credit institution and are guaranteed by a special purpose entity (SPE), which acquires the cover pool. This structure has not yet been used by any issuer.

In the indirect issuance structure the covered bonds are issued by a special purpose entity being a subsidiary of a credit institution, which purchases the cover assets from the credit institution by virtue of the provisions of the Bond Loan and Securitization Law, and are guaranteed by the credit institution.

The reason for introducing the indirect issuance structure was that historically most Greek banks had issued a significant amount of notes under medium term note (MTN) programmes containing negative pledge covenants, which did not allow the creation of security over the cover pool, as is necessary for the direct issuance of covered bonds. However all Greek banks having MTN programmes have now amended the terms of such programmes to carve out the security provided to holders of covered bonds from the scope of the negative pledge covenants, and therefore the need for the indirect issuance of covered bonds has been removed. In fact, the only indirect issuance of covered bonds has now been fully redeemed and it is to be expected that the regulator will likely not approve any future indirect issue of covered bonds.

III. COVER ASSETS

Cover assets are primarily residential mortgage loans, loans secured by a mortgage on commercial properties, loans secured by a mortgage on ships and loans to or guaranteed by state entities. Residential and commercial mortgage loans may only be included in the cover pool if the property subject to the mortgage is situated in Greece and hence is governed by Greek law. The loans may be secured by mortgage prenotations instead of full mortgages (as is the practice for cost reasons in Greece) provided the credit institution has adequate internal procedures to ensure the timely conversion of mortgage prenotations into mortgages. In addition, openings to credit institutions and investment services undertakings may be included in the cover pool up to an aggregate limit of 15% of the nominal value of the outstanding covered bonds. Derivatives may also be included in the cover pool to the extent that they are used exclusively for the purpose of hedging the interest rate, FX or liquidity risk. To the extent that the counterparties to such derivatives are credit institutions and investment services undertakings (as opposed to state entities or central counterparties in organized markets), the net present value of derivatives included in the pool is included in the above 15% limit. Finally, the cover assets may be substituted by certain tradable assets but only up to the amount by which the aggregate nominal value of the cover assets including accrued interest exceeds the nominal value of the outstanding covered bonds including accrued interest.

IV. VALUATION AND LTV CRITERIA

Loans secured by residential mortgages are required to have a loan to value (LTV) ratio of 80%, whereas loans secured by mortgages over commercial properties and ships are required to have an LTV ratio of 60%. Loans with a higher LTV ratio may be included in the cover pool, but they are taken into account for the calculation of the statutory tests described below only up to the amount indicated by the LTV ratio. Thus, by way of example, a loan of EUR 900,000 secured through a residential mortgage over a property valued at EUR 1,000,000 may be included in the cover pool but will be deemed for the purposes of the calculation of the statutory tests to be equal to EUR 800,000.

The valuation of properties must be performed by an independent valuer at or below the market value and must be repeated every year in relation to commercial properties and every three years in relation to residential properties.

V. ASSET-LIABILITY MAMANGEMENT

The Secondary Legislation provides for tests that are required to be met for the full duration of the covered bonds.

More particularly, the Secondary Legislation provides for the following statutory tests:

(a) The nominal value of the covered bonds including accrued interest may not exceed at any point in time 95% of the nominal value of the cover assets including accrued interest.

(b) The net present value of obligations to holders of covered bonds and other creditors secured by the cover pool may not exceed the net present value of the cover assets including the derivatives used for hedging. This test must be met even under the hypothesis of a parallel movement of the yield curves by 200 basis points.

(c) The amount of interest payable to holders of covered bonds for the next 12 months must not exceed the amount of interest expected to be received from the cover assets over the same period. For the assessment of the fulfilment of this test derivatives entered into for hedging purposes are taken into account.

Tests (b) and (c) are performed on a quarterly basis. In case any of the tests is not met, the credit institution is obliged to immediately take the necessary measures to remedy the situation.

The results of the tests (a) to (c) above and the procedures used to monitor the compliance with such tests are audited on a yearly basis by an auditor independent of the statutory auditors of the credit institution.

The breach of the above mentioned legislation leads to regulatory sanctions. The parties can also agree that the breach of the statutory tests constitutes an event of default.

Moreover, since the Bank of Greece approves each issuance of covered bonds, it would not approve any issuance in case the statutory tests (including the liquidity test) are not met. Therefore a breach of the statutory (but not of any contractual) liquidity test would in practice lead to a Programme freeze. Also the failure to comply with the requirement to restore the statutory tests may lead to sanctions by the Bank of Greece. Apart from the sanctions provided by the Primary and the Secondary Legislation, the contracting parties may agree to additional sanctions, in particular, to alternative administration or an event of default.

VI. TRANSPARENCY

Currently, the issuer's reporting obligations (as in detail described under paragraph on reporting duties of section VII) and the disclosure of the cover pool as conducted via the summary registered with the competent land registry for the establishment statutory pledge (for more details on this issue we cross refer to paragraph on the cover pool monitor of section VII) are the basic transparency tools provided under applicable covered bonds legislation. So far in Greece no market nor regulatory initiatives have been undertaken on the creation of a national transparency template, in line with the guidelines of the ECBC Label Initiative.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Cover Pool Monitor

The compliance with statutory tests, mentioned above, is audited by independent auditors. Such audit reports, as well as the quarterly compliance reports by the issuer shall be submitted with the Bank of Greece as regulator.

Prerequisites for the issuance of covered bonds

According to the Primary Legislation, covered bonds may be issued by credit institutions having Greece as home member state. However, in case of issuance of covered bonds by a credit institution having as home state another member state of the European Economic Area (EEA), and provided that they are characterized as covered bonds in accordance with the law of such member state, the provisions of the Primary Legislation on the creation of a statutory pledge will apply in relation to claims governed by Greek law, as well as the tax exemptions which apply to Greek bonds. Therefore, foreign banks established within the EEA having a significant loan portfolio in Greece may use the loans of such portfolio as part of the cover pool.

The Secondary Legislation sets additional prerequisites for the issuance of covered bonds. Specifically the credit institutions issuing covered bonds:

> must have certain minimum risk management and internal control requirements including suitable policies and procedures for the issuance of covered bonds, organizational requirements, IT infrastructure and a policy for the reduction and management of risks deriving from the issuance of covered bonds, such as interest rate risk, counterparty risk, operational risk, FX risk and liquidity risk; and

> must have aggregate regulatory capital of at least EUR 500 m and a capital adequacy ratio of at least 9%.

Reporting duties of the Issuer to the supervisor concerning covered bonds and cover pool

Credit institutions that issue (directly or indirectly) covered bonds shall provide in their financial statements and on their websites information on such covered bonds including on the nominal value and net present value of the bonds and the cover pool and the net present value of derivatives used for hedging.

More particulary, pursuant the Secondary Legislation there are the following disclosure requirements to the Bank of Greece until the end of March of each year in relation to data as of end of December of the year preceding:

> The certified by auditor results arisen following the audit conducted pursuant to the provisions of the Secondary Legislation and following the follow-up of processes and restrictions as set by the Secondary legislation. Any detailed presentation of data, methods and parameters used should also be mentioned.

> Detailed data of the cover pool assets that would confirm the restrictions set under the Secondary Legislation along with the information related to the real estate's revaluation of the mortgages and other loans.

> The following data and information:

a) weighted average interest-rate per category of assets and weighted average interest-rate of all cover pool assets;

b) the real estate values of the mortgages and of the other loans;

c) validation of the selected policy of risk hedging with detailed analysis of the degree of effectiveness of this;

d) table of corresponding maturities of the covered bonds and corresponding assets of the cover pool and the derivatives;

e) Finally all the credit institutions have to communicate to the Bank of Greece, within 30 days from the expiry of each quarter, with data of 1st, 2nd and 3rd quarter end, concise information with regards to the results from the tests provided under the Secondary Legislation.

Banking supervision in crisis

As in detail described under section VIII of this article, the Primary Legislation provides that in case of insolvency of the issuer, the Bank of Greece may appoint an administrator, regardless of the powers they may assign to a special liquidator pursuant to the generally applicable banking special liquidation provisions, if the trustee does not do so.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Segregation of cover assets

In case of a direct issuance the cover assets are segregated from the remaining estate of the credit institution through a pledge constituted by operation of law (statutory pledge). In case of assets governed by a foreign law (which will typically include *inter alia* claims from derivative contracts) a security interest must be created in accordance with such foreign law. The statutory pledge and the foreign law security interest secure claims of the holders of covered bonds and may also secure (in accordance with the terms of the covered bonds) other claims connected with the issuance of the covered bonds, such as derivative contracts used for hedging purposes. The statutory pledge and any foreign law security interest is held by a trustee for the account of the secured parties.

The claims constituting cover assets are identified by being listed in a document signed by the issuer and the trustee. A summary of such document is registered in the land registry of the seat of the issuer. Such summary document includes within its content a description of the assets that constitute the cover pool. Claims may be substituted and additional ones may be added to the cover pool through the same procedure.

The Primary Legislation creates an absolute priority of holders of covered bonds and other secured parties over the cover pool. The statutory pledge supersedes the general privileges in favour of certain preferred claims (such as claims of employees, the Greek state and social security organization) provided for by the Code of Civil Procedure. Furthermore, upon registration of the summary of the document listing the claims included in the cover pool, the issuance of the covered bonds, the establishment of the statutory pledge and the foreign law security interest and the entering into of all contracts connected with the issuance of the covered bonds are not affected by the commencement of any insolvency proceedings against the issuer.

In case of an indirect issuance or a direct issuance guaranteed by an SPE the cover pool assets are segregated from the estate of the credit institution by virtue of their sale to the special purpose entity. For such transfer, the provisions of the Bond Loan and Securitization Law apply, which provide equivalent protection from third party creditors and insolvency to the one the Primary Legislation provides in case of direct issuance.

It is worth noting that according to the Primary Legislation both in case of direct and of indirect issuance the cover assets may not be attached. This has the indirect result that the Greek law claims constituting cover assets are no longer subject to set-off, because according to article 451 of the Greek Civil Code claims which are not subject to attachment are not subject to set-off. This is important because under generally applicable law borrowers the loans to whom become cover assets would have had a right to set-off, which would reduce the value of the cover pool, for all counterclaims (including notably deposits) predating the creation of the pledge or the transfer of the claims, as the case may be.

No specific provisions exist in relation to voluntary overcollateralisation. As a result the segregation applies to all assets of the cover pool, even if their value exceeds the minimum required by law. The remaining creditors of the credit institution will only have access to any remaining assets of the cover pool after the holders of the covered bonds and other creditors secured by the cover pool have been satisfied in full.

Bankruptcy remoteness of and impact of insolvency proceedings on covered bonds

According to the Secondary Legislation covered bonds do not automatically accelerate upon insolvency of the credit institution having issued (in a direct issuance structure) or guaranteed (in an indirect one) the covered bonds.

Pursuant to the Primary Legislation, as amended, the bond loan programme may provide that either from the outset or following the occurrence of certain events, as, indicatively, initiation of insolvency proceedings against the issuer, the trustee will be entitled to assign or undertake the collection and management, in general, of the cover assets by application mutatis mutandis of the Bond Loan and Securitization Law.

Additionally, the Primary Legislation provides that in case of insolvency of the issuer, the Bank of Greece may appoint an administrator, regardless of the powers they may assign to a supervisor or liquidator pursuant to the above articles 63 and 68 of the Primary Legislation, if the trustee does not do so. The proceeds coming both from the collections of the claims that are included in the legal pledge and from the realization of the rest of the assets which are subject to the legal pledge are applied towards the repayment/redemption of the bonds and of the other claims, which are secured by the legal pledge, pursuant to the terms of the bond loan.

The provisions of the Bond Loan and Securitization Law are respectively applied in the sale, transfer, collection and administration, in general, of the assets comprising the cover.

In case of an indirect issuance the obligations of the credit institution under the Guarantee are automatically accelerated in case of bankruptcy by virtue of the generally applicable provisions of bankruptcy law, but this does not lead to automatic prepayment of the covered bonds. To the contrary, the terms of the covered bonds may provide that the proceeds of the Guarantee will be placed in a special account to be used for the servicing of the covered bonds.

Access to liquidity in case of insolvency

The Primary legislation provides that the trustee can be entitled, pursuant to the terms of the programme and the legal relationship connecting the trustee with the bondholders, to sell and transfer the cover assets, and to use the net proceeds of such sale in order to redeem the bonds which are secured by the legal pledge, by way of derogation from articles 1239 and 1254 of the Civil Code.

The above-mentioned sale may occur by virtue of the Bond Loan and Securitization Law or the application of the general applicable provisions

Exercise of the claims of covered bond holders against the remaining assets of the credit institution

The purpose of the Primary Legislation, as was expressly stated in the introductory note to the law, was to ensure that holders of covered bonds would have dual recourse both to the cover pool as secured creditors and to the remaining assets of the credit institution ranking as unsecured and unsubordinated creditors. This was also expressly stated in the Secondary Legislation. Certain doubts which had been raised on this matter by the introduction of the Bankruptcy Code were resolved by an amendment to the Primary Legislation which stated expressly that to the extent that covered bondholders and other secured parties are not fully satisfied from the cover pool, they rank for their remaining claims as unsecured creditors of the issuer.

The programme of the covered bonds may provide that more than one series or issues of bonds may be secured through a single statutory pledge.

The programme may also provide on any other issue related to the priority in satisfaction of the Covered Bondholders and the way they are organized in a group and they are represented, by derogation from the Bond Loan and Securitization Law. Furthermore, the parties may agree to apply a foreign law on these matters.

Protection of depositors

In order to not jeopardize the interests of depositors in case of insolvency of a credit institution due to the segregation (discussed below) of high quality assets in favour for the holders of covered bonds, the

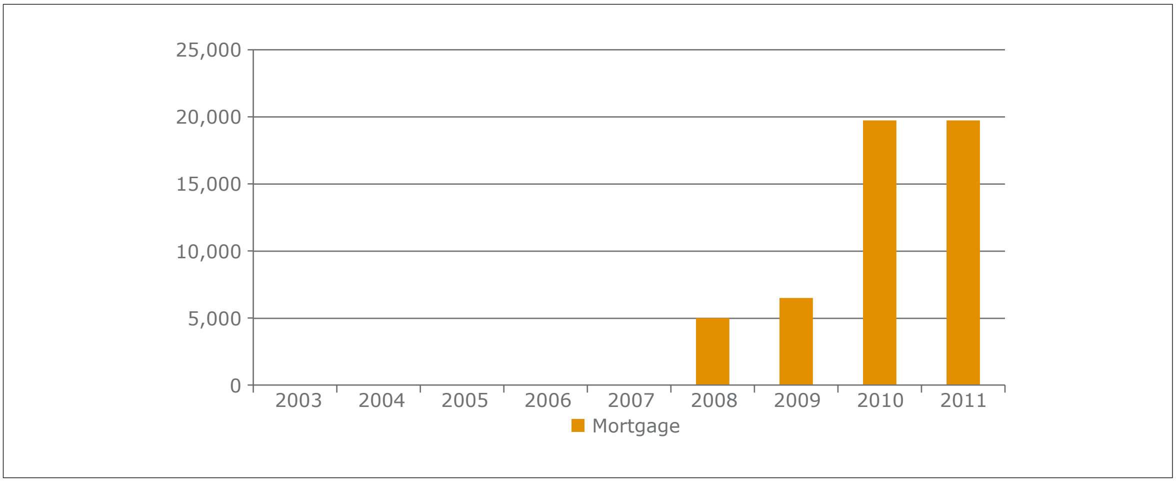
Secondary Legislation provides that, in case the cover assets exceed significantly the amount of 20% of the available assets of the credit institution on an unconsolidated basis, the Bank of Greece may impose additional capital adequacy requirements. For the purposes of this calculation available assets are considered to be all assets of the credit institution excluding (i) assets subject to securitization, (ii) assets subject to reverse repo agreements and (iii) assets encumbered in favour of third parties. In exercising its discretion to impose additional capital adequacy requirements the Bank of Greece will take into account qualitative considerations such as (i) any deterioration of the average quality of the remaining available assets after the issuance of covered bonds, (ii) the increase of the liquidity of the credit institution combined and any positive effects it may have on its credit rating and prospects and (iii) the results of additional stress tests.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk weighting of covered bonds (both Greek and foreign) is regulated by Part B par. 8 2588/20.8.2007, transposing part of the Capital Requirements Directive into Greek law. According to this bonds falling within the provisions of art. 52 par. 4 of the UCITS Directive are considered to constitute covered bonds, provided that the cover pool consists of the assets enumerated in the Capital Requirements Directive. By way of exception, bonds issued before the 31st December 2007 and falling within the provisions of art. 52 par. 4 of the UCITS Directive are considered as covered bonds, even if the cover assets do not comply with the Capital Requirements Directive. Covered bonds have a risk weighting of 10%, if openings to the issuing credit institution have a risk weighting of 20%, and a risk weighting of 20%, if openings to the issuing credit institution have a risk weighting of 50%.

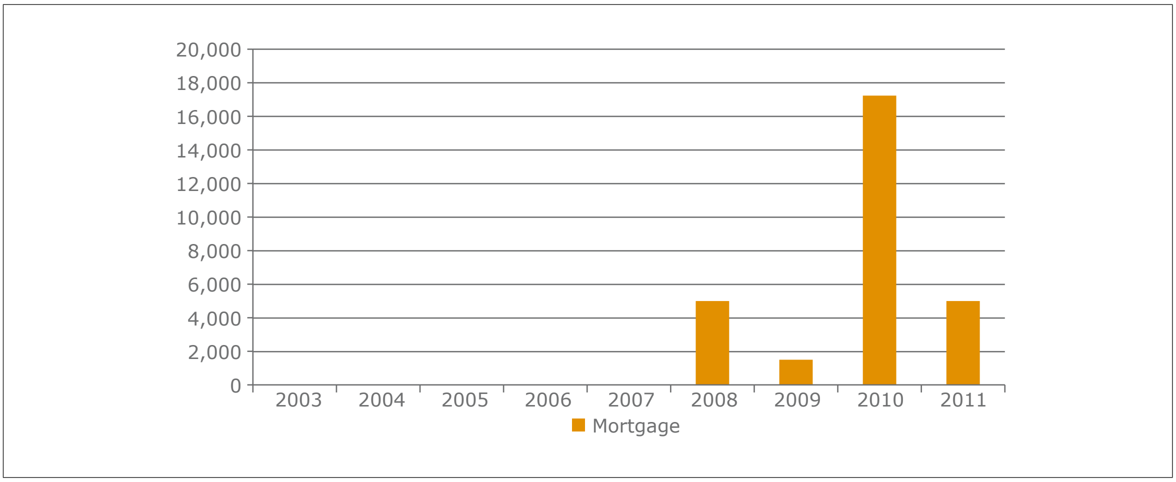
Directly issued Greek covered bonds comply with both the UCITS Directive and the Capital Requirements Directive and, therefore, have the reduced risk weighting mentioned above in Greece and should also have it in other EU member states. In relation to indirectly issued covered bonds it must be noted that they do not fall within the letter of art. 52 par. 4 of the UCITS Directive, because they are not issued by a credit institution.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2011, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2011, EUR M



Source: EMF/ECBC

Issuers: Alpha Bank (Direct Issuance –2010) - 8billions; Marfin Egnatia Bank S.A. (Direct Issuance); National Bank of Greece; EFG Eurobank Ergasias S.A. (Direct Issuance) 2010 1st Programme 3 billions and 2nd Programme 3 billions; Pireus Bank (Direct Issuance 2011- 3billions)

Issuance Summary
Bonds ISIN Ratings Currency Nominal Value Interest Rate Final Maturity

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/66/Greece

3.13 HUNGARY

By András Gábor Botos, Association of Hungarian Mortgage Banks

I. LEGAL FRAMEWORK

Act No. XXX of 1997 on Mortgage Banks and Mortgage Bonds (Mortgage Bank Act) contains the specific rules applicable to mortgage banks and mortgage bonds. Act No. CXII of 1996 on Credit Institutions and Financial Enterprises is applicable generally to the establishment, operation, supervision and liquidation of mortgage banks, unless otherwise provided by the Mortgage Bank Act.

II. STRUCTURE OF THE ISSUER

Mortgage banks are specialized credit institutions in Hungary whose business activity is restricted, in principle, to mortgage lending and auxiliary financial services: mortgage banks grant financial loans secured by mortgages – including independent mortgage liens – on real estate property located on the territory of the Republic of Hungary and other EEA countries. Funds will be raised by way of issuing mortgage bonds. In the Hungarian banking sector only mortgage banks are entitled to issue mortgage bonds ("*jelzáloglevél*"). Cover assets will be held on the balance sheet of the mortgage bank. All the mortgage bonds of a single mortgage bank are covered by the same coverage pool which is only open to changes with the prior permission of the coverage supervisor, acting in the interest of mortgage bond holders.

III. COVER ASSETS

The Mortgage Bank Act provides that mortgage banks shall always possess cover surpassing the principal of outstanding mortgage bonds and the interest thereon both on a nominal basis and based on present value calculation. Decree No. 40/2005. (XII. 9.) of the Minister of Finance contains the detailed provisions on the present value calculation of cover assets and the methodology of stress tests to be published on a regular basis. Furthermore, mortgage banks shall prepare a manual of keeping the register of cover assets ("*fedezet-nyilvántartás*"), which also needs the approval of the Hungarian Financial Supervisory Authority (HFSA) and the coverage supervisor.

Loans secured by a residential real estate can be taken in cover up to 70% of the mortgage lending value of the property. In case of loans secured by commercial real estate the limit is 60%.

Mortgage bonds are covered by loans secured by mortgages ("*jelzálogjog*"), independent mortgage liens ("*önálló zálogjog*") or by joint and several surety assumed by the Hungarian State ("*állami készfizető kezességvállalás"*). Supplementary coverage may exclusively consist of liquid assets listed in the Mortgage Bank Act and may not exceed 20% of the coverage. Pursuant to the Mortgage Bank Act, cover assets must be entered into the register of cover. The availability and quality of cover assets is permanently monitored by the coverage supervisor, reports on availability and quality of cover assets are disclosed on a daily basis.

According to Section 14 (5) of the Mortgage Bank Act, in case mortgage bonds and their coverage are not denominated in the same currency, the mortgage bank is obligated to hedge the currency exchange risk by entering into derivative transactions. Section 3 (10) of the Mortgage Bank Act provides that mortgage banks are entitled to conclude such transactions exclusively for hedging purposes, i.e. risk management and liquidity. The Mortgage Bank Act entitles mortgage banks to include derivatives in the ordinary coverage as well.

IV. VALUATION AND LTV CRITERIA

The rules of calculation of the mortgage lending value ("*hitelbiztosítéki érték*") are included in the Decree of the Minister of Finance No. 25/1997 on the Calculation Methods of the Mortgage Lending Value of Real Estate not Qualifying as Agricultural Land and the Decree of the Minister of Agriculture No. 54/1997 on the Calculation Methods of the Mortgage Lending Value of Real Estate Qualifying as Agricultural Land. Both decrees prescribe the use of comparative methods, and prescribe the application of the principle of carefulness in the valuation process. Furthermore, they also determine the validity of the valuation report.

Mortgage banks may also provide appraisal services to determine the market value and the mortgage lending value of real properties.

Mortgage lending value calculation provisions refer to the sustainable aspects of the property. The mortgage bank's internal regulation for determining mortgage lending value is based on methodological principles defined in the above decrees. Such internal regulations are also subject to the former approval of the HFSA.

V. ASSET - LIABILITY MANAGEMENT

As indicated above, the Mortgage Bank Act provides that mortgage banks shall always possess cover surpassing the principal of outstanding mortgage bonds and the interest thereon. Mortgage banks shall comply with the above requirements as follows:

> The aggregate amount of the outstanding principal claims considered as coverage, reduced by the amount of any value adjustments, shall exceed 100% of the amount of the nominal value of the outstanding Mortgage Bonds; and

> The aggregate amount of interest accrued on the outstanding principal claims considered as coverage, reduced by the amount of any value adjustments, shall exceed 100% of the amount of interest accrued on the nominal value of the outstanding mortgage bonds (Section 14 (2) of the Mortgage Bank Act).

Under Section 14 (4) of the Mortgage Bank Act the amount of coverage for mortgage bonds shall always be calculated and published at their present value as well.

Cash flow mismatch between cover assets and cover bonds is furthermore reduced by special prepayment rules.

VI. TRANSPARENCY

Mortgage banks shall publish the amount of the nominal value and the accrued interest of the outstanding mortgage bonds as well as the value of the coverage assets in a national daily newspaper and in the Exchange Journal as of the last day of each quarter, before the last day of the next month. Such figures need to be certified by the coverage supervisor and disclosed to the HFSA as well.

Hungarian mortgage banks intend to create a national transparency template – in line with the ECBC's Label Initiative in 2012.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The coverage supervisor (cover pool monitor) shall be appointed by the mortgage bank and approved by HFSA. According to Section 16 of the Mortgage Bank Act, a company auditor or an auditor may be appointed; however, the coverage supervisor may not be identical with the auditor of the mortgage bank.

As a matter of fact, Hungarian mortgage banks have had one of the “big four” audit companies as coverage supervisor from the beginning of their operations. The coverage supervisor is responsible for monitoring and certifying, on a permanent basis:

> the existence of eligible security; and

> the registration of the eligible security in the coverage register. In accordance with Section 11 (2) (n) of the Mortgage Bank Act, a certificate from the coverage supervisor shall be attached to each mortgage bond regarding the existence of the coverage.

According to section 16 (7) of the Mortgage Bank Act, a coverage supervisor may be appointed for a fixed period of time, not exceeding five years, however, he may be re-appointed following the termination of the period of his appointment. Although the contract of appointment concluded between the mortgage bank and the coverage supervisor is governed by civil law, it may not be lawfully terminated without the approval of the HFSA. Within the scope of his coverage supervision activities, the coverage supervisor may not be instructed by the mortgage bank.

The HFSA is responsible for verifying the compliance of the credit institutions, including the mortgage banks, with the Credit Institutions Act and other acts e.g. the Mortgage Banks Act, and applicable banking regulations. The HFSA is entitled to impose various sanctions on credit institutions, including warnings of non-compliance, withdrawing licences and imposing fines on credit institutions and their management. Section 22 and 23 of the Mortgage Bank Act provides that the Hungarian Financial Supervisory Authority shall exercise special supervision over mortgage banks in addition to the provisions of the Credit Institutions Act and the provisions of the Capital Markets Act. Within the framework of such special supervision, HFSA shall draw up an analysis schedule and conduct on site audits of mortgage banks according to the analysis schedule it compiles.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Pursuant to the Mortgage Bank Act a cover pool administrator will be delegated to the insolvent mortgage bank to safeguard the interests of bondholders and derivative partners. The cover pool administrator cannot be identical with the insolvency administrator of the mortgage bank. The cover pool administrator should provide for the timely satisfaction of principal and interest claims of bondholders and derivative partners in case of a possible insolvency situation. The cover pool administrator will only safeguard the interests of bondholders and derivative partners and will also have an access to the part of assets not qualifying as coverage and those not recorded in the cover register. The transfer of the portfolio or parts of it to another mortgage bank may grant for liquidity, however, the transfer of the portfolio or parts of it requires the prior written consent of the HFSA.

As a general rule, Section 20/A (4) of the Mortgage Bank Act declares that the cover pool administrator is obliged to maintain the liquidity of the pool on a constant basis, allowing transfer of the pool or parts of it to another mortgage bank and to enter into derivative transactions. Within two years after the commencement of the liquidation procedure, both the cover pool administrator and the bondholders may request the court to complete the cover from the general insolvency estate. The cover pool administrator shall be entitled to receive remuneration for his work and refund of appropriate expenses. Although holders of the mortgage bonds, derivative partners or the coverage supervisor may inform HFSA or the only competent Metropolitan Court Budapest on issuer default, after proving all relevant circumstances, it is only the HFSA who is entitled to initiate an insolvency proceeding against the mortgage bank.

Hungarian legal provisions also provide for a wide-range of measurements, including extraordinary measurements, to be taken by the HFSA prior to any insolvency situation.

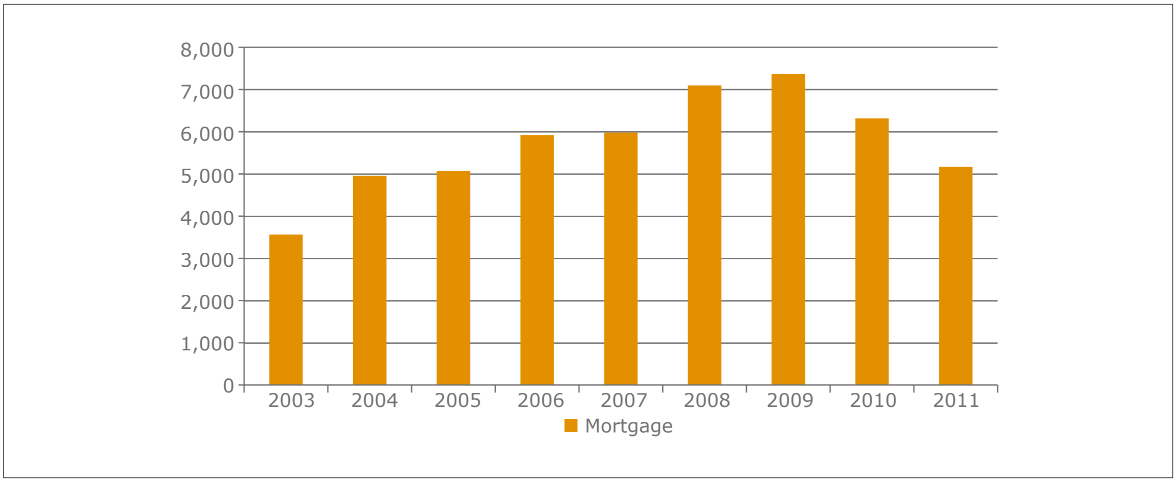
For example, the HFSA is entitled to delegate a supervisory commissioner to the mortgage bank. This extraordinary measurement may be taken by the HFSA prior to the commencement of any insolvency procedure – in accordance with Section 157 (1) of the Credit Institution Act. In this case both the rights of the owners of the mortgage bank and the rights of the management of the mortgage bank will be restricted in order to guarantee the satisfaction of the claims of the mortgage bank's creditors, e. g. bondholders' and derivative partners' claims.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Hungarian mortgage bonds comply with the requirements of Article 52(4) of the UCITS Directive as well as with those of the CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f) as have been reported to the Commission in accordance with Article 63 of the Directive 2000/12/EC and published on its website.

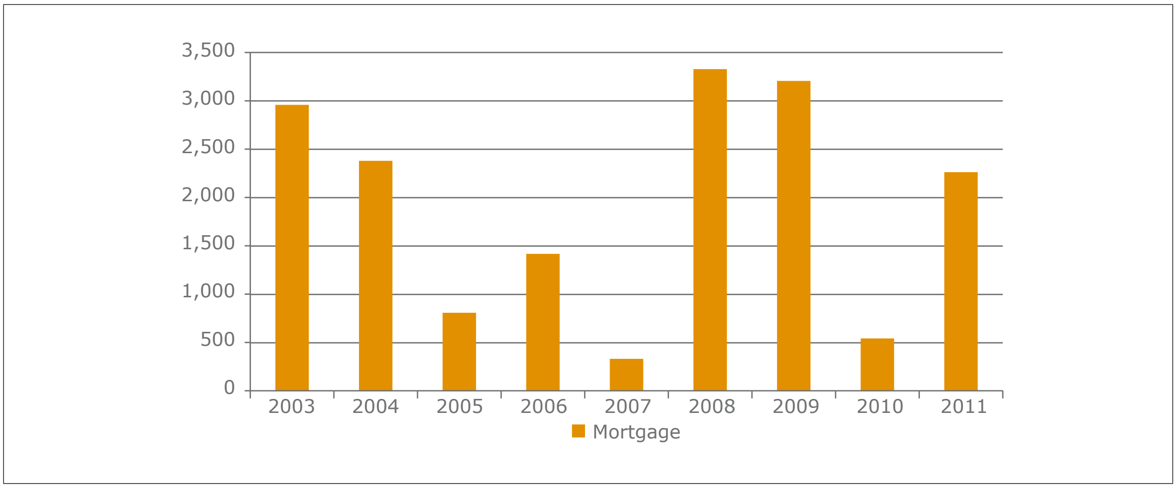
Hungarian covered bonds issued in euro zone countries qualify as ECB eligible; furthermore, in February 2008 one of the Hungarian mortgage banks successfully closed its debut transaction in the "Jumbo" covered bond market.

> Figure 1: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

Issuers: There are three mortgage banks issuing mortgage bonds on the Hungarian market: OTP Jelzálogbank Zrt. (OTP Mortgage Bank Ltd.), FHB Jelzálogbank Nyrt. (FHB Mortgage Bank Ltd.) and UniCredit Jelzálogbank Zrt. (UniCredit Mortgage Bank Ltd).

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/27/Hungary

3.14 IRELAND

By Nicholas Pheifer, Depfa Bank
and Sinéad Gormley, Bank of Ireland

I. FRAMEWORK

Irish covered bonds benefit from the protection of specialist covered bond legislation in the Irish Asset Covered Securities Act 2001 and the Asset Covered Securities (Amendment) Act 2007 (the "ACS Acts") and the regulations and regulatory notices issued thereunder.

II. STRUCTURE OF THE ISSUER

An issuer (an "ACS Issuer") of Irish asset covered securities ("ACS") must hold a banking licence and be registered under the ACS Acts as a designated credit institution. An ACS Issuer is required to limit the scope of its banking activities to certain permitted business activities. An ACS Issuer is therefore subject to regulation by the Central Bank of Ireland (the "CBI") in its capacity as a bank and separately, in its capacity as an ACS Issuer. Each ACS Issuer will be registered as one or more of the following: a designated public credit institution (authorised to issue public credit covered securities); a designated mortgage credit institution (authorised to issue mortgage credit covered securities); and/or a designated commercial mortgage credit institution (authorised to issue commercial mortgage credit covered securities).

The ACS Issuer holds the assets backing the ACS on its balance sheet. The collection of either mortgage credit assets, commercial mortgage credit assets or public credit assets (the "cover assets") backing the issue of ACS (the "cover pool") is described as dynamic or open in the sense that the ACS Issuer may move cover assets in and out of the cover pool provided that it does so in accordance with the provisions of the ACS Acts. One such control is that the ACS Issuer must maintain a register (a "cover register") of all ACS issued, all cover asset hedge contracts and the cover assets (including any substitution assets and any cover assets constituting over-collateralisation) and any amendment to the cover register can only be effected with the approval of a cover-assets monitor (the "CAM") which is an independent professional third party, or the CBI.

Statutory Preference

The claims of ACS holders are protected by a statutory preference under the ACS Acts. As preferred creditors, upon an ACS Issuer insolvency, ACS holders are entitled to have recourse to the cover assets included in the cover pool ahead of all other creditors of the ACS Issuer other than the super-preferred creditors (i.e. the CAM and NTMA - see further section VIII below) and pari passu with other preferred creditors (such as the pool hedge counterparties – see further section V below). In this way the ACS holders have protection against the general Irish insolvency laws.

Restriction on business activities

The ACS Acts provide that an ACS Issuer may not carry on a business activity other than a permitted business activity as set out in the ACS Acts. Permitted business activities comprise dealing in and holding public credit assets, mortgage credit assets or commercial mortgage credit assets (depending on the type of designation of ACS Issuer) and limited classes of other assets, engaging in activities connected with the financing and refinancing of such assets, entering into certain hedging contracts, holding collateral under cover asset hedge contracts (referred to in the ACS Acts as 'pool hedge collateral') and engaging in other activities which are incidental or ancillary to the above activities. The ACS Acts limit the scope of non-core ACS business that an ACS Issuer can undertake by restricting its dealing in or holding of financial assets that are not otherwise eligible for inclusion in the cover pool to 10% of the total of all the ACS Issuer's assets. There is also a similar 10% limit imposed on the volume of non-cover pool-eligible OECD assets that an ACS Issuer can acquire. In addition, designated mortgage credit institutions and designated commercial mortgage credit institutions must maintain the aggregate prudent loan to value ("LTV") of their overall mortgage books at or below, respectively, 100% and 80%.

III. COVER ASSETS

The classes of assets which are eligible for inclusion in a cover pool are dependent upon whether the ACS Issuer is a designated public credit institution; a designated mortgage credit institution; or a designated commercial mortgage credit institution.

Designated public credit institutions

The classes of asset eligible for inclusion in the cover pool of a designated public credit institution ("public credit assets") are financial obligations (collectively, "public credits"), including obligations given as a guarantor or surety and indirect or contingent obligations, in respect of money borrowed or raised (whether in the form of a security that represents other public credit that is securitised or not) where the person who has the obligation is any one of the following:

> Central governments, central banks, ("Sovereigns") public sector entities, regional governments or local authorities ("Sub-sovereigns") in any EEA country;

> Sovereigns in Australia, Canada, Japan, New Zealand, the Swiss Confederation or the USA (each an "Eligible Non-EEA Country");

> Sub-sovereigns in any Eligible Non-EEA Country; and

> Multilateral development banks or international organisations, in each case which qualify as such for the purposes of the Capital Requirements Directive ("CRD").

Risk weighting and credit worthiness tests apply to the categories of cover assets outside the EEA countries to comply with the CRD Covered Bond eligibility requirements. In particular, any Sovereign or Sub-sovereign entity within an Eligible Non-EEA Country must have an independent credit rating of at least A-/A3 and any Sub-sovereign entity within an Eligible Non-EEA Country must have, in addition, a risk weighting at least equal to that of a financial institution (i.e. 20% or lower). In addition, the aggregate nominal value of any such assets included in the cover pool from an Eligible Non-EEA Country with credit ratings below AA-/AA3 (but at least A-/A3) cannot exceed 20% of the total aggregate value of the cover pool.

Designated mortgage credit institutions

Those assets eligible for inclusion in the cover pool of a designated mortgage credit institution ("mortgage credit assets") are financial obligations (collectively, "mortgage credits"), including obligations given as a guarantor or surety and indirect or contingent obligations, in respect of money borrowed or raised that are secured by a mortgage, charge, or other security on residential or commercial property that is located in any EEA country or any Eligible Non-EEA Country. This is subject to a concentration limit, for mortgage credit assets secured on commercial property, of 10% of the total prudent market value of all mortgage credit assets and substitution assets in the cover pool. Non-performing mortgage credit assets may not be included in a cover pool. Furthermore, a mortgage credit asset may not be counted as part of a cover pool if a building related to that mortgage credit asset is being or is to be constructed until the building is ready for occupation as a commercial or residential property. A mortgage credit institution may also include securitised mortgage credit subject to certain credit quality criteria and limits as to percentage of the cover pool.

Designated commercial mortgage credit institutions

A designated commercial mortgage credit institution may include in its cover pool financial obligations ("commercial mortgage credits") in respect of money borrowed or raised that are secured by a mortgage, charge, or other security on commercial property that is located in any of the EEA or the Eligible Non-EEA Countries. Securitised commercial mortgage credits may also be included in the cover pool. As with designated mortgage credit institutions, restrictions apply on inclusion in a cover pool of non-performing assets and assets secured on properties under construction.

Substitution assets

Substitution assets can be included in any cover pool provided that they comply with applicable CRD requirements and certain other restrictions. Effectively, these are deposits having a minimum credit rating of Step 2 with a limited duration of 100 days with eligible financial institutions.

IV. VALUATION AND LTV CRITERIA

Designated public credit institution

Public credit assets maintained in the cover pool of a designated public credit institution are ascribed a prudent market value equal to 100% of the amount of the related public credit outstanding on the date of valuation.

Designated mortgage credit institution

The maximum prudent LTV levels for mortgage credit assets included in the cover pool of a mortgage credit institution are 75% for mortgage credit assets backed by residential property and 60% for those backed by commercial property. Prudent LTV levels for mortgage credit assets in the cover pool can exceed the 75% threshold, however the balance of the mortgage credit above this threshold is disregarded for valuation purposes. The inclusion in the cover pool of mortgage credit assets secured on commercial property is restricted to 10% of the prudent market value of all mortgage credit assets and substitution assets included in the cover pool at any time.

A designated mortgage credit institution is first required to determine the market value of a property asset at the time of origination of the mortgage credit asset secured on it. It is market practice for such property valuations to be conducted by independent valuers. The designated mortgage credit institution is then required to calculate the prudent market value of such property asset at the time of inclusion of the related mortgage credit asset in the cover pool and also at such intervals (at least once a year) as may be specified by the CBI. In addition, a designated mortgage credit institution is required to calculate the prudent market value of mortgage credit assets and securitised mortgage credits included in the cover pool on a quarterly basis, or more frequently if so instructed by the CAM, for the purposes of demonstrating compliance with the asset-liability and over-collateralisation requirements of the ACS Acts. In practice, the prudent market value of relevant property assets is calculated on a quarterly basis also as this calculation forms part of the valuation process for mortgage credit assets.

For these subsequent calculations, the designated mortgage credit institution must apply the house price index published by the Irish Central Statistics Office to the valuation obtained at origination, with same being verified by the CAM on a monthly basis.

Designated commercial mortgage credit institution

For a designated commercial mortgage credit institution, the maximum prudent LTV level for mortgages included in the cover pool is 60%. Prudent LTV levels for commercial mortgage credit assets in the cover pool can exceed the 60% threshold, however the balance of the loan above this threshold is not considered for valuation purposes.

The prudent market valuation of a commercial property asset is its market value at the time of origination or, where relevant, the most recent independent valuation of the property asset, reduced to take account of any declines in the commercial property reference index agreed with the CAM since the valuation was carried out.

The market value of a commercial property asset must be reviewed by an independent valuer where the reference index falls by more than 7% in any 6 month period or where information indicates that the value of the property asset has declined materially relative to general market prices. For commercial mortgage loans greater than EUR 3 m, the valuation must be reviewed by an independent valuer at least every 3 years.

A designated commercial mortgage credit institution is required to calculate the prudent market value of each commercial mortgage credit asset and related property asset and each securitised commercial mortgage credit at the time of its inclusion in the cover pool and at least once every 3 months thereafter for the purposes of demonstrating compliance with the asset-liability and over-collateralisation provisions of the ACS Acts.

V. ASSET-LIABILITY MANAGEMENT

The ACS Acts include important asset-liability controls to minimise various market risks.

Duration matching: The weighted average term to maturity of a cover pool cannot be less than that of the related ACS.

Over-collateralisation: The prudent market value of the cover pool must be at least 3%, in the case of designated mortgage credit institutions and public credit institutions, and at least 10%, in the case of designated commercial mortgage credit institutions, greater than the total of the principal amount of the ACS in issue (see also Over-collateralisation below).

Interest matching: The amount of interest payable on cover assets over a 12-month period must not be less than the amount of interest payable on the related ACS over the same 12-month period.

Currency matching: Each cover asset must be denominated, after taking into account the effect of any cover assets hedge contract, in the same currency as the related ACS.

Interest rate risk control: The net present value changes on the balance sheet of an ACS Issuer arising from (i) 100bps upward shift, (ii) 100bps downward shift and (iii) 100bps twist, in the yield curve, must not exceed 10% of the ACS Issuer’s total own funds at any time.

Hedge contracts

Hedge contracts are used in the cover pool to minimise risks on interest rates, currency exchange rates, credit or other risks that may adversely affect the ACS Issuer's business activities that relate to an ACS or cover assets. All such hedge contracts are required to be entered on the cover register by the ACS Issuer. Once so entered, pool hedge counterparties rank as preferred creditors, pari passu with the ACS holders, provided they are not in default of any of their financial obligations. Upon the insolvency of an ACS Issuer, any hedge contract will remain in place subject to its terms. Any collateral posted under a hedge contract by a pool hedge counterparty must be recorded on a separate register maintained by the ACS Issuer.

Over-collateralisation

The ACS Acts mandate a minimum over-collateralisation of ACS of 3% by designated mortgage credit institutions and designated public credit institutions and of 10% by designated commercial mortgage credit institutions. It is also market practice in Ireland for ACS Issuers to commit by contract to an additional minimum level of over-collateralisation. The CAM is responsible for monitoring the levels of legislative and contractual over-collateralisation. Upon an ACS Issuer insolvency ACS holders will benefit from any cover assets which make up the over-collateralisation to the extent of their claims.

VI. TRANSPARENCY

All ACS Issuers are required to make specific disclosures in relation to cover assets included in their cover pools in their annual financial statements.

Designated public credit institutions

Designated public credit institutions are required to disclose:

> the geographic location of their public credit assets and the volume and percentage of assets in each such location; and

> details of public credit assets secured on loans to multilateral development banks and international organisations and the volume and percentage of such assets.

Mortgage credit institutions

Mortgage credit institutions are required to disclose in respect of the date to which the financial statements are made up, details of:

> the number of mortgage credit assets with the amounts of principal outstanding in respect of the related credits being broken down by size;

> the geographic location of their mortgage credit assets and the volume and percentage of assets in each such location;

> the number and principal amounts outstanding of non-performing mortgage credit assets;

> whether or not any persons who owed money under mortgage credit assets had, during the immediately preceding financial year of the ACS Issuer (if any), defaulted in making payments in respect of those assets in excess of EUR 1,000 (so as to render them non-performing for the purposes of the ACS Acts) at any time during that year, and if any such persons had defaulted, the number of those assets that were held in the cover pool;

- the number of non-performing mortgage credit assets replaced with other assets;
- the total amount of interest in arrears in respect of mortgage credit assets that has not been written off;
- the total amount of payments of principal repaid and the total amount of interest paid in respect of mortgage credit assets; and
- in relation to any related mortgage credits that are secured on commercial property, the number and the total amounts of principal of those credits that are outstanding.

Commercial mortgage credit institutions

The disclosure required of commercial mortgage credit institutions in relation to commercial mortgage credit assets is identical to that specified for mortgage credit institutions above, save for that only defaults in excess of EUR 25,000 are required to be disclosed under the fourth bullet above in respect of commercial mortgage credit assets.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

One of the key features of the ACS legislation is the rigorous monitoring role undertaken by the CAM. The CAM is appointed by the ACS Issuer with such appointment being approved by the CBI.

There are strict eligibility requirements for CAMs. A CAM must be a body corporate or partnership, comprising personnel or partners who are members of a professional representative body. It must demonstrate to the CBI that it is experienced and competent in (i) financial risk management techniques, (ii) regulatory compliance reporting and (iii) capital markets, derivatives, and, as applicable, public credit business, mortgage credit business and commercial mortgage credit business. The CAM must demonstrate that it has sufficient resources at its disposal and sufficient academic or professional qualifications and experience in the financial services industry to satisfy firstly, the designated credit institution and secondly, the CBI, that it is capable of fulfilling this role.

The CAM is responsible for monitoring the cover pool, the ACS Issuer's compliance with specific provisions of the ACS Acts and reporting any breaches of same to the CBI. The CAM issues regular reports to the ACS Issuer (every 1-4 weeks) and submits a report on a quarterly basis to the CBI.

Some of the CAM's principal obligations include: ensuring that the matching requirements of the ACS Acts with respect to the cover assets and the ACS are met; ensuring that the asset eligibility requirements are met; approving any inclusion in or removal from the cover register, of a cover asset, ACS or hedge contract; checking that the level of substitution assets included in the cover pool does not exceed the required percentage; and ensuring that the legislative and contractual levels of over-collateralisation are maintained.

The CBI is given statutory responsibility for supervising ACS Issuers. The CBI may, with the consent of the Minister for Finance, revoke the registration of an ACS Issuer and/or suspend its business if an ACS Issuer breaches any provision of the ACS Acts. In addition, the CBI has wide-ranging powers under the Irish Central Banking legislation to impose significant fines and administrative sanction on ACS Issuers and/or their senior management for contraventions of the ACS Acts.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

As noted above, an ACS Issuer holds its cover assets on its balance sheet. However, the cover assets are ring-fenced from the other assets of the ACS Issuer for the benefit of ACS holders by virtue of (i) their being recorded in the cover register, and (ii) a statutory preference created by the ACS Acts.

Segregation: Cover asset register

Each ACS Issuer must maintain a cover register including the details of its ACS in issue, the cover assets and substitution assets backing its ACS and any cover asset hedge contracts in existence. The cover asset register is important as a cover asset or a cover asset hedge contract cannot be described as such unless and until it is recorded on the register. Their registration is prima facie evidence of such assets and hedge contracts being included in the cover pool entitling the ACS holders and pool hedge counterparties to benefit from the insolvency protection specified in the ACS Acts in respect of such assets and hedge contracts. An ACS Issuer may only remove or amend a register entry with the consent of the CAM or the CBI which further safeguards the interests of ACS holders.

Preferential treatment of ACS holders

Once a cover asset has been entered in the cover register, it will remain a cover asset for the benefit of ACS holders and other preferred creditors until the CAM or the CBI has consented to its removal from the cover register and consequently, the cover pool. Cover assets included in a cover pool do not form part of the assets of the ACS Issuer for the purposes of insolvency until such time as the claims of ACS holders and other preferred creditors under the ACS Acts have been satisfied.

If the claims of the ACS holders (and other preferred creditors, including the pool hedge counterparties) are not fully satisfied from the proceeds of the disposal of the cover assets, such parties are, with respect to the unsatisfied part of their claims, to be regarded as unsecured creditors in the insolvency process.

Impact of insolvency proceedings on ACS and hedge contracts

Upon insolvency of an ACS Issuer, all ACS issued remain outstanding and all cover asset hedge contracts will continue to have effect, subject in each case, to the terms and conditions of the documents under which they were created.

Upon an ACS Issuer's becoming insolvent, the claims of ACS holders on the cover pool are protected by operation of law. Cover assets and hedge contracts that are included in a cover pool are not liable to interference by a bankruptcy custodian or similar person whether by attachment, sequestration or other form of seizure, or to set-off by any persons, that would otherwise be permitted by law so long as claims secured by the insolvency provisions of the ACS Acts remain unsatisfied. ACS holders have recourse to cover assets ahead of all other non-preferred creditors regardless of whether the claims of such other creditors are preferred under any other enactment or any rule of law and whether those claims are secured or unsecured.

The role of the manager and access to liquidity in case of insolvency

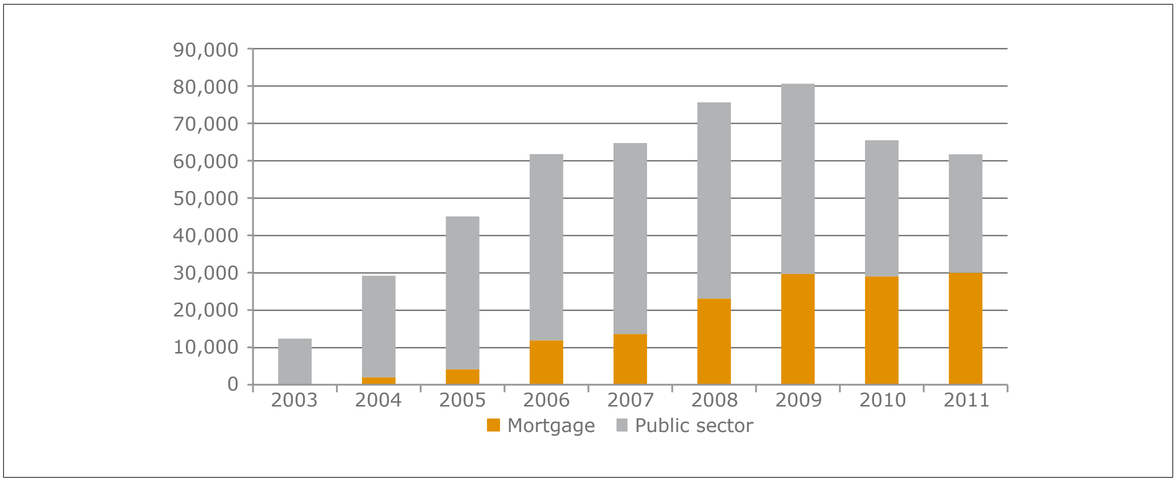
The ACS Acts makes provision for the management of the asset covered securities business of an ACS Issuer upon an ACS Issuer insolvency through the services of the Irish National Treasury Management Agency ("NTMA"). If no suitable manager can be found by the CBI or the NTMA, the NTMA will attempt to locate an appropriate body corporate as a new parent entity for the ACS Issuer. Failing that, the CBI will appoint the NTMA to act as a temporary manager until a suitable manager or new parent entity is found.

Upon appointment, the manager will assume control of the cover assets, the asset covered securities business and all related assets of the ACS Issuer. The manager is required to manage the ACS business of the ACS Issuer in the commercial interests of the ACS holders and the pool hedge counterparties. The manager shall have such powers as may be designated to it by the CBI under its notice of appointment. It is possible for such manager to obtain a liquidity facility through the use of a hedge contract, such hedge contract if recorded in the cover register would constitute a cover asset hedge contract for the purposes of the ACS Acts and the pool hedge counterparty would rank pari passu with ACS holders and other pool hedge counterparties.

IX. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

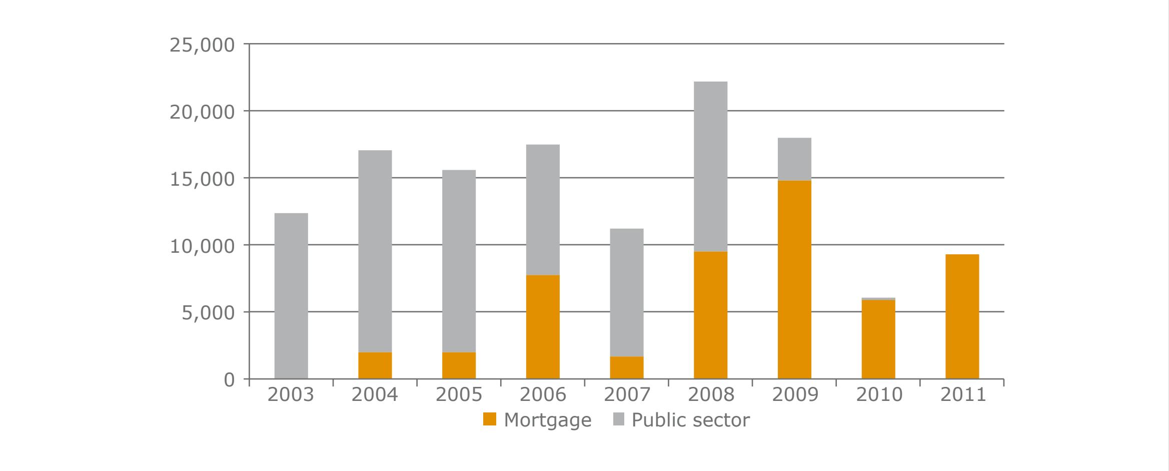
ACS meet the requirements of UCITS 52(4) and currently benefit from a risk-weighting of 10% as applied by the CBI. The eligibility of cover assets set out in the ACS Acts also match the criteria for the preferential risk weighting of covered bonds set out in the CRD.

> Figure 1: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

Issuers: To date there have been six ACS Issuers: Bank of Ireland Mortgage Bank, DEPFA ACS BANK, West LB Covered Bond Bank (now EAA Covered Bond Bank plc), Allied Irish Mortgage Bank, EBS Mortgage Finance and Anglo Irish Mortgage Bank (now Irish Bank Resolution Corporation).

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/28/Asset_Covered_Securities

3.15 ITALY

By Alfredo Varrati, Italian Bankers Association

I. FRAMEWORK

The Italian Legislator enacted a new regulation (Law no. 80/2005) in May 2005, by means of which two specific articles (article 7-*bis* and article 7-*ter*) were inserted into the existing Italian securitization law (Law no. 130/1999), providing for covered bonds.

The legislator decided to supplement Law no. 130/99 rather than adopt a separate and autonomous law/legal framework, in light of the markets' and international operators' positively assessing Italian securitization law. They found that the law introduced an established and reliable legal framework (e.g. from a standpoint of "bankruptcy remoteness").

Pursuant to paragraph 5 of the first of the two articles mentioned above, on 14 December 2006, the Ministry of Economy and Finance issued secondary rules in relation to some key issues of the structure. In particular, implementing rules have been enacted with respect to the type of assets eligible for the cover pool, the maximum allowed ratio between transferred assets and issuable securities, the type of guarantee to be provided to bondholders by the SPV.

As for the last procedural step, which formally allows Italian banks to start issuing covered bonds, the Bank of Italy enacted its implementing measures on 17 May 2007, in relation to the requirements to be complied with by issuing banks, the criteria to be adopted to evaluate the cover assets and the relevant formalities to integrate such assets, as well as the formalities to check that the banks are complying with their obligations under the same article 7-*bis*, also through auditors.

II. STRUCTURE OF THE ISSUE OF COVERED BONDS

Pursuant to the abovementioned article 7-*bis*, the structure of a covered bond transaction is as follows:

> A bank transfers eligible assets to a special purpose vehicle (SPV), whose sole corporate purpose is the purchase of such assets and the granting of a guarantee for the issued securities over which bondholders have a senior claim;

> The SPV purchases the transferred assets by means of a loan granted or guaranteed to it by a bank (not necessarily the same bank transferring the assets);

> The bank transferring the assets (or another bank) issues covered bonds;

> The assets purchased by the SPV are applied to satisfy the rights attaching to the covered bonds and the counterparties of derivative agreements entered into for hedging the risks related to the assets, and to pay the costs of the transaction.

According to the Bank of Italy's regulation, covered bonds can be issued only by banks with the following prerequisites:

> A consolidated regulatory capital not lower than EUR 500 m

> A total capital ratio not lower than 9%

It is also provided that these requisites must be fulfilled by the transferring banks as well (i.e. cover pool providers), if they are not the issuers.

There are no business restrictions to the issuer's activity, hence there is no special banking principle that needs to be enforced. Bondholders hold a preferential claim on the cover assets and the covered bonds are direct, unconditional obligations of the issuer.

III. COVER ASSETS

As provided for by paragraph 1 of Article 7-bis of the securitization law, the eligible assets as coverage for covered bonds are:

> Residential mortgage loans with a maximum LTV of 80% or commercial mortgage loans with a maximum LTV of 60%;

> Claims owed by (or guaranteed by) the following entities, up to 10% of the cover pool:

> Public entities of EEA member countries and Switzerland with a maximum risk-weight of 20%;

a) Public entities of non-EEA member countries with a risk weight of 0%;

b) Other entities of non-EEA member countries with a risk weight of 20%.

> Notes issued under a securitisation transaction backed (for a minimum of 95%) by the claims under the abovementioned letters a) and b) with a maximum risk weighting of 20%.

As regards the transferring of such eligible assets to the SPV, the Bank of Italy sets different limits according to the different regulatory capital levels of the issuer (see Table 1)

> Table 1

Regulatory capital level		Transfer limitations
Class A	Total capital ratio ≥ 11% and, Tier 1 ratio ≥ 7%	No limitations
Class B	Total capital ratio ≥ 10% and < 11% and Tier 1 ratio ≥ 6.5%	Eligible assets can be transferred up to 60% of total
Class C	Total capital ratio ≥ 9% and < 10% and Tier 1 ratio ≥ 6%	Eligible assets can be transferred up to 25% of total

As provided for by the secondary legislation enacted by the Italian Ministry of Economy, assets must at least equal liabilities both on the nominal and NPV bases, and the revenues arising from cover assets must be sufficient to pay coupons to bondholders and to cover the cost of derivative transactions.

The integration of cover assets can be performed through:

> The transfer of additional eligible assets to the pool;

> The opening of deposit accounts at banks located in an EEA member country, or in other countries with a 0% risk-weight;

> The transfer of banks' own debt securities (with maturity of less than 1 year) to the pool.

It is also provided that integration through assets under points 2 and 3 is allowed only up to 15% of the cover pool's nominal value. With respect to such provisions, the Bank of Italy established that integration is allowed only to:

> Maintain the ratio of issued bond to cover assets up to the abovementioned level provided for by the Ministry of Economy;

> In case of voluntary over-collateralisation, maintain the ratio of issued bond to cover assets up to the contractually-agreed limit;

> Respect the abovementioned 15% limit for eligible supplementary assets.

IV. ASSET-LIABILITY MANAGEMENT

In order to allow the SPV to fulfil its obligations, issuing banks are required to adopt proper asset-liability management techniques and to perform specific controls at least every 6 months, to ensure that the proceeds from the cover pool assets are always sufficient to pay the coupons on the covered bonds, and the overall cost of the transaction.

V. TRANSPARENCY

The main Italian OBG issuers, coordinated by the Italian Banking Association are working together to create a transparency template, consistent with the guidelines of the ECBC Label Initiative. The OBG transparency template is expected to be finalised by September 2012 and to be adopted by most covered bond issuing institutions thereafter.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

As far as regulatory supervision is concerned, the Bank of Italy sets and monitors, on an ongoing basis, the abovementioned specific eligibility requirements for issuing banks which are stricter than those provided for traditional banking activities. These parameters require, in particular, a consolidated supervisory capital of at least EUR 500 million and a consolidated total capital ratio of at least 9%. It is also provided that eligible assets may be assigned to the SPV only subject to a series of restrictions, graduated based on the total capital ratio and Tier 1 ratio at the consolidated level.

Although in some European countries the issuance of covered bond is subject to a "licence" granted by the Supervisory Authority upon the fulfilment of specific requirements, the Italian legislator has decided to make a different choice. Rather than introducing a "licence" system, it has defined a series of requirements and limitations to issuance which, together, can be *de facto* considered as the objective basis upon which to grant an issuance authorization. Moreover, it must be considered that such requirements and limitations are in most cases stricter than those required by other regulatory frameworks.

Furthermore, Italian regulation prescribes that the monitoring of the regularity of the transaction and of the integrity of the collateral securing investors must also be performed by an external asset monitor (AM) appointed by the issuer. The AM must be an auditing firm possessing the professional skills required to perform such duties and must be independent from the bank engaging it (e.g. it cannot be the same firm appointed to audit the accounts of the issuing bank) and of any other person participating in the transaction. It has to report at least once a year to the Board of Directors and to the internal audit department of the bank.

Although no specific reporting to the Bank of Italy is prescribed by law, in practice the AM will report to the Supervisor any material anomaly found. It must also be considered that the AM's report is reviewed by the bank's auditor which reports regularly to the Bank of Italy. Should such report contain negative evaluations, the bank's auditor is obligated to bring the issue to the Bank of Italy's attention.

In general terms, specific control requirements on banks issuing covered bonds find their primary source from EU and national legislation. Additionally, in consideration of the peculiarities of a covered bond transaction, the Bank of Italy assigns to issuers the primary responsibility to evaluate the risk involved in the operations, to arrange a proper control mechanism and to ensure its functioning through the time. In particular, at least every six months and for each operation, issuers have to check: i) the quality of the cover pool; ii) compliance with the predetermined ratio between outstanding covered bonds and cover assets; iii) compliance with transfer limitations and asset integration requirements; iv) the performance of any derivative agreement entered into in order to hedge risks.

As far as information flows are concerned, it is provided that issuing/transferring banks shall acquire, from all the parties involved in the structuring of the covered bonds, information relating to:

> The possessory titles of the transferred assets (in order to be able to track down each borrower whose loan has been transferred to the SPV);

> The performance of the transferred assets (in order to monitor the "health" of the cover assets).

This information is necessary to issuing/transferring banks in order to perform both the abovementioned controls in terms of cover pool monitoring and the regulatory reporting (i.e. reporting of defaulted loans to the Bank of Italy's *Centrale dei Rischi*).

VII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

As provided for by the secondary legislation enacted by the Italian Ministry of Economy, the guarantee granted by the SPV to the covered bondholders, must be irrevocable, first-demand, unconditional and independent from the issuing bank's obligations on the covered bonds. It will be callable upon non-payment and bankruptcy of the issuing bank, and it will be limited to cover pool asset value to ensure bankruptcy remoteness of the SPV.

The SPV is a financial intermediary, registered in the "special list" provided for by article 107 of the Banking Law, and therefore subject to the Bank of Italy's supervision.

Covered bondholders will have the right, represented exclusively by the SPV, to file a claim with the issuing bank for full repayment of the covered bonds. In case of liquidation of the issuing bank, the SPV will be exclusively responsible to make payments to covered bondholders (as well as other counterparties) and will represent covered bondholders in proceedings against the issuing bank.

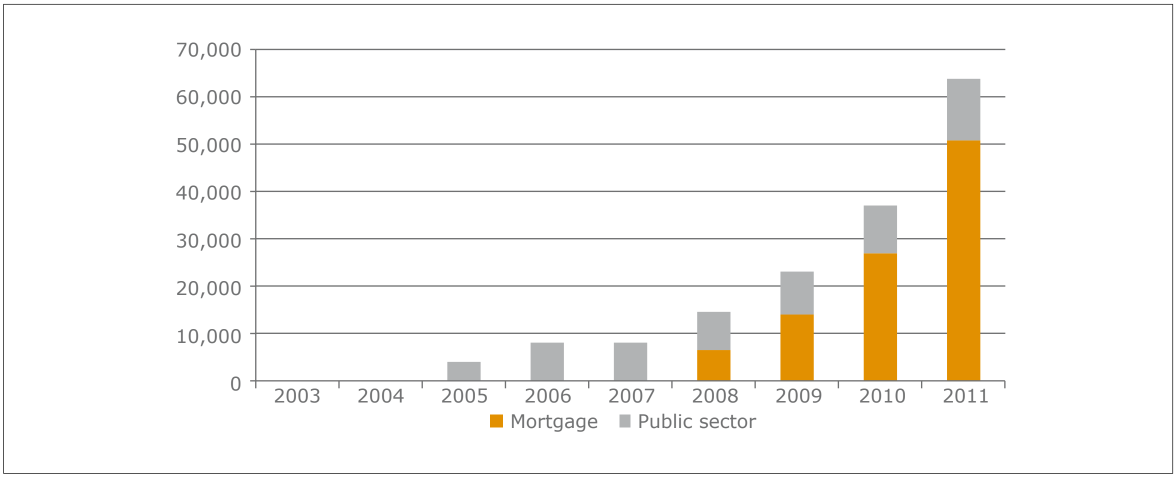
All the amounts obtained as a result of the liquidation procedure will become part of the cover pool and therefore used to satisfy the rights of covered bondholders. The redemption of the subordinated loan granted by the issuer of the covered bonds to the SPV is junior to any outstanding claims of covered bondholders, swap counterparties and transaction costs.

In case the proceeds obtained as a result of the liquidation procedure are insufficient to meet the obligations to bondholders in full, investors would still have an unsecured claim against the issuer for the shortfall.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

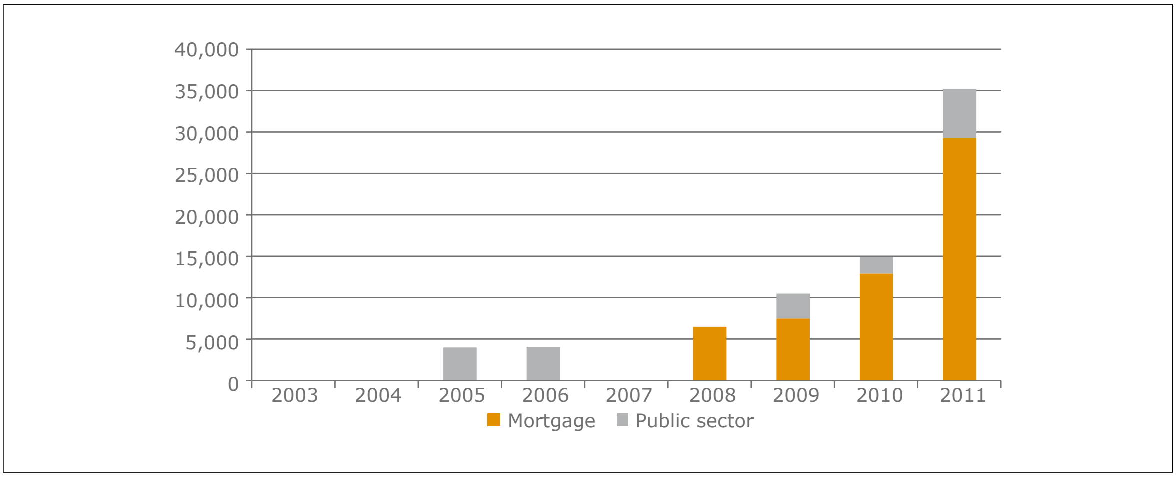
Italian covered bonds fulfil both the criteria of UCITS 52(4) and Annex VI, Part 1, Paragraph 68 (a) to (f) of the Capital Requirements Directive. They are also eligible in repo transactions with the Bank of Italy. The current risk-weight is 20%.

> Figure 1: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/31/Obbligazioni_Bancarie_Garantite

3.16 LATVIA

By Kaspars Gibeiko, Mortgage and Land Bank of Latvia

I. FRAMEWORK

In Latvia, the legal basis for covered bond issuance is the Law on Mortgage Bonds (HKZL – Hipotekāro ķīlu zīmju likums) from 10 September 1998 and subsequent amendments to the HKZL (1 June 2000, 5 July 2001, 6 November 2002 and 25 October 2006). The insolvency and bankruptcy procedure is captured both by the HKZL (Section 4) and the Law on Credit Institutions (Articles 561, 161 and 191).

II. STRUCTURE OF THE ISSUER

There is no specialised banking principle in Latvia. As a result every registered bank can issue mortgage-backed covered bonds. The minimum requirements a bank must fulfil in order to issue mortgage bonds are as follows:

> Tier1 and Tier2 capital should be not less than stated in the Law on Credit Institutions;

> Provision of the banking services specified in Article 1, Clause 4 of the Law on Credit Institutions without any restrictions imposed by the Financial and Capital Market Commission (FCMC);

> Submission of rules approved by the bank’s supervisory board regarding the valuation of the real estate to be mortgaged and the management of the mortgage bond cover register to the FCMC.

The issuer holds the cover assets on his balance sheet and the cover assets are not transferred to a different legal entity. All obligations from mortgage bonds are obligations of the issuing bank as a whole, to be paid from all the cover assets of the issuer. In the case of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved for the claims of the mortgage bond holders.

The HKZL does not prescribe the issuing bank to have separate employees to manage the cover pool, but it prescribes that the cover assets are managed separately from other assets of the issuer. Therefore, if employees of the bank are involved both in the management of the cover assets and the management of non-cover assets, separation of the duties and responsibilities should be clearly stipulated in the bank’s by-laws and internal procedures. There are also no specific requirements regarding the outsourcing of the management of cover assets in the Latvian covered bond legislation.

III. COVER ASSETS

Cover assets can be eligible mortgage loans or loans secured by either guarantees of the Latvian Government or guarantees of the local governments.

Up to 20% of the nominal volume of outstanding mortgage bonds and interest expenses (substitute cover) may consist of:

> Cash;

> Balances with the central banks of the EU member states; and

> Securities issued and guaranteed by the EU member state governments up to 95% of their market value whilst not exceeding the face value of these securities or securities issued by the EU member state’s financial institution and traded on the EU regulated securities market up to 95% of their market value whilst not exceeding the face value of these securities.

The eligible mortgage assets are restricted in geographical scope to the extent that a property that secures a mortgage loan should be registered with the EU member state's property register. This means that only properties which are registered in the EU member state can be used as collateral for mortgage loans included in the cover pool. The loans secured by Latvian sovereign and sub-sovereign guarantees are not restricted by geographical scope, but they are restricted by loan purpose; loans which finance public and infrastructure projects are eligible.

Derivatives are eligible for cover pool inclusion for the purpose of mitigating currency - and interest rate risk. The volume of derivatives is not limited and the general documentation used is the standard for derivatives.

IV. VALUATION AND LTV CRITERIA

Property valuation is regulated in Article 15 of the HKZL. Property valuation is carried out according to the international valuation standards. The basis for property valuation is market value. Professionals responsible for the determination of the market value of a property must be in possession of a relevant professional qualification. In addition to that, Article 151 (introduced by the amendment to the HKZL on 25th of October 2006) stipulates that the market value of property registered in the EU member state is determined by the persons who have received professional, real estate valuation, licence according to the legislation of particular EU member state.

The issuer is responsible for the monitoring of the property value. The frequency of monitoring is not defined by the HKZL, but it is prescribed by the regulations of the FCMC and by-laws of the issuer.

Article 14 of the HKZL stipulates that a mortgage loan together with debts previously registered with the national property register may not exceed 75% of the market value of residential property and 60% of the market value of other type of property.

V. ASSET - LIABILITY MANAGEMENT

Article 9 of the HKZL stipulates the following requirements to the asset-liability management of the cover pool:

> The total volume of the cover assets must be larger than the total volume of outstanding mortgage bonds at their face value by at least 10% of the risk weighted value of the cover assets, where risk weighted value of the cover assets is calculated based on specific weights of each type of the cover assets;

> The currency of the cover assets and that of the outstanding mortgage bonds may differ only if the issuer has taken all the necessary measures to prevent the currency risk in the cover pool;

> The total interest income from the cover assets must exceed the total interest expenses on outstanding mortgage bonds;

> The cash-flows from the outstanding mortgage bonds (in accordance with the mortgage prospectus) must always be covered by the cash-flows from the cover assets in terms of volumes and maturities.

The issuer of the covered bonds has to prepare a report on the cash-flow mismatches and submit it to the FCMC on a semi-annual basis.

The latest amendment to the HKZL stipulates that the issuer should separate loans secured by a mortgage and loans secured by central or municipal governments. This requirement was introduced in order to separate mortgage bonds and public sector bonds.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The Latvian covered bond legislation does not require the appointment of a special entity to monitor the cover pool. Instead, the cover pool is managed by the issuing bank and it is the issuing bank's responsibility to set up a system to ensure that the cover pool is managed properly. In some banks, monitoring of the cover pool is executed by the internal audit department

The FCMC supervises cover pools. It inspects cover pool (quality and eligibility of the cover assets, quality of the asset-liability management) during regular banking supervisory audits which are carried out on average every two years.

The FCMC has the right to suspend the issue of mortgage bonds under the following circumstances:

> The issuing bank does not comply with the conditions laid down in the Law on Mortgage Bonds;

> The issuer does not ensure that the redemption and interest payments on outstanding mortgage bonds are always covered by the principal and interest payments of the cover assets of a higher value;

> By-laws on the valuation of properties securing the mortgage assets and by-laws on the management of cover pool submitted to the FCMC are not followed.

VII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

A cover register facilitates the identification of the cover assets, because all the cover assets, including substitute cover as well as derivatives, are recorded in the cover register. The type and scope of the information recorded regarding the cover assets in the cover register are determined by FCMC regulations

The legal effect of registration is the fact that in the case of insolvency of the issuer, the assets which form part of the separate legal estate can be identified and all assets recorded in the cover register qualify as part of this separate legal estate.

Asset segregation

A cover pool is a part of the general estate of the issuing bank as long as the issuer is solvent. If the insolvency proceedings are opened, by operation of law, the assets recorded in the cover register are excluded from the insolvency estate of the issuer. Those assets will not be affected by the opening of the insolvency proceedings, but automatically form a separate legal estate.

After the opening of the insolvency proceedings, a special cover pool administrator initiated by the FCMC and appointed by court carries out the administration of the cover assets.

Impact of insolvency proceedings on covered bonds and derivatives

Covered Bonds do not automatically accelerate when the issuing institution becomes insolvent, but will be repaid at the time of their contractual maturity. The same applies to derivatives which are registered in the cover register and form part of the cover pool. During an insolvency procedure, derivatives' counterparties have the same rights as the holders of mortgage bonds.

Preferential treatment of covered bond holders

Covered bond holders enjoy a preferential treatment as the HKZL and the Law on Credit Institutions stipulates the separation of the cover assets in a case of the insolvency of the issuing bank. According to Article 191 of the Law on Credit Institutions, mortgage bond holders have the first access rights to the cashflows generated by the assets recorded in the cover register.

In the case of insolvency of the issuer, it is forbidden to modify the content of the cover register and all cash flows from the cover assets must be accrued within it. As long as there is sufficient cover, a moratorium on the insolvency's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of Covered Bond holders.

Only in the case of over-indebtedness or insolvency of the cover assets shall the FCMC file an application to court regarding the insolvency of the cover register (Article 26 of the HKZL). Insolvency of the cover pool is the only catalyst which could the trigger acceleration of covered bond.

Access to liquidity in case of insolvency

With the appointment of the cover pool administrator, the right to manage the cover assets is transferred to him by law. Thus, the cover pool administrator has first access to the cover assets and collects the cash flows according to their contractual maturity.

The cash-flows from the cover assets may only be used for the following purposes and the use of assets in any other manner is inadmissible:

> Disbursements to mortgage bond holders if the term for interest payments or mortgage bond redemption has become due

> Purchase of mortgage bonds issued by the issuer itself with their subsequent redemption in the public securities market at a price not exceeding the face value of the mortgage bonds if the remaining cover assets are sufficient to cover outstanding mortgage bonds

> Payments under derivatives' agreements concluded on the cover asset risk mitigation, provided that the contracting parties have met the conditions of such agreements.

The cover pool administrator is permitted, in case of the insolvency of the issuer, to exceed the substitute cover limit.

No specific regulation exists with respect to the insolvency remoteness of voluntary overcollateralisation. However, the cover pool administrator is not allowed to use voluntary overcollateralisation until all payments to mortgage bond holders are made fully and on time.

The cover pool administrator may carry out legal transactions in respect of the cover pools in so far as this is necessary for an orderly settlement of the cover pool and for the full and timely satisfaction of the cover pool's creditors.

Sale and transfer of mortgage assets to other issuers

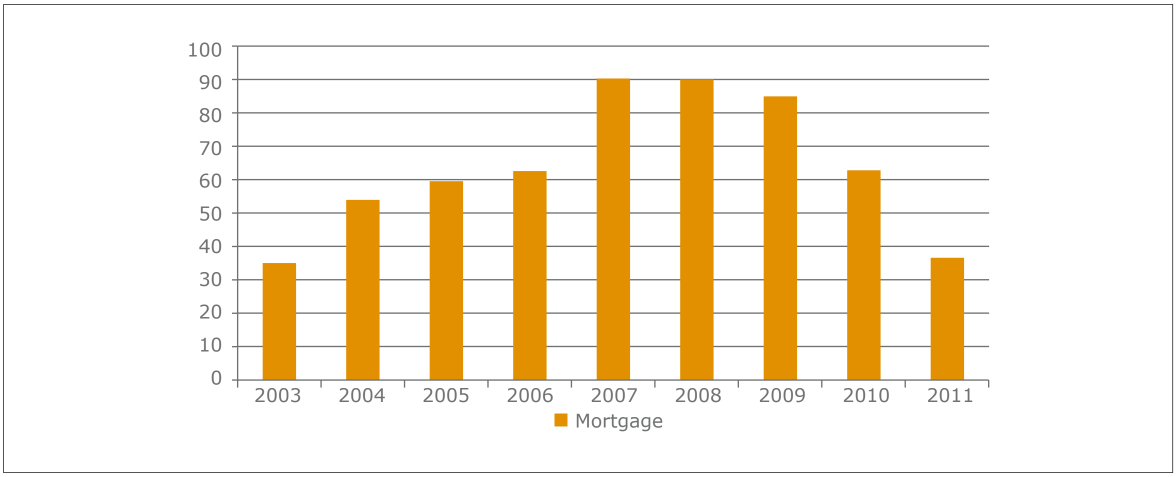
The HKZL and the Law on Credit Institutions provide that the cover assets in a case of insolvency of issuer are transferred to other bank chosen by the FCMC. The bank to which the cover assets are transferred, also takes responsibility for all the obligations arising from outstanding mortgage bonds.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Latvian mortgage bonds comply with the requirements of Art. 52 par. 4 UCITS Directive as well as with those of the CRD Directive. The current risk weight applied to mortgage bonds in Latvia is 20%.

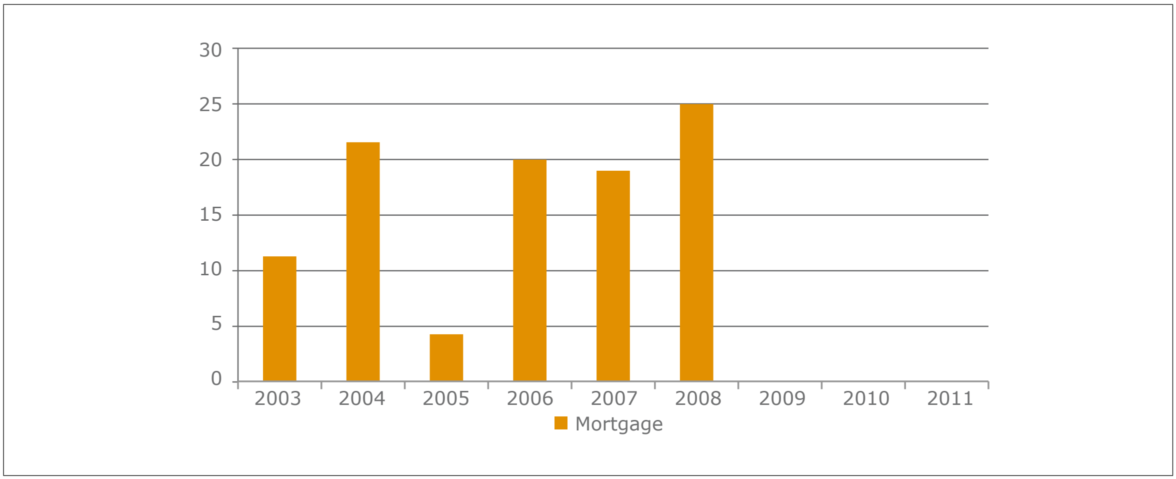
Latvian investment legislation allows mutual funds to invest up to 25% of their assets in mortgage bonds and pension funds – up to 10% of their assets.

> Figure 1: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

Issuers: Mortgage and Land Bank of Latvia and Trasta Komercbanka.

3.17 LUXEMBOURG

By Frank Will, RBS
and Reinolf Dibus, EUROHYPO Europäische Hypothekenbank S.A.

I. FRAMEWORK

The issuance of Lettres de Gage is regulated by Articles 12-1 to 12-9 of the Financial Sector Act of 5 April 1993 (the Financial Sector Act). These Articles were introduced by the Act of 21 November 1997 for banks issuing mortgage bonds and amended by the Act of 22 June 2000 and by the Act of 24 October 2008. The Lettres de Gage regulations are supplemented by the CSSF (Commission de Surveillance du Secteur Financier) Circular 01/42 which lays down the rules for the appraisal of real estate and CSSF Circular 03/95 which defines the minimum requirements for the maintenance and control of the cover register, for the cover assets and for the issuance limit for outstanding Lettres de Gage. The CSSF is the supervisory authority in Luxembourg.

The amendments in October 2008 include an increase of the loan-to-value limit for residential mortgage loans from 60% to 80%, the stipulation of a minimum over-collateralisation level of 2% and the permission to include securitised assets. The most important modification, however, has been the introduction of a new form of Lettres de Gage backed by movable assets including ships, aircrafts and trains.

II. STRUCTURE OF THE ISSUER

The Lettres de Gage issuers have to be credit institutions with a specialist bank licence. Their business activities are restricted: In the past, the bank's principal activities were limited to mortgage lending and public sector financing which were primarily funded by issuing Lettres de Gage Hypothécaires and Lettres de Gage Publiques. According to the last covered bond law amendments, the Luxembourg issuers are also allowed to issue Lettres de Gage backed by movable assets (Lettres de Gage Mobilières). Movable assets can be mortgage loans on ships, aircrafts and trains. However, other classes of movable assets are possible as well provided that they are registered in a public register. Consequently, the permitted principal activities of an issuer have been widened to allow the origination of those movable assets. The issuers may only engage in other banking and financial activities if these activities are accessory and auxiliary to their main business.

The issuer holds the cover assets on its balance sheet in separate registers. Each class of Lettres de Gage has its own register: one for assets which are allocated to the Lettres de Gage Hypothécaires, another one for the cover assets backing the Lettres de Gage Publiques and potentially several more for the various forms of Lettres de Gage Mobilières. Each movable asset class requires a separate cover pool register, i.e. ship Lettres de Gage would be backed by a segregated pool of ship mortgage loans while aircraft Lettres de Gage would be backed by a pool of aircraft exposures. The cover assets remain on the balance sheet of the issuer. They are not transferred to another legal entity (special purpose vehicle) like in a securitization. All obligations arising from Lettres de Gage are direct, unconditional obligations of the issuer. In the case of issuer insolvency, the cover pools are segregated by law from the general insolvency estate and are reserved for the claims of the Lettres de Gage holders. There is no direct legal link between a single asset in the cover pool and an outstanding Lettre de Gage. Interest and principal payments of the outstanding Lettres de Gage Hypothécaires, Lettres de Gage Publiques and the various forms of Lettres de Gage Mobilières (including any derivatives benefiting from the preferential treatment) are backed by the assets in the respective cover pools.

Lettres de Gage issuers employ their own staff. The issuers have to be banks and according to the Financial Sector Act they need to have sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms which restrict the extent of outsourcing legally possible. In addition, the way of permitted outsourcing is described in detail in different CSSF Circulars.

III. COVER ASSETS

The eligible cover pool assets are defined in Article 12-1 of the Financial Sector Act of 5 April 1993. Since the amendments of the covered bond legislation in October 2008, there are three asset classes: mortgage assets, public sector exposures and movable assets, i.e. mortgage loans on ships, aircrafts, trains or other classes of movable assets. In each of the various cover pools the assets may be replaced by up to 20 % of the nominal value of the outstanding Lettres de Gage by substitution assets, for example cash, assets with central banks or with credit institutions whose head office is in a member state of the EC, EEA or OECD or bonds satisfying the conditions set out in article 43 (4) of the law of 20 December 2002 concerning undertakings for collective investments.

The geographical scope of the cover assets is restricted to the member states of the EU, EEA and the OECD. There is no further limit in place. It is also possible to hold the cover assets indirectly through a third-party bank located in a member country of the EU, the EEA or the OECD.

The Lettres de Gage Mobilières are backed by movable assets, i.e. mortgage loans on ships, aircrafts, trains or other classes of movable assets. In order to be cover pool eligible, the movable assets and the charges on the property of those assets need to be registered in a public register within the European Union (EU), the European Economic Area (EEA) or the OECD.

In addition, securitised assets are cover pool eligible if they comply with the eligibility criteria laid down for the various types of Lettres de Gage. The amount of securitised assets that are not cover pool eligible per se will be limited to 10% of the collateral pool. This can be achieved in two ways: One option would be that at least 90% of the assets of each securitisation (vehicle) are cover pool eligible. The other option would be that at least 50% of the assets of each securitisation (vehicle) are cover pool eligible. In that case, the percentage of securitisation assets shall not exceed 20% of the total collateral pool. The issuer can choose one of the two options for each type of Lettre de Gage but cannot combine the two options. Moreover, the securitisation tranches should have a minimum rating of Aa3 from Moody's or a rating of AA- from S&P or Fitch. The law allows only true sale transactions and synthetic securitisations are explicitly excluded.

Moreover, the amended law clarifies that any kind of obligations from public sector institutions including public private partnerships (providing a controlling public sector stake; other public private partnership structures are subject to the above mentioned 10% limit) are cover pool eligible.

There is no limitation on the volume and the types of derivatives used as long as they are employed as hedging instruments.

The cover pools are dynamic. Assets can be included, excluded and exchanged as long as the requirements of the law are not breached.

There are no explicit transparency requirements regarding cover pools. However, there is common understanding among the six Lettre de Gage issuers that a broad range of information should be provided on a voluntary basis in the interest of bond holders.

IV. VALUATION AND LTV CRITERIA

The property valuation methods are defined by a CSSF Circular 01/42 and are based on the mortgage lending value of the property. A special auditor, who may not simultaneously hold the position of company auditor, has the responsibility of determining whether the property valuation has been undertaken according to the valuation rules.

The LTV limit for residential property has been increased from 60% to 80% of the estimated realisation value. The LTV ratio of 60% will remain in force for all other immovable and movable properties including commercial real estate loans. The actual loan, however, can exceed the 60% limit (or 80% limit in case of residential mortgages). In those cases, only the first 60% (80%, respectively) of the mortgage lending value is eligible for the cover pool.

V. ASSET-LIABILITY MANAGEMENT

The new law has introduced a minimum overcollateralisation level of 2% on a nominal basis as well as on a net present value basis. The Luxembourg regulator has the right to review and adjust these overcollateralisation levels. Any mismatches in terms of currency or interest rate risk have to be hedged and the respective hedge instruments have to be included in the collateral pool. In addition, there are the requirements imposed by the rating agencies.

The special auditor has to ensure that there is always sufficient collateral in the pool. This has to be certified by the special auditor when Lettres de Gage are issued. Cover assets may only be removed from the cover pool when the prior written consent of the special auditor has been received and provided that the remaining cover assets are sufficient to guarantee the legally protected cover.

The calculation of the nominal value and of the net present value of the collateral pool as well of the outstanding Lettres de Gage volume must be reported to the supervisory authority on a monthly basis.

Moreover, the law changes removed the restriction of the outstanding volume of Lettres de Gage to 60 times the issuer’s equity.

There is no obligation for the issuers to publish specific information referring to the collateral pool. However, there is a voluntary practice by the Lettres de Gage issuers to publish specific cover pool data on their respective internet pages.

VI. TRANSPARENCY

In line with the ECBC Label Initiative the covered bond issuers in Luxembourg want to increase transparency for their investors. Currently, there is no legal provision in place which requires the covered bond issuers to publish information, e.g. regarding the composition of the cover pool. So far, all the information provided is on a voluntary basis. But the covered bond issuers started an initiative to add such a provision in the current law. The details about the information to be provided should be determined in a regulation by the general banking regulator “Commission de Surveillance du Secteur Financier (CSSF)” which is the supervisory authority of the covered bond issuers.

Furthermore, there is a general intention to modernize the current legal provisions applicable to covered bond issuers.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The supervisory authority of covered bond issuers is the CSSF, as already mentioned above. The CSSF has a specialised department which is responsible for supervising the Lettres de Gage issuers. It is entitled to demand relevant reports and intercede if liquidity problems have been identified at a bank. The CSSF is also responsible for the approval of the various types of covered bonds secured by movable assets. Definitions, the details on which types of movable assets qualify and other practical issues will be clarified in a separate CSSF Circular.

For the independent control of the cover pool a special auditor which is recommended by the Lettres de Gage issuer has to be approved by the supervisory authority. Only auditing firms which satisfy the conditions set forth in the law of 2009 regarding réviseurs d'entreprises (independent auditors) can be appointed as special auditors. The issuer communicates the names of the partners of these auditing firms who will fulfil the function to CSSF. The special auditor must have a suitable qualification and must be able to call upon the experience and technical expertise of a recognized international auditing firm.

The special auditor is continuously responsible for monitoring the collateral pool and the outstanding Lettres de Gage. He must ensure that there are sufficient assets in the collateral pool to service the obligations resulting from the outstanding Lettres de Gage up to the final maturity of the last outstanding bond. He is obliged to inform the supervisory authority immediately should any of the prudential limits be violated. The Lettres de Gage issuer is also obliged to immediately inform the supervisory authority of the violation of any limits.

Rating agencies do not play any mandatory role in the monitoring process. The issuers comply with the rating agencies' requirements on a voluntary basis.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS REGULATED

The cover registers for mortgage, public sector and moveable assets include all necessary data to identify the assets and the derivatives included. As soon as an asset or derivative product is registered in the official cover register it forms part of the collateral pool.

The cover register is managed by the issuer but regularly monitored by the special auditor. The special auditor is obliged to inform the CSSF of any irregularities and provide an annual report.

Asset segregation

In the case that a Lettres de Gage issuer is declared bankrupt, the assets and derivatives in the collateral pool are separated from the other assets and liabilities of the bank. The respective collateral pools remain unchanged and are administered by the CSSF up to the final maturity of the last outstanding Lettre de Gage. By law the derivative counterparties rank pari passu with the Lettres de Gage creditors.

Impact of insolvency proceedings on Lettres de Gage and derivatives

Lettres de Gage do not automatically become due when the issuing bank becomes insolvent. Interest and principal are paid as per their original due dates. The same applies to derivatives registered in the cover register which are part of the cover pool. The net present value of the derivatives after netting ranks pari passu with the claims of the Lettres de Gage holders.

Preferential treatment of covered bond holders

Lettres de Gage holders benefit from a preferential treatment in case of an issuer insolvency. The registration of the cover assets in the cover register provides the Lettres de Gage holders with a preferential right, above all other rights, preferences and priorities of any nature whatsoever, including those of the Treasury. The general bankruptcy administrator has no direct access to the assets in the collateral pool.

If the assets in the collateral pool are insufficient to meet the demands of the Lettres de Gage creditors, the bondholders may draw on the bankruptcy estate and the ordinary rules of collective liquidation will apply, but restricted to the amount which has not been satisfied by the cover assets. In this case, the Lettres de Gage holders participate in the general bankruptcy procedure and have an unsecured claim against the issuer ranking pari passu with other senior unsecured investors.

Access to liquidity in case of insolvency

The CSSF administers the cash flows resulting from the cover assets and according to the Article 12-8 (5) it can transfer the administration of the cover assets and the Lettres de Gage to another bank.

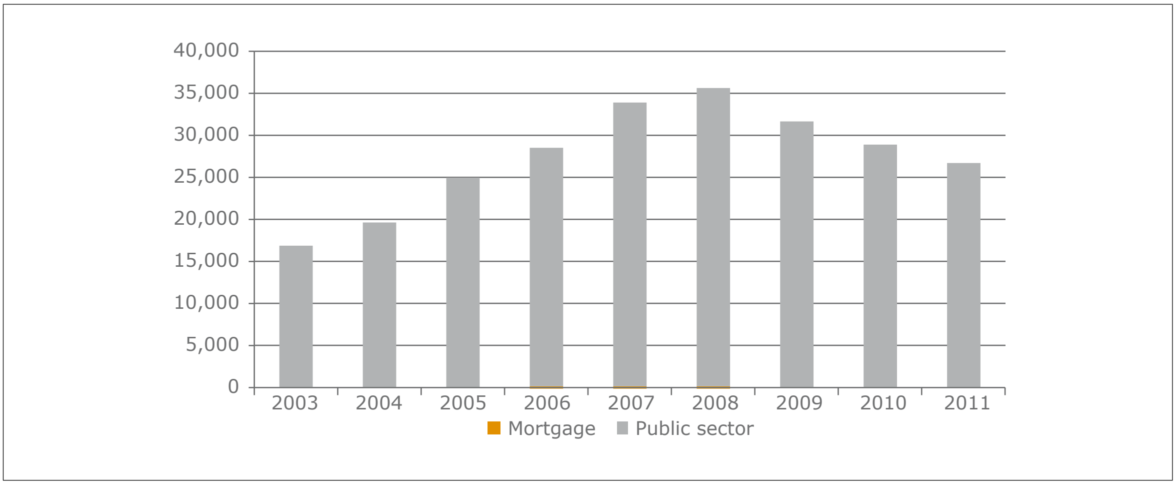
There is no explicit provision in the law regarding any voluntary overcollateralisation. However, Article 12-8 (5) stipulates that assets remaining after the creditors enjoying the preferential rights have been paid off in full, those assets shall be transferred to the general pool of assets comprised in the liquidation of the bank. From this regulation the conclusion can be drawn that the voluntary overcollateralisation is only available to the non-privileged creditors when the claims of the last outstanding Lettre de Gage holders have been satisfied.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The Luxembourg Covered Bond legislation fulfils the criteria of Art. 52 (4) of the UCITS Directive (Council Directive of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)). Derivatives included in the cover pool are currently 0-20% risk-weighted according to the risk weighting of the counterparties. In its current format, the Lettres de Gage legislation does not fulfil the requirements set out in Annex VI, Part 1, Article 68 a) to f) of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), the Capital Requirements Directive (CRD). The recent amendments of the Luxembourg covered bond legislation did not make the Lettres de Gage legislation CRD-compliant. However, it should be possible for issuers to make their outstanding Lettres de Gage ‘CRD compliant’ by limiting their cover pool exposure.

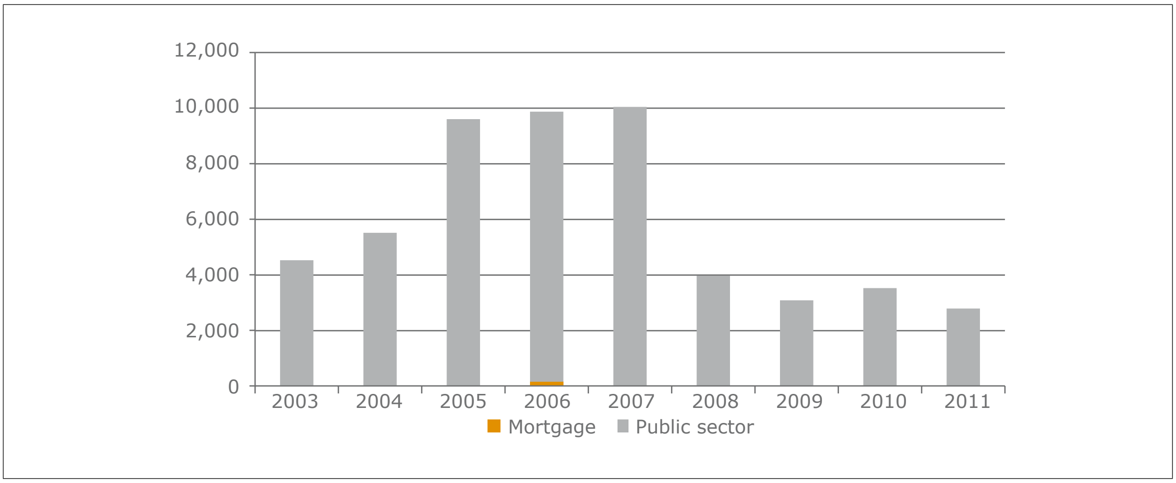
Lettres de Gage are principally eligible for repo transactions with the European central bank. But this applies only to Lettres de Gage issued in Euro and in New Global Note format for Euro-System eligibility.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2011, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2011, EUR M



Source: EMF/ECBC

Issuers: There are six issuers in Luxembourg: Dexia LdG Banque S.A., Erste Europäische Pfandbrief- und Kommunalkreditbank AG in Luxemburg S.A., EUROHYPO Europäische Hypothekenbank S.A., Hypo Pfandbrief Bank International S.A., Nord/LB Covered Finance Bank S.A. and Société Générale Lettres de Gage S.A.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/84/Lettres_de_Gage_publiques, http://ecbc.eu/framework/85/Lettres_de_Gage_hypoth%C3%A9caires and http://ecbc.eu/framework/86/Lettres_de_Gage_mobili%C3%A8res

3.18 THE NETHERLANDS

By Daniëlle Boerendans, ABN AMRO Bank N.V.
Rezah Stegeman, Clifford Chance LLP
and Kees Westermann, Linklaters LLP

I. FRAMEWORK

The Dutch regulation (the "Regulation") for the issuance of regulated covered bonds ("Regulated Covered Bonds") aims to:

> Provide Dutch issuers 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 prescribes a so-called 'segregated' structure, being a structure where the cover assets are segregated from the issuer and owned by an independent, special purpose covered bond company (CBC). Under the Regulation, asset segregation takes place on the basis of the Dutch Civil Code and the Dutch Bankruptcy Code. As the applicable statutory provisions are relatively creditor-friendly they did not need to be amended when the Regulation was adopted.

The Regulation is not a separate instrument. It is a collection of rules forming part of two layers of secondary regulation implementing the Dutch Financial Supervision Act (*Wet op het financieel toezicht*, the "FSA"). These are:

> The Decree on Prudential Rules Regulation (*Besluit prudentieel toezicht Wft*); and

> The Implementing Regulation (*Uitvoeringsregeling Wft*).

II. STRUCTURE OF THE ISSUER

Under the Regulation the issuer needs to be a bank (that is a credit institution as meant in article 4(1)(a) of the Banking Consolidation Directive (2006/48/EC; the "BCD") that is licensed by the Dutch Central Bank (*De Nederlandsche Bank N.V.*; "DNB"). General banking supervision by DNB on the solvency, liquidity, business operations et cetera of the issuer falls outside the scope of this chapter.

The Regulated Covered Bonds are guaranteed by the CBC owning the cover assets, thus creating dual recourse for the covered bondholders. The CBC is a special purpose vehicle set up as a bankruptcy-remote, orphan entity, as follows. It is a private company with limited liability (*besloten vennootschap met beperkte aansprakelijkheid*) wholly owned by a foundation (*stichting*), with independent directors provided by a corporate services provider and no employees. It has a limited corporate objects clause, so that any third party dealing with the CBC will be able to see that it is dealing with a special purpose vehicle. Non-petition and limited recourse wording is agreed with all transaction parties that are creditors of the CBC under the transaction documents. Any remaining third party creditors not signing up to such non-petition and limited recourse provisions are listed high in the relevant priority of payments, so as to procure they are timely paid. An insolvency of the issuer does in itself not result in an insolvency of the CBC.

The cover assets are owned by the CBC, but from an accounting perspective the assets remain on the consolidated balance sheet of the issuer, which continues to carry the credit risk of the cover assets. The CBC pledges the cover assets to a security trustee, which is a foundation especially established to act as a security trustee in relation to the relevant Regulated Covered Bonds. The security trustee receives the rights of pledge in its own name, but acts in the interest of the covered bondholders and certain other transaction parties that are creditors of the CBC.

III. COVER ASSETS

The Regulation does not impose the detailed provisions on cover assets as prescribed under Annex VI, Part 1, point 68 of the BCD (together with the Capital Adequacy Directive (2006/49/EC) constituting the Capital Requirements Directive (CRD)), but instead only lists the general requirements from section 52(4) of the Undertakings for Collective Investment in Transferable Securities Directive (85/11/EC; "UCITS") as interpreted and implemented by the Dutch Ministry of Finance. The Regulation therefore allows issuers of Dutch Regulated Covered Bonds the flexibility to choose whether their Regulated Covered Bonds are UCITS-compliant only or both UCITS- and CRD-compliant.

To date all Dutch Regulated Covered Bond programmes are backed by residential mortgage loans. In addition they allow for inclusion of substitution assets, meaning euro-denominated:

> Cash; or

> Other assets eligible to collateralise covered bonds under the CRD, subject to minimum rating and maximum percentage requirements (this differs per programme).

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, German residential mortgage loans.

For each registered programme, DNB indicates in its Regulated Covered Bond register (as referred to in more detail below) whether the relevant Regulated Covered Bonds are compliant with both UCITS and the CRD.

IV. VALUATION AND LTV CRITERIA

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 Regulated Covered Bond programmes take a two-step approach towards LTV-ratio's of Dutch residential mortgage loans, as follows:

> Subject to some exceptions in some programmes, a loan is only eligible to be transferred to the CBC if the LTV-ratio did not exceed 125% (the "Eligibility Percentage") at origination; and

> 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 (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. Currently the LTV Cut-Off Percentage applied to Dutch residential mortgage loans is:

a) 80% for all Regulated Covered Bonds, which is in line with the maximum LTV ratio prescribed by the CRD; and

b) In some covered bond programmes, 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*).

Like the CRD, the Regulation does not prescribe whether the foreclosure value or the market value of the underlying mortgaged property should be taken into account when calculating the LTV ratio. To date under the Dutch Regulated Covered Bond programmes:

> The Eligibility Percentage is applied to the foreclosure value at origination; and

> The LTV Cut-Off Percentage is applied to the market value of the mortgaged property at the relevant time. The way in which the market value is determined differs per programme.

V. ASSET - LIABILITY MANAGEMENT

Under all Dutch Regulated Covered Bond programmes a total return swap in relation to the cover assets is entered into at inception of the programme. The total return swap basically swaps the different types of interest to be received on the cover assets to 1 month's EURIBOR. In addition, an interest rate swap or structured swap is entered into each time a series of Regulated Covered Bonds is issued. The interest rate/structured swap basically swaps the aforementioned 1 month's EURIBOR/euro's to the interest rate/currency payable under the relevant series of Regulated Covered Bonds.

All Dutch Regulated Covered Bond programmes require the issuer to establish a reserve fund equal to, in short,3 months' interest payments on the Regulated Covered Bonds plus certain costs and expenses for 3 months (or a comparable amount) if the issuer's credit rating falls below F1 (short term) and/or A (long term) (Fitch)/P-1 (short term) (Moody's)/A-1 or A-1+ (this differs per programme)(short term) (S&P).

To mitigate liquidity risk on principal payments all Dutch Regulated Covered Bond programmes use either:

> A pre-maturity test which is taken on each business day falling 6 or 12 months or less prior to the maturity of the relevant Regulated Covered Bonds (depending on the programme and the rating agencies involved). The pre-maturity test is failed if on the relevant test date the issuer's short term rating falls below F1+ (Fitch)/P-1 (Moody's)/A-1+(S&P). A breach of the pre-maturity test requires (a) the issuer to cash-collateralise the relevant maturing Regulated Covered Bonds or (b) the CBC to procure alternative remedies in relation to the relevant maturing Regulated Covered Bonds such as a guarantee of the issuer's obligations, a liquidity facility and/or a sale or refinancing of cover assets; or

> A 12 or 18 months' (this differs per programme) maturity extension. The possible extension applies only to the CBC and only to any final redemption amount payable by the CBC in relation to a series of covered bonds under the guarantee.

For all Dutch Regulated Covered Bond programmes a minimum level of over-collateralisation is required, which is taken into account in a monthly asset cover test where asset percentages are used ranging from approximately 70 to 85%.

VI. TRANSPARENCY

The Dutch issuers of Regulated Covered Bonds are currently developing a national transparency template, which will be based on a template developed for Dutch residential mortgage-backed securities, in order to create more transparency for investors in Regulated Covered Bonds. The Regulated Covered Bond template is in line with the guidelines of the ECBC Label Initiative.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Under all Dutch Regulated Covered Bond programmes the issuer is obliged to frequently send out investor reports that contain detailed information about, among other things, the cover assets and the performance of a monthly asset cover test. The accuracy of the asset cover test calculation is required to be tested at least annually by an independent auditor. Each year the CBC is required to produce audited financial statements.

When reviewing a Dutch covered bond programme submitted to it for registration under the Regulation, DNB requires:

> A valid safeguarding of sufficient cover assets for the covered bondholders. The assets must be validly transferred by the issuer to the CBC and pledged by the CBC to the security trustee;

> The covered bonds to have a credit rating of at least AA-/Aa3;

> A healthy ratio between the programme/issuance amount on the one hand and on the other hand (a) the value of the cover assets, (b) the value of the remaining assets of the issuer eligible for addition to the cover assets and (c) the consolidated balance sheet of the issuer (the latter to protect other stakeholders); and

> The issuer to 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.

The register of Regulated Covered Bond programmes is available on-line and can be found at http://www.toezicht.dnb.nl/en/2/2/51-202602.jsp (click on: Searching in the register).

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

> It must keep a record of all Regulated Covered Bonds issued and of all assets serving as cover assets;

> It must demonstrate at least quarterly that the Regulated Covered Bonds continue to meet the criteria summarised above, by granting DNB access to the records referred to in the previous paragraph and for instance audit reports, credit rating reports and reports regarding the cover assets. This is without prejudice to the general authority of DNB to request information from the issuer on the basis of its regular banking supervision powers;

> It must demonstrate at least annually to DNB that it has 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;

> 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;

- It must immediately notify DNB if, for as long as any Regulated 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 Regulated 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 Regulated Covered Bonds; and
- Before it issues any further Regulated Covered Bonds, (i) it must ascertain that the requirements for registration are complied with (there is no need to have the further Regulated Covered Bonds assessed by DNB); and (ii) if the ratio between the total nominal value of the Regulated Covered Bonds and the consolidated balance sheet total of the issuer increases beyond what DNB had determined to be a healthy ratio, the issuer must demonstrate to DNB that the new ratio can be considered healthy.

If the Regulated Covered Bonds no longer meet the requirements set by the Regulation or if the issuer 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 issuer, which may be disclosed by DNB in its register. DNB is entitled to ultimately strike the registration of a Regulated Covered Bond programme. In practice it is not very likely that DNB would ever exercise its deregistration authority. Apart from verbal assurance this is confirmed by the explanatory notes to the Regulation, which in short state:

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

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

The regulations enabling the segregation of the cover assets and bankruptcy-remoteness of the CBC are set out in the Dutch Civil and Bankruptcy Codes.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

As explained above, Dutch Regulated Covered Bonds are registered either as UCITS-compliant or as UCITS- and CRD-compliant. Dutch covered bonds which are not registered under the Regulation are neither UCITS- nor CRD-compliant.

It differs per type of investor whether investing in a certain category of covered bonds provides regulatory special treatment. For ease of reference such regulatory treatment (for Dutch financial institutions) is set out in more detail below, focusing on Dutch Regulated Covered Bonds:

Dutch Regulated Covered Bond category		**UCITS -compliant**	**UCITS- and CRD-compliant**
Type of investor			
UCITS and insurers		Higher investment limits	Higher investment limits
Banks and investment firms using:	Standardised Approach	None	- Lower risk weighting
	Foundation Internal Ratings Based (IRB) Approach	None	- Lower loss given default value

A further regulatory special treatment which is not reflected in the above diagram, is available to CRD-compliant Dutch Regulated Covered Bonds in the context of banks and investment firms entering into repurchase transactions (repo's) with the Dutch issuer. If the issuing Dutch bank posts its own CRD-compliant Regulated Covered Bonds as collateral under the repo, then such covered bonds qualify as financial collateral under Annex VIII, part 2, point 6 of the BCD for the purpose of mitigating the credit risk of the bank/investment firm on the issuing Dutch bank as its repo counterparty if such Regulated Covered Bonds are CRD-compliant.

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

> They need not be admitted to trading on a regulated market (as defined in the Markets in Financial Instruments Directive; MiFID); and

> Unlike other asset-backed securities:

a) They are not eligible for an exemption from the general rule that debt instruments must have a fixed, unconditional principal amount;

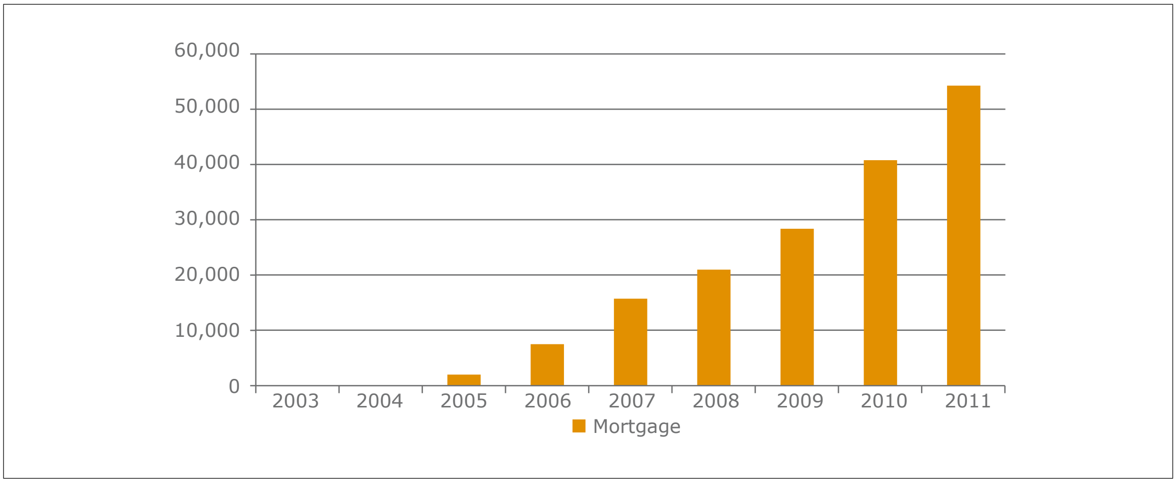
b) They may be backed by credit-linked notes or similar claims resulting from the transfer of credit risk by means of credit derivatives; and

c) They are exempt from certain true sale requirements. In addition, if issued prior to 1 January 2008, they are exempt from certain credit quality thresholds. However, these exemptions are of lesser relevance for Dutch UCITS-compliant covered bonds because the Regulation requires a segregated structure as well as a credit rating of at least AA-/Aa3.

X. ADDITIONAL INFORMATION

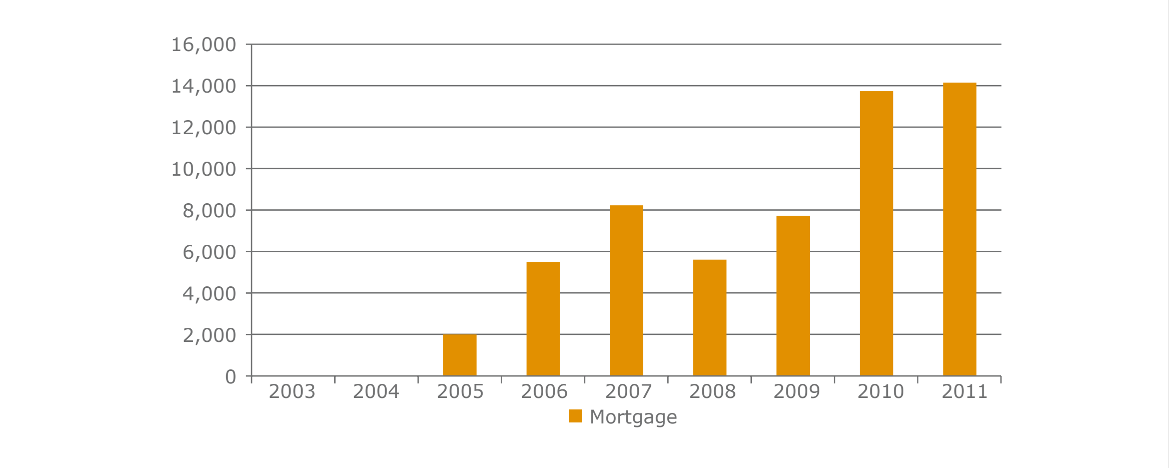
On 7 January 2011 the Dutch Association of Covered Bond Issuers (DACB) was established. The statutory aim of the DACB is generally to promote the interests, both national and international, of Dutch covered bond issuers and aims for a strong, healthy and internationally competitive covered bond market in the Netherlands. The website of the DACB can be found at: www.dacb.nl.

> Figure 1: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

Issuers: Currently there are four issuers of Regulated Covered Bonds in the Netherlands: ABN AMRO Bank N.V., ING Bank N.V., NIBC Bank N.V.and SNS Bank N.V.. Achmea Hypotheekbank N.V.'s covered bond programme is in the process of being approved by DNB.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/65/Dutch_registered_CBs_programmes

3.19 NEW ZEALAND

By Neville Wood, ASB Bank Limited
and Frank Will, RBS

SUMMARY

The first covered bond was issued out of New Zealand in June 2010. At that time, New Zealand did not have a legislative covered bond framework and the domestic issuers used the well-tested general law-based covered bond approach following in the footsteps of the UK, France, and Canada. Since then the regulatory authorities in New Zealand have developed a dedicated covered bond legislation to support further growth of this market segment. In May 2012 the Minister of Finance introduced the Reserve Bank of New Zealand (Covered Bonds) Amendment Bill into Parliament and it is currently before the Finance and Expenditure Select Committee. It is expected that the new framework will come into effect in late 2012 / early 2013 with a transition period to enable the registration of existing covered bond programmes.

I. FRAMEWORK

No covered bond regulation was in place in June 2010 when New Zealand covered bonds were first issued and issuance of covered bonds was neither prohibited nor limited by any prudential requirements or other regulation.

In October 2010, the central bank released a consultation paper on proposals for a regulatory framework to provide additional certainty to investors, and to improve the disclosure requirements in order to support the development of the covered bond market in New Zealand.

In January 2011, the RBNZ introduced a regulatory issuance limit for the issuance of covered bonds by New Zealand banks (which came into force in April 2011). The regulation limits the value of assets encumbered for the benefit of covered bondholders to 10% of total assets of the issuing bank. At that time the RBNZ said that this was an initial limit and that its appropriateness would be reviewed by the central bank within the next two years (i.e. by 2013), taking into account the developments within the covered bond market in New Zealand.

In December 2011, the RBNZ conducted another public consultation. The final paper was in essence aligned with the earlier consultation paper. Following approval by Cabinet in April 2012, the Reserve Bank released a Cabinet paper and Regulatory Impact Statement confirming policy positions relating to the matters discussed in the Reserve Bank’s December 2011 consultation paper on covered bonds.

In May 2012, the first reading on the Amendment Bill took place. Following its first reading, the Bill was referred to the Finance and Expenditure Select Committee which has until 22 November 2012 to report.

The proposed New Zealand covered bond legislation will allow existing covered bond issuers six months to register their covered bond programme with the RBNZ. Each issuance under the programme is also proposed to be registered with RBNZ. Several existing covered bond issuers in New Zealand have a clause in their prospectus allowing them to exchange, without the consent of the trustees or the covered bondholders, any existing covered bond for a new covered bond, provided that amongst other things, each of the rating agencies then rating the existing covered bonds confirms in writing that any such new covered bonds will be assigned the same ratings as the existing covered bonds. The new bonds would be subject to the same economic terms and conditions as the existing bonds and would be identical in form, amounts and denominations.

II. STRUCTURE OF THE ISSUER

As of the beginning of August 2012, issuers from four New Zealand banking groups have issued covered bonds, being ANZ National Bank Limited (ANZ), ASB Bank Limited (ASB), BNZ and Westpac New Zealand Limited (Westpac). Typically, NZD denominated bonds have been issued directly by the New Zealand banks, while non-NZD bonds have been issued through the London branches of their respective subsidiaries and are guaranteed by the New Zealand parent company. However, in all four cases the ultimate Australian parent companies ANZ, CBA, NAB and Westpac do not guarantee the covered bonds. The RBNZ emphasised from the outset that it is supportive of the covered bond product.

Banks can issue bonds backed by a dynamic pool of assets, and the covered bonds rank pari-passu to each other. The covered bonds are irrevocably guaranteed by the covered bond guarantor (CB guarantor) under the covered bond guarantee. The CB guarantor will only make payments under the bonds when (a) an issuer event of default has occurred, and a notice to pay is served on the CB guarantor or, (b) a CB guarantor event of default has occurred and a covered bond guarantee acceleration notice is served on the CB guarantor and the issuers.

III. COVER ASSETS

The existing covered bond programmes are backed by a dynamic pool of residential mortgage loans originated in New Zealand.

The common eligibility criteria for these mortgage loans across the four programmes are listed below:

> Are denominated and repayable only in New Zealand Dollars (NZD);

> Are secured by first ranking residential mortgages in New Zealand

> Are mortgage loans with a term not exceeding 30 years

> Have an outstanding principal balance of no more than NZD 1.5 m (Westpac)/NZD 2.0 m (ANZ, ASB)/NZD 2.5 m (BNZ)

> Are not in arrears/have not been in default for more than 30 days

Some of the issuers have additional features beyond these requirements. Moreover, issuers are also allowed to hold liquid substitution assets. These assets, are subject to an overall limit of 10-20% of the cover portfolio depending on the issuer (Westpac 20%, BNZ 15%, ANZ and ASB 10%), with the exception of cash that has no limit.

Although the covered bond legislation is yet to be finalised, the current proposal foresees a "registration framework", under which investors' rights to the asset pool of a registered covered bond would be protected from the issuer insolvency (or statutory management of the issuer) rather than a "safe harbour framework", under which the investors' rights to the asset pool of a covered bond would be protected if the covered bond programme fulfils the requirements of the covered bond law.

The mandatory registration would involve the recognition of a covered bond issued with the effect that the cover assets would be explicitly protected from the insolvency or statutory management of the issuer. The RBNZ must keep a public register of registered covered bond programmes and issuances under each programme. The draft law requires the Reserve Bank to determine the form and content of the register and can designate registered covered bond programmes to particular classes of programmes depending on the underlying assets.

The proposed law requires that the cover pool assets are held by a special purpose vehicle (SPV), which is a separate legal entity from the issuer.

IV. VALUATION AND LTV CRITERIA

In New Zealand, every property is typically valued during the underwriting process. All four existing covered bond programmes do not restrict the LTV limit for mortgage loans in the cover pool. However, in the case of ASB and Westpac, the Assets Coverage Test (ACT) caps the valuation of the property at 75%. In case of ANZ, and BNZ, this cap is set at 80%. In effect, this means the maximum amount of a loan that can count in the ACT test is 75% or 80% of the property value respectively.

V. ASSET-LIABILITY MANAGEMENT

Issuance limit: As mentioned above, there is a regulatory issuance threshold which limits the value of assets encumbered for the benefit of covered bond holders to 10% of the total assets of the issuing bank. RBNZ highlights that this is an initial limit and its appropriateness will be reviewed by Jan 2013 taking into consideration the development of the covered bond market. The RBNZ states that the 10% limit is "similar to the limit set in Australia" of 8%.

Currency & interest hedging: The underlying mortgage loans are denominated in NZD. However, covered bonds can be issued in other currency denominations, which introduces currency risk for the issuer. Moreover, the interest payable for the covered bonds will not exactly match the interest received on the mortgage loans in the collateral pool. Under the existing covered bond programmes, the issuers are required to hedge the interest and currency risks.

Soft vs hard bullet structures: The existing issuers (ANZ, ASB BNZ and Westpac) can issue hard bullet covered bonds, or covered bonds with extendable maturity of one year ("soft bullet" bonds). Hard bullet covered bonds will, depending on short term rating of the relevant bank, be subject to a 12-month pre-maturity test giving the CB guarantor 12 months to raise liquidity by selling assets of the pool.

Over-collateralisation (OC): The issuers have committed to various OC levels under the prospectuses and to the rating agencies. The proposed law only requires that value of the cover pool assets is at least equal to the principal amount outstanding on the covered bonds.

VI. COVER POOL MONITOR AND BANKING SUPERVISON

The existing issuers provide investor reports on a monthly or quarterly basis. In addition, monthly or quarterly reports are prepared for the rating agencies. The agencies re-calculate the required asset percentage used in the ACT on a regular basis and prior to each issuance under the respective covered bond programme.

An independent asset monitor annually checks the arithmetic accuracy of the calculations performed by the calculation manager (usually the issuer), with respect of the asset coverage test or amortisation test (as applicable). If the issuer rating of the calculation manager is downgraded below a certain trigger level, the asset monitor will check the arithmetic accuracy on a monthly basis. Moreover, (1) if the asset monitor notices any errors in the calculations performed by the calculation manager which result in a failure in the asset coverage test or (2) if the adjusted aggregate mortgage loan amount or the amortisation test aggregate mortgage loan amount is misstated by the calculation manager by an amount exceeding 1%, then the asset monitor will be required to test the calculation monthly for a period of six months.

VII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

The covered bonds are direct, unsecured, unsubordinated and unconditional obligations of the relevant issuer. In addition, the CB guarantor guarantees the payments of interest and principal of the covered bonds. The issuer provides a subordinated loan to CB guarantor which allows the CB guarantor to acquire a mortgage loan portfolio. The portfolio includes mortgage loans and the related security sold by the seller in accordance with the terms of the mortgage sale agreement.

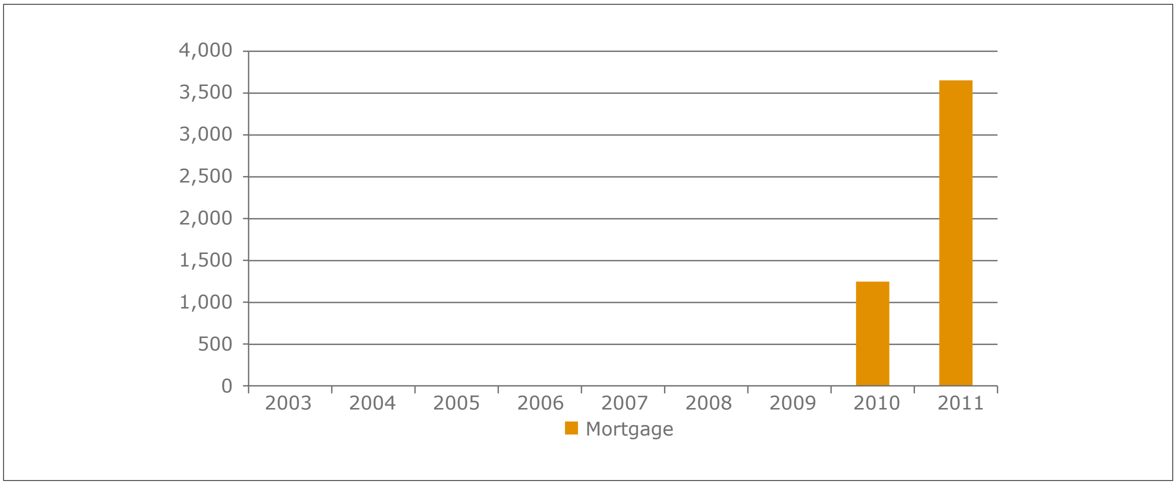
Under the existing covered bond programmes, the sale of the loans and their underlying security by the seller to the CB Guarantor is in form of equitable assignment of the seller's rights, title, interest and benefit in and to the loans, their related security and the other assets which are being sold. The equitable assignment requires neither a notice to the borrowers nor a registration in the land registry. As a result, the legal title to the mortgage loans remains with the seller until legal assignment is delivered to the CB guarantor and notice of perfection of legal title is given to the borrowers. The perfection of title of the mortgage security to the CB guarantor will be triggered by certain trigger events including the notice to pay on the CB guarantor, downgrade of the issuer to sub-investment grade or insolvency of the issuer. The equitable assignment is a well-known procedure in the UK and is usually used by the covered bond issuers in the UK.

VIII. RISK WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

The Reserve Bank of New Zealand accepts NZD denominated AAA rated covered bonds for its Domestic Markets Operations. For maturities of less than three years the haircut is 5% while covered bonds with a maturity of three years or longer are subject to a higher haircut of 8%. This includes covered bonds issued by New Zealand banks.

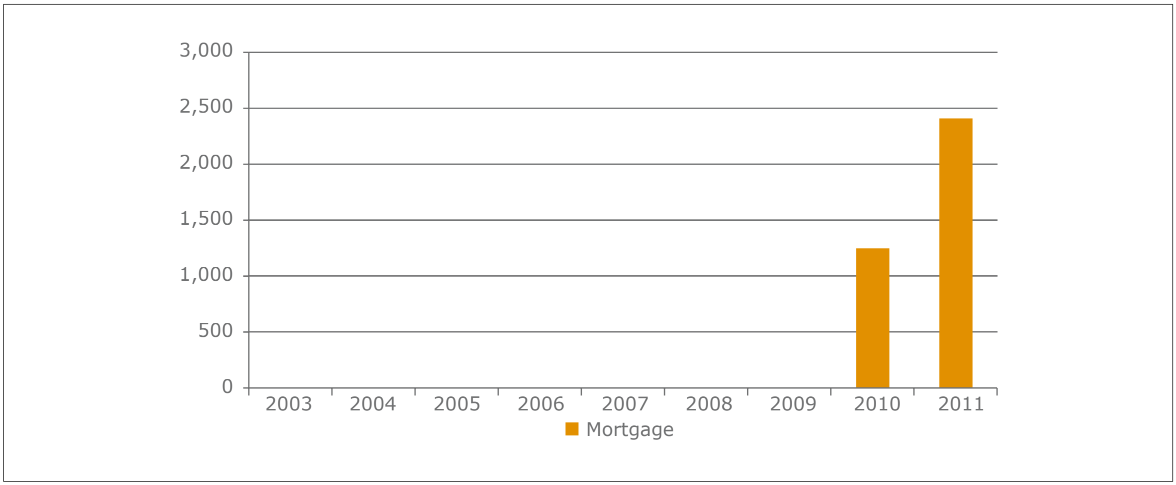
The covered bonds issued directly by financial institutions with registered offices in New Zealand are neither CRD nor UCITS compliant as both frameworks require the issuer to be based in the EU. Moreover, the UCITS Directive (and therefore the CRD) requires special legal supervision – usually in form of a dedicated covered bond law which as of August 2012 does not exist in New Zealand. The New Zealand covered bonds therefore do not benefit from the lower risk weighting for bank treasuries in the EU.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2011, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2011, EUR M



Source: EMF/ECBC

3.20 NORWAY

By Stein Sjølie, FNO – Finance Norway

I. FRAMEWORK

In June 2012 the Norwegian covered bond legislation passed its five year milestone. The legislation was a result of a lengthy study and is closely matching corresponding EU directives and regulations, in particular the CRD, which was adopted and implemented in Norway in late 2006. The legislative framework has so far proved to be a solid and sustainable base for the issuers' commercial activity. The law provides investors strong protection from the issuing institution's cover pool, and the Norwegian covered bonds are seen as being among the best in class of European covered bonds. The high quality of Norwegian covered bonds is supported by the Kingdom of Norway's very strong macroeconomic position.

Three specialised institutions were established from the beginning and started issuance of Norwegian covered bonds in international markets during the second half 2007. This activity had thus barely started when the crisis hit the international financial markets the following year. In order to provide liquidity to the Norwegian banking market the authorities opted to swap treasury bills against covered bonds with Norwegian banks and mortgages institutions. This gave an impetus to the fledgling domestic market of covered bonds; a large number of banks established new subsidiaries in order to take advantage of this liquidity window. Today more than 20 Norwegian specialized credit institutions are licensed to issue covered bonds. The smallest ones only operate in the domestic market. The largest issuers already have been, and are expected to continue to be, present in the international capital markets on a regular basis.

II. STRUCTURE OF THE ISSUER

The Norwegian Covered Bond legislation entered into force on 1 June 2007. Relevant amendments were made to the Financial Services Act, hereafter "the Act", and, at the same time, the Ministry of Finance adopted a supplementary regulation, hereafter "the Regulation", to the Act. The legislation permits specialized mortgage credit institution to raise loans by issuing covered bonds. These institutions are licensed credit institutions, supervised by the Financial Supervisory Authority of Norway – Finanstilsynet, hereafter the FSA. They are subject to the same type of regulations as other Norwegian financial institutions, for example capital adequacy requirements, general requirements for liquidity management etc.

A commercial bank or a savings bank will not be allowed to issue such bonds in its own name, but may establish a mortgage credit institution as a subsidiary. Alternatively, a mortgage credit institution may be established as an independent institution with several shareholders.

A licensed mortgage credit institution may raise loans by issuing covered bonds where the object of the institution, as laid down in the articles of association, is (1) to grant or acquire specified types of mortgages and public sector loans and (2) to finance its lending business primarily by issuing covered bonds. The articles of association of the institution shall state which types of loans that shall be granted or acquired by the institution. The scope of the business will therefore be restricted and the institution will have a very narrow mandate. Thus, Norwegian issuers of covered bonds are transparent companies.

III. COVER ASSETS

According to the Act the cover pool may consist of the following assets:

> Residential mortgages

> Commercial mortgages

> Loans secured on other registered assets (subject to further regulations)

> Public sector loans

> Assets in form of derivative agreements (in accordance with the Regulation)

> Substitute assets (in accordance with the Regulation)

The mortgage loans have to be collateralized with real estate or other eligible assets within the EEA or OECD, and the public sector loan borrowers have to be located within the EEA or OECD. The Regulation adds rating requirements on the individual public sector borrowers, if located outside the EEA.

The derivate agreements and the substitute assets are, logically, accessory to the loans. The substitute assets may only amount to 20% of the cover pool (30% for a limited period of time with the consent of the FSA). In addition, the substitute assets ought to be secure and liquid. The Regulation adds requirements necessary in order to comply with the description of covered bonds given in EU Directive 2006/48/EC. Counterparty and rating regulations in accordance with the directive apply to these two asset classes, as well as to the public sector loans.

IV. VALUATION AND LTV CRITERIA

Loan to value ratios (LTV) and monitoring are fixed by the Regulation, in accordance with the EU Directive 2006/48/EC. For residential mortgages the LTV is 75%, and for commercial mortgages 60%. The mortgage credit institution shall monitor the development of the LTV of the individual asset as well as the market of the underlying assets, according to the Act, and in accordance with the said directive.

Upon inclusion of loans in the cover pool, a prudent market value shall be set. The market value for a property shall be set individually by an independent and competent person. The valuation shall be documented. However, valuation of residential properties may be based on general price levels.

Predominantly, residential properties in Norway are sold in open auctions in the market. Hence the actual selling price in principle reflects the market value and a recent sales contract may serve as documentation of the market value of a property.

The mortgage institution shall establish systems for monitoring subsequent price developments. Should property prices later fall, that part of a mortgage that exceeds the relevant LTV limit is still part of the cover pool and protects the holders of preferential claims. However, that part of a loan that exceeds the LTV limit is not taken into account when calculating the value of the cover pool to compare it with outstanding covered bonds, please refer to the matching regulations as described below. The same principle applies to loans that are in default, i.e. more than 90 days in arrears.

V. ASSET - LIABILITY MANAGEMENT

The Act establishes a strict balance principle, i.e. the value of the cover pool shall at all times exceed the value of the covered bonds with a preferential claim over the pool. The Regulation establishes a strict mark to market principle of both assets and liabilities. Only the value of mortgages within the LTV limits is taken into account in this context. Also, the act caps the maximum exposure to one single borrower at 5% of the cover pool when compliance with the matching requirement is assessed.

There is no requirement in the legislation for a certain percentage of overcollateralization (OC). However, if an issuer chooses to provide voluntary OC, these assets are part of the cover pool, and bankruptcy remote in case of the issuer going into bankruptcy proceedings. The issuing institutions typically declare a certain level of OC, e.g. 5%, to which they are bound. Equally, the mortgage credit institution shall ensure that the payment flows from the cover pool enable the institution to honour its payment obligations.

The mortgage institution may enter into derivative agreements in order to secure the balance principle and payment obligations. If it has a positive market value, a derivative agreement will be part of the cover pool; if negative, the counterparties to derivative agreements will have a preferential claim over the pool, pari passu with the holders of covered bonds. As a corollary to this, the counterparties in the derivative agreements will be subject to same restrictions with respect to declaration of default as the bondholders. In addition to this, the mortgage institution will have to adopt strict internal regulations with respect to liquidity risk, interest rate risk and currency risk.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Mortgage and other credit institutions are regulated under chapter 3 of the Act. This chapter sets out the general provisions for a credit institution, i.e. the obligation to obtain a license and to fulfill capital requirements and undertake organizational measures etc.

The issuing of covered bonds is regulated by chapter 2, subchapter IV of the Act. The issuance of such bonds is not subject to any further governmental approvals. However the articles of association shall be approved by the FSA. Furthermore, the institution shall notify the FSA no later than 30 days prior to the initial issuance of covered bonds. The FSA has the power to instruct licensed mortgage institutions not to issue covered bonds whenever the financial strength of the institution gives rise to concern.

The mortgage institution shall maintain a register of issued covered bonds and of the cover assets assigned thereto, including derivative agreements. To oversee that the register is correctly maintained an independent inspector shall be appointed by the FSA. The inspector shall also regularly review compliance with the requirements concerning the balance principle, and report to the FSA, yearly or whenever the institution does not comply.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

The Act gives the bondholders a preferential claim over the cover pool in case of bankruptcy. The term "covered bonds", or literally "bonds with preferential claim" (in Norwegian "obligasjoner med fortrinnsrett") is protected by law. In case of bankruptcy of the mortgage credit institution an administrator shall be appointed by the court. The assets in the pool remain with the estate in case of bankruptcy, but the bondholders have exclusive, equal and proportionate preferential claim over the cover pool, and the administrator is bound to assure timely payment, provided the pool gives full cover to the said claims.

The preferential claim also applies to payments that accrue to the institution from the cover pool. And, as long as they receive timely payments, the creditors have no right to declare default. Details about this may be reflected in the individual agreements between the issuer and (the trustee of) the bondholders. These provisions will also apply to any netting agreements between the institution and its counterparties in derivative transactions.

Bankruptcy or insolvency does not in itself give holders of covered bonds and derivative counterparties right to accelerate their claims. However, should it not be possible to make contractual payments when claims fall due, and an imminent change that will ensure such contractual payments is unlikely, the bankruptcy manager shall introduce a halt to payments. Thereafter further administration of the cover pool shall proceed under the general bankruptcy legislation.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation fulfils and is in compliance with the relevant EU legislation, i.e. EU Directive 2006/48/EC and in particular UCITS Directive, Article 52 (4). Hence, the Norwegian Covered Bonds being in compliance with the UCITS and the CRD, are eligible for reduced (10%) risk weighting under the standard method for capital adequacy requirement. The Norwegian Covered Bonds are also eligible as collateral in ECB.

The issuers are licensed credit institutions under supervision of the Norwegian FSA, and as such bound to comply with all relevant single market directives and regulations applicable to European credit institutions.

X. ADDITIONAL INFORMATION

Legislation supplementing the covered bond legislation

The legal framework regulating the housing market is well developed. This framework provides legal certainty and foreseeability for both consumers as borrowers and owners of housing, and for credit institutions as lenders and creditors. This includes specific consumer protection legislation, a centralized electronic registry system for the ownership of and rights (mortgage, etc.) in real estate, and an effectively and expedient forced sale procedure.

The Financial Contracts Act (Act 1999-06-25 no. 46) regulates the contractual conditions in respect of a loan agreement between financial institutions and their customers, both consumers and corporate clients. The Act applies in principle to all types of loans, whether they are secured or not. This also includes mortgage backed loans included in a cover pool. The act is invariable in respect of consumer contracts, i.e. it cannot be dispensed with by agreement that is detrimental to the customer.

The Mortgage Act (Act of 8 February 1980 no. 2) regulates i.a. mortgages on real estate. Mortgage rights acquire legal protection by registration in the Land Registry/Register of Deeds.

The Forced Sales Act (Act of 26 June 1992 no.86) provides for an effectively and expedient forced sale procedure. A lender may, if a loan is accelerated and the borrower fails to pay any due amount, file an application before the county court for a forced sale of the property that backs the mortgage loan. The registered mortgage contract will itself constitute basis for such application. The court will normally appoint a real estate broker to administer the sale in order to obtain a reasonable price. Normally, nine to twelve months are required to repossess the property and satisfy the holder of a mortgage.

Market overview

The covered bonds are listed. Virtually all active issuers have issues listed on the Norwegian market places offered by Oslo Børs, either on the regulated market or on Oslo ABM, the non-regulated market place run by Oslo Børs. International issues may be listed in a financial centre abroad.

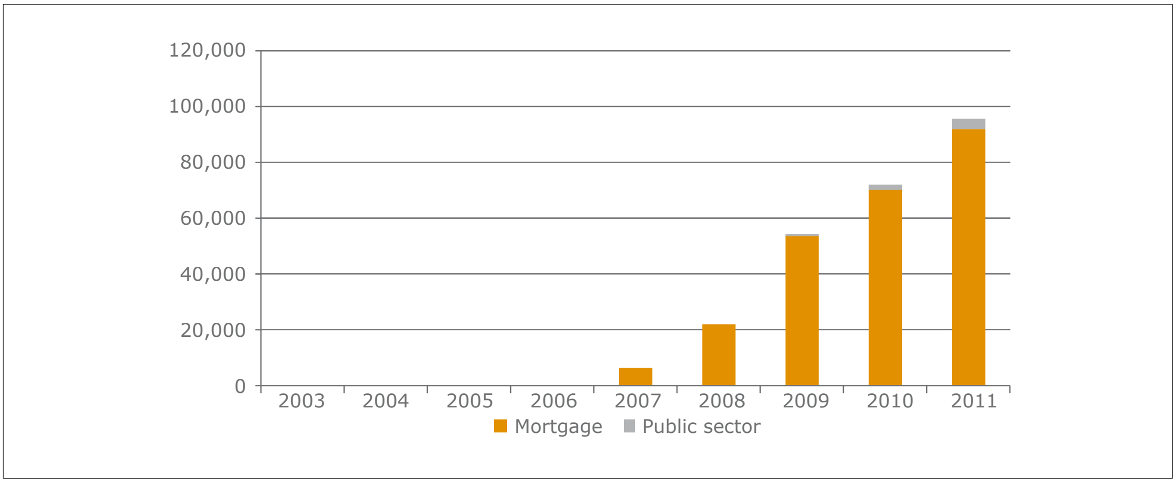
The Norwegian Government's swap program that was introduced to provide extra liquidity to the market at the outbreak of the financial crisis was discontinued by end 2009. Since then, there has been no government sponsored program stimulating the market for covered bonds. Of the total amount of NOK

230 bn. (ca. EUR 30 bn.) of Norwegian covered bonds that were lodged in the swap agreements during 2008 and 2009, NOK 150 bn. (ca. EUR 20 bn) still remain in the Treasury. As these swap agreements come to maturity during the next two years the bonds have to be refinanced in the market. The amount corresponds to less than one year's current issuance in the market. The transaction activity and the liquidity in the Norwegian market have showed an increasing trend since the improvement of the capital market after the financial crisis.

During 2011 Norwegian institutions maintained at steady growth in their issuer activity, despite difficult market conditions during the second half. Due to the travails of the euro market the main Norwegian issuers reduced their euro issuance, but compensated with increased activity in the US dollar and the domestic markets during the year. The smaller institutions, which stick to the domestic market, were as such not affected by the Euro Zone crisis. There was a monetary easing by Norges Bank as a reaction to the development in the European market late 2011.

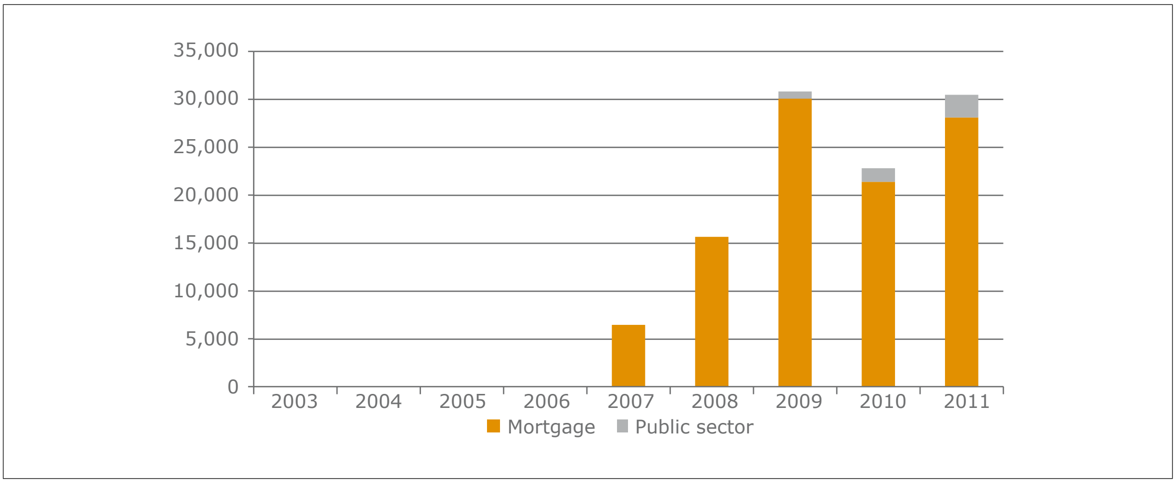
A total of more than EUR 30 bn. covered bonds was issued by Norwegian firms during 2011. Of this amount more than half was issued in the domestic (NOK) market. Less than EUR 9 bn. was placed in the euro market, and around EUR 6 bn. was raised in other, mainly USD markets. The intense issuing activity brought the total outstanding to EUR 95 bn. by the end of the year. Issuing activity has progressed during 2012, both in the domestic and the foreign markets. By May 2012 more than 170 issues were traded on the Norwegian market places. The volume of outstanding covered bonds on the Norwegian market now exceeds that of Norwegian Government bonds.

> Figure 1: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/75/Norway

3.21 POLAND

By Agnieszka Drewicz-Tułodziecka, Mortgage Credit Foundation
and Piotr Cyburt, BRE Bank Hipoteczny

I. LEGAL FRAMEWORK

The legal basis for covered bond issuance in Poland is "Act on mortgage bonds and mortgage banks" of August 29, 1997; Journal of Laws no. 99, item 919 (List Zastawny Act – hereafter: LZ Act). There is also a special chapter concerning bankruptcy of mortgage banks in the new Bankruptcy Act - *Article 442 – Article450* - Bankruptcy and Reorganisation Law of 28 February 2003.

II. STRUCTURE OF THE ISSUER

The issuer is a specialised mortgage bank, licensed by the National Bank of Poland.

A mortgage bank may only engage in the activities specified in the LZ Act.

According to the Article 12 LZ Act, the core operations of mortgage banks include:

> Granting credits secured with mortgages;

> Granting loans not secured by mortgage, only if the borrower, guarantor or underwriter of a loan repayment to its full amount, including the interest due, is the National Bank of Poland, Central European Bank, governments or central banks of the European Union states, Organisation for Economic Cooperation and Development, excluding those countries, which are or have been for the past 5 years restructuring their foreign debt, or by means of a guarantee or security granted by the State Treasury;

> Acquisition of other banks' receivables on account of loans granted by them, secured by a mortgage and receivables on account of credits not secured by a mortgage, granted to the entities of the local self-government;

> The issue of mortgage bonds the base of which constitute the Bank's receivables on account of the granted loans secured by a mortgage or purchased receivables of other banks on account of the loans granted by them secured by mortgage;

> Issuing public mortgage bonds on the basis of:

a) the mortgage bank's receivables arising from its credits not secured by mortgages referred to in point 2);

b) purchased receivables of other banks arising from their credits not secured by mortgages referred in point 2).

According to the Article 15 LZ Act, apart from core operations referred to in Article 12, mortgage banks may engage in the following activities:

> Accepting term deposits;

> Taking credits and loans;

> Issuing bonds;

> Safekeeping securities;

- Purchasing and taking up shares and stocks of other entities whose legal form limits the liability of a mortgage bank to the sum invested insofar as it helps the performance of activities of a mortgage bank, where the total value of purchased or taken up shares and stocks may not be higher than 10% of the mortgage bank's equity;
- Keeping bank accounts for servicing investment projects financed through credits granted by a mortgage bank;
- Providing consulting and advice with respect to the property market, including help in establishing the mortgage lending value of the property;
- Managing receivables of a mortgage bank and other banks arising from credits referred to in Article 12 LZ Act, as well as granting these credits on behalf of other banks on the basis of relevant cooperation agreements.

All the listed activities may be executed also in foreign currencies upon obtaining relevant authorizations.

Under the LZ Act, the range of activities that can be performed by mortgage banks is specified in a closed catalogue as mentioned above. Particularly, mortgage banks cannot collect deposits of individual saver. The narrowing of activity of mortgage banks facilitates the development of a simplified and clear activity structure (which facilitates supervision, especially external one), the specialization of the loan division and an improvement in methods of credit risk assessment in the field of real (estate) property financing. Due to the above limitations, funds resulting from the issue of mortgage bonds are mainly used towards the financing of the lending activity.

The issuer holds the cover assets on his balance sheet. The covered bonds are direct, unconditional obligations of the issuer.

III. COVER ASSETS

All covered bonds must be fully secured by cover assets. There are two specific classes of the covered bonds: *hipoteczne listy zastawne* (mortgage covered bonds) and *publiczne listy zastawne* (public covered bonds); registered in two separate cover registers.

The cover register for mortgage bonds

The LZ Act provides for a cover register for the mortgage assets, which will be used in the cover pool for the mortgage covered bonds.

There is also a provision for substitute assets, which is limited to 10% of the cover pool and come from the asset categories below:

- In securities issued or guaranteed by the National Bank of Poland, European Central Bank, governments or central banks of European Union Member States, OECD(with the exclusion of states which are or were restructuring their foreign debt in the last 5 years), and the State Treasury;
- In the National Bank of Poland;
- In cash.

In addition, receivables secured by mortgages established on buildings which are in construction phase may not in total exceed 10% of the overall value of mortgage-secured receivables in the cover pool. Within this limit, the receivables secured by mortgages on construction plots in compliance with the land use plan, may not exceed 10% (Article 23 of LZ Act).

The cover register for public covered bonds

A public bond is a registered or bearer security issued on the basis of receivables of a mortgage bank arising from:

- Credits within the secured part with due interest, a guarantee or surety of the National Bank of Poland, the European Central Bank, governments or central banks of the EU Member States, the Organisation for Economic Cooperation and Development, except for states which are currently in the process of restructuring of restructured their foreign debts during the last 5 years, as well as a guarantee or surety of the State Treasury in accordance with provisions of separate laws; or
- Credits granted to entities listed in the point above; or
- Credits in the secured part with due interest, a guarantee or surety of local government units and credits granted to such local government units.

In regard to collateral location, mortgage collateral is restricted to mortgages against the right of perpetual usufruct or the right of ownership to a property situated in Poland are eligible for the cover. For public covered bonds, there is a wider scope and includes the following countries and institutions as eligible for the cover: National Bank of Poland, the European Central Bank, governments or central banks of the EU Member States, the OECD, except for states which are currently in the process of restructuring of restructured their foreign debts during the last 5 years, as well as a guarantee or surety of the State Treasury.

IV. VALUATION AND LTV CRITERIA

The mortgage lending value of real estate is determined under the LZ Act. The mortgage lending value of real property is determined prudently, with due diligence, on the basis of an expert opinion prepared by the mortgage bank or entities with appropriate real estate appraisal qualifications commissioned by the mortgage bank. The mortgage lending value cannot be higher than the market value of the real estate.

There are special banking supervisory regulations, which stipulate in details the assessment of the mortgage lending value and impose on the bank a duty to have a database for real estate prices.

The LTV limits are as follows:

- Single Loan to Value of Security limit: not more than 100% of mortgage lending value (Art 13.2 LZ Act)
- Value of Security limit, relating to the single loan: max. 60% of the mortgage lending value, to fund eligible assets (Art 14 LZ Act: *Funds raised from the issue of mortgage bonds may be used by a mortgage bank for refinancing mortgage-secured credits and purchased receivables of other banks arising from their mortgage-secured credits; the refinancing may not, however, exceed 60% of the mortgage lending value of the property*)
- Absolute portfolio Loan to Value of Security limit: (Art 13.1 LZ Act: T*he total amount of receivables from granting credits secured with the mortgages or purchased receivables of other banks arising from their mortgage-secured credits, in the part above 60% of the mortgage lending value of the property, may not exceed 30% of the total sum of the mortgage bank's receivables secured with mortgages*).

V. ASSET-LIABILITY MANAGEMENT

According to the article 18 of the LZ Act:

- The total nominal value of all outstanding mortgage bonds shall not exceed the sum of nominal amounts of the bank's receivables secured with mortgages, which form the basis for the mortgage bond issue.
- The bank's income from interest on its mortgage-secured receivables, referred to in the point above, may not be lower than the amount of the bank's payable interest on outstanding mortgage bonds.

The Act also ensures a suitable monitoring, according to the Article 25: A mortgage bank shall keep a mortgage cover account to ensure compliance, in the long term perspective, with the requirements referred above.

Additionally, according to the internal policy of each mortgage bank, the internal limits are set using management's experience in a development bank as reference.

VI. TRANSPARENCY

The information of the activity of the Polish mortgage banks can be found on the Polish Mortgage Credit Foundation's website: www.ehipoteka.pl.

The range of data published on a yearly basis includes: new issues of covered bonds, outstanding covered bonds (mortgage & public), total assets of mortgage banks and residential & commercial property credits' sale.

Detailed information on the covered bonds issues can also be found on the issuers' websites:

BRE Bank Hipoteczny: http://www.brehipoteczny.pl/offer/covered-bonds/what-is-a-covered-bond.

Pekao Bank Hipoteczny: http://www.pekaobh.pl/u235/navi/31467.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

According to the Article 31 LZ Act, the cover pool monitor (*powiernik*) maintains ongoing supervision of the management of the mortgage cover register.

The cover pool monitor should ensure that:

- Commitments pertaining to the outstanding mortgage bonds are at all times covered by the mortgage bank in compliance with the provisions of LZ Act;
- The mortgage lending value of the property adopted by the mortgage bank has been established in accordance with the regulations referred to in Article 22, paragraph 2; the cover pool monitor shall not be required to investigate whether the mortgage lending value of the property corresponds to its actual value;
- The mortgage bank observes the limits laid down in Article 18 LZ Act; the cover pool monitor shall promptly inform the Banking Supervisory Commission of any cases of non-compliance by the mortgage bank with these limits.
- The manner in which the mortgage bank keeps the mortgage cover register is in compliance with this Act;

> The mortgage bank ensures appropriate cover for planned mortgage bond issues in accordance with the provisions of this Act, and proper control of appropriate entries in the mortgage cover register.

In order to perform tasks referred to in Article 30 LZ Act, the cover pool monitor shall have the right to inspect accounting books, registers and other bank documents at any time.

In matters not regulated by the LZ Act, supervision over mortgage banks shall be exercised in compliance with the Banking Law and the regulations on the National Bank of Poland (NBP). The NBP regularly checks the cover assets.

The Banking Supervisory Commission may commission an independent expert at the expense of the inspected mortgage bank to inspection of the appropriateness of the mortgage bank's entries to the mortgage cover register. This would also including establishing the mortgage lending value of the property was in compliance with the rules referred to in Article 22, paragraph 5 LZ Act.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

The Act of 28 February 2003 – Bankruptcy and Rehabilitation Law (Journal of Law no. 60 item 535) contains separate chapter: Chapter II - Bankruptcy proceedings for mortgage banks – Articles 442-450.

In case of bankruptcy of the mortgage Bank, the claims, rights and means referred to in Article 18.3 and 18.4 of LZ Act, recorded in the mortgage bonds cover register, shall constitute a separate bankruptcy estate, which shall serve in the first place to satisfy the claims of mortgage bond creditors; after satisfying the mortgage bonds creditors, the surplus of the assets of the separate estate shall be allocated to the bankruptcy estate.

In declaring the bankruptcy, the court appoints a curator (*kurator*) who represents the rights of covered bond holders in the bankruptcy proceedings. Before the appointment of the curator, the court seeks an opinion on the proposed curator of the Banking Supervisory Commission (Article 443.1. of the Bankruptcy and Rehabilitation Law).

The following order shall apply to the satisfaction from the separate bankruptcy estate:

> The costs of liquidation of this estate, including also the remuneration of the curator,

> The amounts due to the mortgage bonds per their nominal value,

> Interest (coupons).

In case that the separate bankruptcy estate does not fully satisfy the mortgage bondholders, the remaining balance shall be satisfied from the whole bankruptcy estate funds; with that sum the curator shall vote when the arrangement is being adopted – according to Article 449 of the Bankruptcy and Rehabilitation Law: *If the separate estate is not sufficient for full satisfaction of covered bond holders, the remaining sum is satisfied from the distribution of the funds of the bankrupt estate; with this sum the curator votes in the signing of the arrangement; he has one vote for each sum resulting from dividing the sum of all other claims of those entitled to vote by the number of creditors representing these claims. The sum earmarked for the satisfaction of covered bond holders is moved from the funds of the bankrupt estate fund to the funds of the separate bankrupt estate*.

In that case, the additional amount for satisfying the mortgage bondholders shall be transferred from the bankruptcy estate funds to the separate bankruptcy estate funds. It means that the covered bond holders get preference over other creditors.

According to the Article 446 Bankruptcy Act – The declaration of bankruptcy of a mortgage bank does not infringe maturity dates of its obligations towards covered bond holders. It means that the covered bonds do not accelerate.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

In order to apply a preferential risk-weighting for covered bonds, the instrument needs to meet the criteria of UCITS Directive and CRD.

Polish covered bonds (*list zastawny*) already fulfil the criteria of UCITS 52(4)- in December 2008, the Polish list zastawny was notified by the European Commission as an European "eligible bond" – i.e. covered bond – the instrument with a qualified collateral. In that way, the notification procedure, applied by the Polish Ministry of Finance, was finished. Polish *list zastawny* can be found on the EC's website.

The covered bond (*list zastawny*) falls also within the criteria of the Annex VI, Part 1, Paragraph 68 (a) to (f) of the Capital Requirements Directive (CRD).

The new requirement of LTV limit – it is fulfilled by the Polish law - see Article 14 of the Covered Bond Act:

"Funds raised from the issue of mortgage bonds may be used by a mortgage bank for refinancing mortgage-secured credits and purchased receivables of other banks arising from their mortgage-secured credits; the refinancing may not, however, exceed 60% of the mortgage lending value of the property." The limit of 60% is used for every single loan and the limit is even more restrictive than the one allowed for covered bonds by the CRD (which is 80%).

The CRD requirements were word–for–word implemented by the Polish Financial Supervision Authority – see Resolution 380/2008. Therefore it is to assume that the Polish covered bonds (*listy zastawne*) apply the preferential treatment.

Moreover, National Central Bank added covered bonds (*listy zastawne*) to the list of instruments eligible for pawn credit / repo transactions. As of April 2010, the haircut level for repo amounts to 15,0 (3M repo); 20,0 (6 M repo); 25,0 (pawn credit) – ave. maturity of covered bonds – 5 years.

In Poland, the investment regulations pertaining to the limits for covered bonds are as follows:

> Banks – no limits

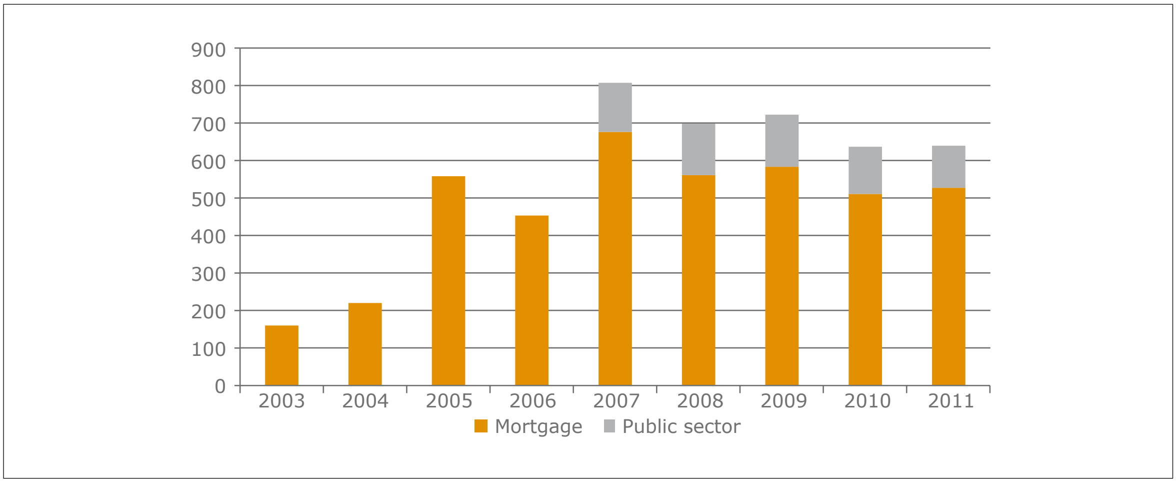
> Insurance companies – up to 40% of technical-insurance reserves – insurance companies (10% in covered bonds which were not allowed to public trading)

> Investment funds – open: 25% of the assets may be invested in covered bonds issued by one mortgage bank; but: total investments in covered bonds may not exceed 80% of the fund's assets and total value of investments in securities or in monetary market instruments, issued by the same mortgage bank, deposits in that entity, as well as the total value of risk connected with the transactions on non-standardised derivatives, which were dealt with that bank, can't exceed 35% of the fund's assets.

> Pension funds up to 40% of the total asset value.

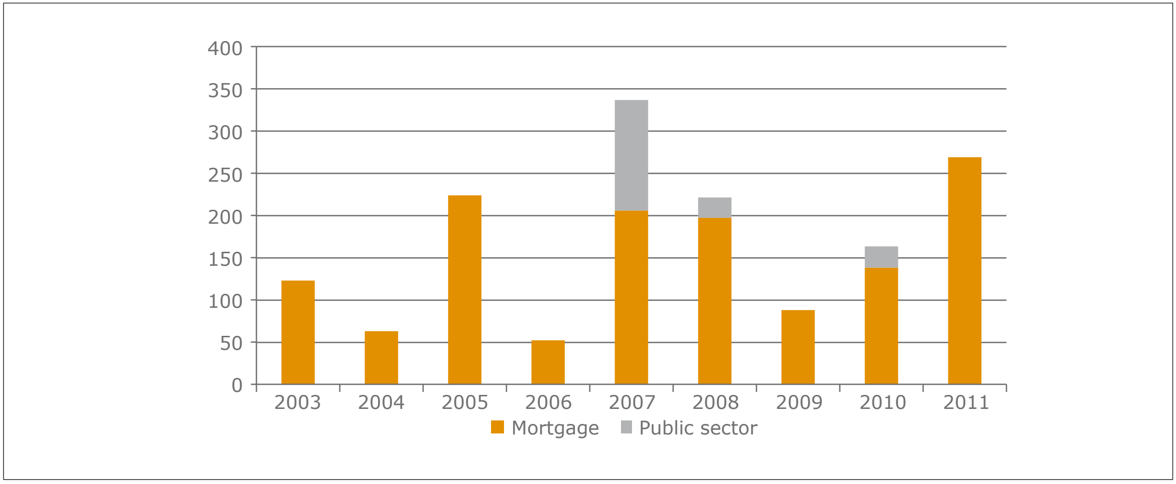
> Only the specialised mortgage banks are entitled to the issue of the *list zastawny* (the Polish covered bond). The current *list zastawny* issuers are: BRE Bank Hipoteczny S.A., BPH Bank Hipoteczny S.A. and ING Bank Hipoteczny S.A.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2011, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2011, EUR M



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/77/Polish_CBs

3.22 PORTUGAL

By Alda Pereira, Caixa Geral de Depósitos

I. FRAMEWORK

In Portugal, the legislation on Covered Bonds (*Obrigações Hipotecárias* and *Obrigações Sobre o Sector Público*) is regulated by Decree-law no. 59/2006 of March 20th 2006 and complemented by secondary legislation - Notices and Regulatory Instruments of the Central Bank (*Avisos e Instruções*), which address issues such as the segregation of assets from the insolvent estate in case of issuer insolvency, the compliance of asset and liability matching and mortgage valuation methodology.

The exemption of withholding tax for non-resident investors for bonds issued by Portuguese entities was passed in November 2005 (Decree Law n. º 193/2005).

II. STRUCTURE OF THE ISSUER

Obrigações Hipotecárias and *Obrigações Sector Público* may be issued by credit institutions legally authorised to grant credits guaranteed by mortgages on real estate and with own funds amounting to no less than EUR 7,500,000. These credit institutions are either universal banks or special issuance entities – Mortgage Credit Institutions (MCI).

If the issuer is a universal bank, a direct issue will take place with the cover assets remaining on its balance sheet. If the issuer is a MCI, its authorised business activity is restricted to the granting and acquisition of credits guaranteed by a mortgage or loans of the central government, regional or local authorities or credits guaranteed by these entities. They may also undertake the management of assets that have been repossessed from credits in default, and undertake the activities necessary to obtain additional liquidity and adequately manage the pool.

Assuming the MCI is wholly-owned, the asset originator then transfers the cover assets to this institution and the assets and liabilities will consolidate on the originator's balance sheet. However, it is also possible for the MCI to have multiple owners and, in this case, the assets may or may not consolidate back to the originator.

Considering the MCI has a limited business activity which only makes sense within the context of Covered Bond issuance, one could expect the MCI to be a 100% owned subsidiary and, as such, act as a complement to the originator's business and funding activity. In this sense, it seems reasonable to expect that it could draw on the parent company's resources to operate.

However, the Bank of Portugal will always determine, on a case by case basis, the necessary conditions that must be met in order to set up an MCI.

III. COVER ASSETS

Credit mortgage loans are eligible as collateral for mortgage Covered Bonds i.e. credits guaranteed by first ranking mortgage loans. Second mortgage loans can be assigned to the pool if the first mortgage loan was previously assigned as well – therefore both loans are attached to the same property, provided that the total amount of these loans does not exceed the maximum Loan to Value (LTV) permitted.

Public sector assets are eligible as collateral for Public sector bonds i.e. loans granted to the central governments, regional or local authorities or guaranteed by these entities.

The Law specifies that the registration of the assets must assure mortgage credit and public sector segregation. This means that separated pools will have to be set up.

Substitution assets (up to 20%) can be included in the pool:

> Deposits with the Bank of Portugal in cash, government bonds or other eligible bonds (ECB Tier 1 assets)[1];

> Deposits in other credit institutions rated at least "A-";

> Other low risk and high quality assets – if necessary, to be defined by the Bank of Portugal.

Even thought, at first look, it would seem that OH would not meet all the requirements of the CAD since Portuguese law allows for substitution assets up to a limit of 20% of the pool, this cannot be considered per se. In fact, Bank of Portugal's regulation establishes that the pool can only trade with credit institutions qualifying for credit quality assessment step 1 and that the aggregate risk positions cannot exceed 15% of the aggregate nominal value of the outstanding covered bonds or public sector covered bonds.

The geographical scope of eligible assets is restricted to loans guaranteed by first lien mortgages on property located in the European Union (EU) or loans granted to the central governments and regional or local authorities located in an EU member state.

Derivative contracts are permitted in the cover pool for hedging purposes, namely to mitigate interest rate, exchange rate and liquidity risks. The transactions involving derivatives, must be executed in a regulated market of a Member State of the European Union, in a legally established exchange of a full member of the OECD, or entered into with a counterparty that must be a credit institution rated "A-" or above. The legal documentation (agreement between the parties) should be standard, however this will have to safeguard the preferential claim for the counterparty. If the currency of the issue is not in EUR, the use of exchange rate derivative contracts is mandatory in order to hedge the inherent risk of the issue.

The cover pool is dynamic while the originator is solvent and issuers are required to maintain a record of all the assets in the cover pool, including derivatives contracts.

IV. VALUATION AND LTV CRITERIA

The value of the mortgaged asset[2] is the commercial value of the real estate, considering:

> Sustainable characteristics over the long term;

> Pricing under normal market conditions;

> The peculiarities of the local market; and

> The current and alternative uses given to the mortgage asset.

The value of the mortgage asset ascertained by the issuer cannot be superior to its market value, which is the price that the object could be sold at the time the appraisal is made. This assumes that the real estate is placed on sale and that market conditions allow for a regular transmission of the mortgaged asset within an adequate timing.

[1] Notice n.º 6/2006

[2] Notice n.º 5/2006

The property appraisal should be carried out by an independent appraisal specialist, previous to the respective mortgage credits being assigned to the Covered Bond pool.

Appraisals already carried out by a property appraisal expert are also accepted as long as the following conditions have been met:

> Appraisals have been carried out by an expert independently of the credit analysis and decision process of the bank;

> Appraisals have been documented in a written report that includes, in a clear and rigorous form, the elements that allow for an understanding of the analysis conducted and the conclusions arrived at by the expert;

> The property was appraised from a market value perspective or a property value perspective as defined in the law;

> There is no evidence that the property appraisal, arrived at from the perspective above mentioned, was overvalued at the time the loan was assigned to the Covered Bond pool.

The value of the mortgaged property must be checked by the institution on a periodic basis, at least every three years for residential mortgages and at least once a year for commercial properties. More frequent checks must be carried out if market conditions are prone to significant changes.

In order to check the value of the mortgaged property or to identify those properties that require periodic appraisal by an expert, the institution may use indices or accepted statistical methods that it considers appropriate. When indices or statistical methods are employed, the credit institution must submit to the Bank of Portugal a report detailing the foundations for the use of those indices or statistical methods along with an opinion on their adequacy by an external independent appraisal specialist.

Property appraisal must be revised by an expert whenever there is relevant information that indicates that a substantial reduction of the asset value has occurred or that the asset value relative to the general trend of the market has declined significantly.

For loans that exceed 5% of the institutions' own funds or exceed EUR 500,000 for residential mortgages and €1 million for commercial mortgages, the appraisal must be carried out at least every three years.

Revision of the value of an asset must be documented by the credit institution, in a clear and rigorous way, namely a description of the criteria and frequency of such a revision.

The property appraisal should be carried out by an independent appraisal specialist, with qualifications, competency and professional experience to perform this function.

The appraisal specialist is deemed not to be independent if he is in a situation susceptible of affecting his unbiased opinion, namely if he has any specific interest in the real estate being appraised or any relationship - commercial or personal - with the debtor, or if his compensation is dependent on the appraisal value of the property. The appraisal specialist may belong to the institution; however, he must have independence from the credit analysis and decision process.

The selection of the appraisal specialist by the institution must assure both diversification and rotation, and the credit institution has to maintain an updated list of the selected appraisal specialists, identifying the criteria justifying their selection and the real estate appraised by each specialist.

This list should be sent to the Bank of Portugal until the end of January of each year, reporting up to the 31 December of the previous year, and indicate any changes from the last report. If there are any doubts on the performance of the appraisal specialist, the Bank of Portugal can refuse to accept the valuations, demanding the appointment of another appraisal specialist by the credit institution.

When choosing the appropriate method, the appraisal specialists should consider the specific characteristics of the real estate and its local market. The appraisal of the real estate performed by the specialist should take the form of a written report and include all the elements that allow for an understanding of the analysis carried out and conclusions arrived at.

The maximum loan to value accepted for assets to be eligible into the pool is 80% for residential mortgages and 60% for commercial mortgages loans.

V. ASSET - LIABILITY MANAGEMENT

There are various asset and liability matching requirements established in the decree-law:

> The global nominal value of the outstanding mortgage bonds cannot exceed 95% of the global value of mortgage credits and other assets at any point in time assigned to the bonds (i.e., mandatory overcollateralisation of 5.2632%);

> The average maturity of outstanding mortgage bonds can never exceed the average life of the mortgage credits and substitution assets assigned to the issues;

> The total amount of interest to be paid by the mortgage bonds shall not exceed, at any point in time, the amount of interest to be collected from mortgage credits and other assets assigned to the bonds – cash flows from the cover pool must all be sufficient to meet all scheduled payments due to covered bond holders.

The law also promotes a sound cover pool management by allowing the issuer to apply the funds (for example, funds received from early repayment) to other assets and assign new mortgages to the pool. This option allows issuers to avoid potential cash-flow mismatches. It is also possible for issuers to establish a credit facility to provide for liquidity. This credit facility counterparty is required to have a minimum credit rating of "A-".

Issuers may use derivatives contracts to hedge the interest and exchange rate and liquidity risks. The derivatives are included in the cover pool and derivative counterparties – who also benefit from preferential claim - have to be rated "A-"or above.

If the limits defined in the Decree Law are exceeded, the issuer shall immediately resolve this situation by assigning new mortgage credits, purchasing outstanding bonds in the secondary market and/or assigning other eligible assets. These will, in turn, be exclusively assigned to the debt service of the bond.

Regarding these matters, the secondary legislation[3] determines the application of the following criteria:

> Loans must be accounted according to their outstanding principal, including matured interest;

> Deposits shall be accounted according to their amount including accrued interest;

[3] Notice n.º 6/2006

> Interests eligible for Eurosystem credit transactions shall be accounted according to the value resulting from the rules regarding valuation margins defined by the Eurosystem or, if lower, according to its nominal value, including accrued interest;

> Covered bonds and public sector covered bonds shall be accounted according to the corresponding outstanding principal, including accrued interest.

Interest rate or FX derivatives must be accounted in accordance with their market value and in the event that the corresponding loans and other substitute assets are denominated in different currencies, the issuer must ensure hedging of the relevant currency risk, and the reference exchange rates published by the European Central Bank shall be used for this purpose.

Single name risk is also addressed. The aggregate in risk positions with credit institutions - excluding those with a residual maturity date of 100 days or less - cannot exceed 15% of the aggregate nominal value of the covered bonds or public sector covered bonds outstanding.

The actual amount of the liabilities arising from the issuance of mortgages covered bonds or public sector covered bonds cannot be higher than the actual amount of the portfolio allocated to such bonds, taking into account any derivative instruments put in place. The ratio established shall be able to comply even when 200 basis points parallel movements of the curve are considered.

Each issuer must deliver in writing the specific and individual policies in written form for risk management, namely exchange risk, liquidity risk, interest rate risk, counterparty risk and operational risk and any other procedures aimed at ensuring compliance with the applicable regulatory regime and with any devised risk limitation policies set by the Issuer.

The Bank of Portugal may also make use of its regulatory role to require additional steps by the issuers to meet with all the asset-liability criteria that it sets out.

VI. TRANSPARENCY

Portuguese covered bonds Issuers have set up a working group which is currently developing a common National Transparency Template that will be available in each bank's website most probably from the start of the second semester of 2012 regarding data for the second quarter. This information will be provided on a quarterly basis.

The working group has taken into consideration the CBIC Template, regarding specific and detailed information on the Portuguese covered bonds and the cover pools. Explanation ok key concepts will be attached to the Investor Report.

Portuguese issuers will not be providing general information on the banks because this information is already available on the respective website and Investors can always contact directly the different issuers for detailed information.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The Board of the issuer will appoint an independent auditor who must be registered with the Portuguese Securities Commission, with the task of defending the interests of the bondholders and verifying the compliance to applicable legal and regulatory guidelines. An annual report must be published. The Bank of Portugal will review its content and may make use of its regulatory role to request additional information[4].

In the law, there are no specific rules on the cover pool monitor's responsibility. General rules on civil and contractual responsibility apply. The cover pool monitor will only be liable in case it does not comply with rules applicable to its activity or with its contractual obligations. If the cover pool monitor has complied with all its obligations it will not be liable in case the issuer has not respected the applicable regulation.

Also, a bondholders' joint representative – common to all mortgages or public bond issues - is to be appointed by the Board of Directors of the issuer in order to represent the interest of the bondholders and supervise the cover pool.

The Bank of Portugal and the Portuguese Securities Commission (CMVM) are responsible for banking and capital markets supervision. The law grants powers to the Bank of Portugal to regulate and supervise the issuers of covered bonds, so they must comply with the requirements of the law and all applicable regulations. Non-compliance by the issuer could imply the application of fines and other sanctions and, ultimately (in a worst case scenario) could determine the revocation of the issuer's licence.

Additionally, the Bank of Portugal has been granted powers to control compliance of the applicable rules for as long as the bonds remain outstanding, namely it may:

> Refuse asset valuations made by a valuation's expert if it has doubts concerning its performance, and demand to the issuer its replacement;

> Require new asset valuations by different experts; and

> Ask for clarifications or additional documents concerning all reports required and received.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Preferential status for Portuguese covered bonds holders and bankruptcy remoteness

Holders of covered bonds benefit from special preferential claim over the assets assigned to the issue, with precedence over any other creditors - the covered bond law supersedes the general bankruptcy regulation – for the redemption of principal and payment of interest.

The mortgages that guarantee these credits prevail over any real estate preferential claims. The derivatives contracts are part of the pool and derivatives counterparties rank pari passu with bondholders in terms of preferential claim over the assets in the pool, and consequently, their contracts are not expected to be called in case of insolvency of the originator.

Despite the absence of a direct link between the cover assets and the outstanding covered bond issuance, there is a legal provision that links the cover pool to the payment of capital and interest on the covered bonds thus rendering covered bonds direct, unconditional obligations of the issuer. The issuer of covered bonds holds the claims on the cover assets and these, in turn, will guarantee the covered bonds until all payments due to bondholders have been met.

If the issuer becomes insolvent, cover assets form a separate legal estate - a pool that is to be administered in favour of the covered bond holders, and consequently there is no automatic acceleration of the mortgage bonds.

[4] Regulatory Instrument n.º 13/2006

However, bondholders may convene a bondholders' assembly and may decide by a majority of 2/3 with regard to the outstanding bond volume to call the mortgage bonds, in which case, the administrator shall provide for the liquidation of the estate assigned to the issues and thereafter the payment of creditors in accordance with the provisions defined in the decree-law.

If the cover assets are not sufficient for the covered bonds, bondholders and derivative counterparties will rank pari passu with any common creditors of the issuer in relation to all other assets of the issuer (not included in the cover pool), after all guaranteed and privileged creditors have been duly paid up, for the payment of the remaining debt due to them.

Asset segregation

The assets - mortgages loans or public sector loans and substitute assets – and derivative contracts assigned to the issues are held by the issuer in separated accounts – cover register - and can be identified under a codified form. This information is deposited in the Bank of Portugal in the form of a code key. The Bank of Portugal regulates the terms and conditions by which the bondholders will have access to such key in case of default[5].

The legal effect of registration is to segregate those assets from the insolvent estate over which bondholders will have a special claim in case of insolvency/bankruptcy. In this situation the assets pledged to one or more issues of mortgage bonds will be separated from the insolvent estate for the purpose of its autonomous management until full payments due to the bondholders have been met. Despite this, the law stipulates that timely payments of interest and reimbursements should continue. In that way, cover assets form a separate legal estate, a pool administered in favour of the covered bondholders.

In an insolvency situation of the issuer two situations may occur:

> The issuer voluntarily assumes that it is insolvent and will present a project to the Bank of Portugal pursuant to article 35.-A of the Credit Institutions General Regime, containing the identification of the credit institution that will be appointed to manage the cover pool, together with the terms under which those services will be rendered;

> The revocation of the authorisation of the issuer with outstanding covered bonds or public sector covered bonds takes place, and the Bank of Portugal shall appoint a credit institution[6] to undertake the management of the cover pool.

The cover pool will be managed autonomously by this credit institution, which should prepare, immediately upon initiating its management, an opening balance sheet in relation to each autonomous portfolio and relevant bonds, supplemented by the necessary explanatory notes and should perform all acts and deals necessary for a sound management of the loan portfolio and its guarantees with the aim of ensuring a timely payment on the covered bonds, including selling credits, assuring their servicing all administrative procedures pertaining to these credits, the relationship with the debtors, and all modifying and extinguishing acts relating to their guarantees and must carry out and keep updated a registry, in off-balance sheet accounts, the details of the cover pool, in the terms set forth in the Decree-law no. 59/2006.

[5] Notice n.º8/2006

[6] Designated Credit Institution

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

According to secondary legislation, stated in the notice of Bank of Portugal[7], and in compliance with Basel I, Article 52(4) of UCITS, a 10% risk-weighting can be applied for covered bonds issued within the scope of the Portuguese jurisdiction, as well as to covered bonds that already benefit from a 10% risk-weighting in their home country. The risk-weighting of derivatives that are included in the cover pool will be 20%. Investment funds can invest a maximum of 25% of their own funds in a single issuer's covered bonds.

Portuguese covered bonds also meet the requirements of the Annex 6 of CRD of June 2006.

X. ADDITIONAL INFORMATION

Developments in the Portuguese covered bond market

During 2011, the main trends in capital markets were uncertainty originating high volatility, a perception of growing risk and scarcer liquidity. In Portugal, a rescue plan was put in place by the IMF/EU/ECB and set to last for three years in order to streamline public finances and recover the economy.

In this negative context, rating agencies continued to downgrade sovereign debt to junk status, which was followed by downgrades of covered bonds. Portuguese covered bond continued to underperform throughout the year mainly influenced by the deteriorating conditions of Portuguese public finances and economic environment.

However, within these circumstances, Portuguese covered bonds kept their improved position when compared to senior debt, mainly due to the collateral underlying covered bond issues, which from a credit perspective constitutes the most valuable asset quality, and as such, is accepted as collateral by the ECB in exchange of liquidity. The strong covered bonds legal framework, with strict rules that ring-fence the pool of assets underlying the covered bond issues from the bank balance sheet, the special preferential claim that investors enjoy over these assets with precedent over any other creditors, the clarified regime of bankruptcy remoteness and the close supervision of Bank of Portugal are some other characteristics that make *Obrigações Hipotecárias* and *Obrigações sobre o Sector Público* one of the strongest legal and regulatory frameworks.

Additionally, the pools of assets have maintained average low LTV ratios and overcollaterisation at adequate levels in order to granting a considerable level of security reinforcing the safety characteristics of this asset class. In addition, Portuguese housing markets, not suffering from a speculative bubble have kept relatively stable, maintaining the high level of guarantees.

In order to assure transparency and provide liquidity to covered bond holders, three main Portuguese banks tapped the market launching public tender offers on their covered bond issues, with implicit premiums over the secondary market levels.

In January 2012, Banco Português de Investimento conducted its tender offer for the €1 billion 3.25% 2015 covered bond issue. The offer had a relatively small premium versus where the bond had been trading in the secondary market, and the covered bond buyback reached only 7.8% of total outstanding amount.

[7] Notice n.º7/2006

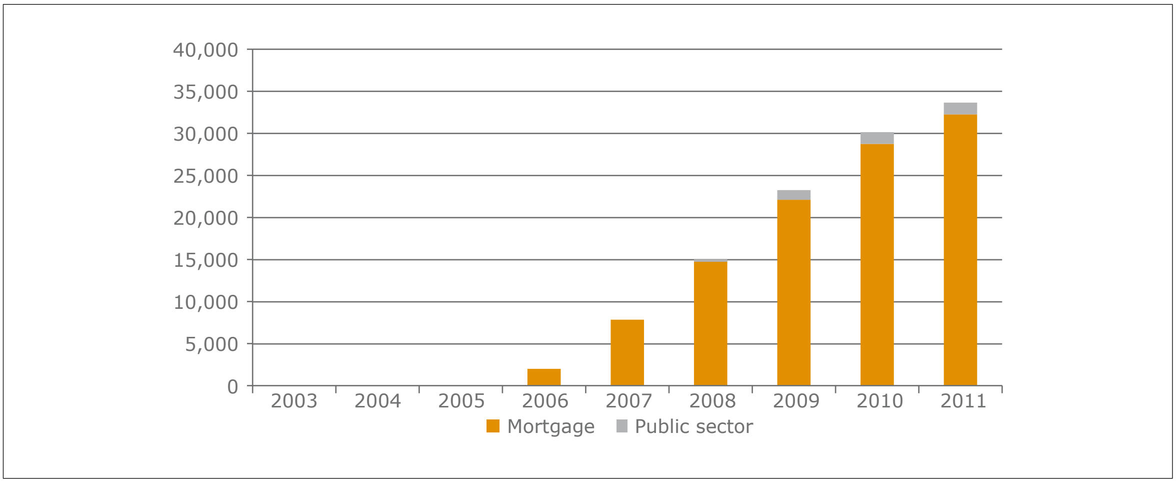
In March 2012 Caixa Geral de Depósitos and also Banco Comercial Português (BCP) also launched buy-backs of some of their covered bond issues with more aggressive premiums.

CGD's tender offer of its EUR 2 bn 3.875% 2016 mortgage covered bonds and its EUR 1 bn 3.625% 2014 public sector covered bonds achieved an overall take-up of 30%.

BCP offered to buyback its EUR 1 bn 4.75% 2014, its € 1 billion 3.75% 2016 and its EUR 1.5 bn 4.75% 2017, thus achieving a total buyback percentage of 26.25%.

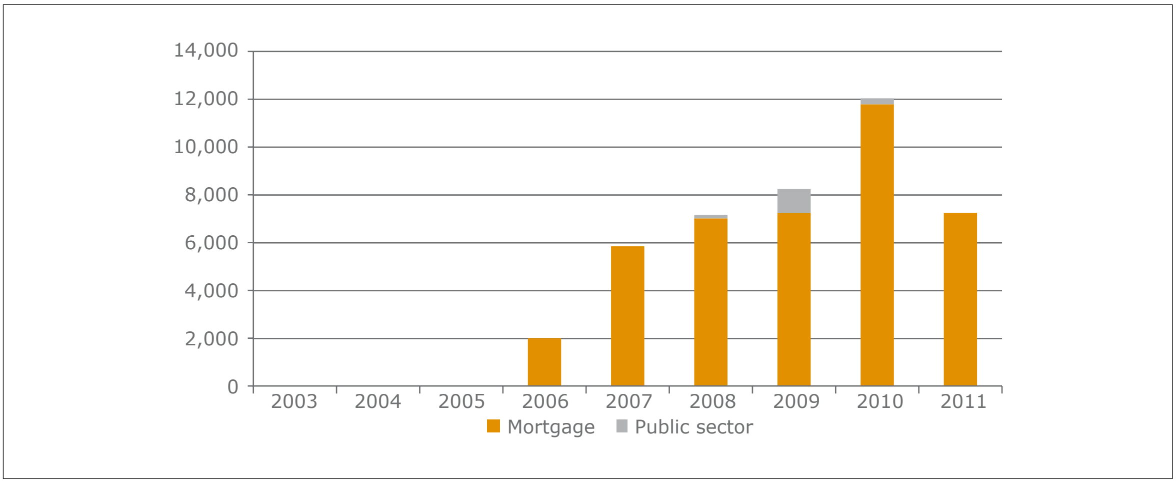
By December 2011, both O*brigações Hipotecárias* and *Obrigações sobre o Sector Público* combined have achieved an outstanding amount of EUR 15.35 bn of Jumbo issues with a residual weighted average tenor of 3.2 years.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2011, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2011, EUR M



Source: EMF/ECBC

Issuers: There are 6 active issuers in Portugal: Milleniumbcp Banco Comercial Portugues, Banco Espirito Santo, Banco Portugues de Investimento, Caixa Económica Montepio Geral, Caixa Geral de Depositos and Santander Totta.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/38/Public_Sector_CB_%28Obriga%C3%A7%C3%B5es_sobre_o_Sector_P%C3%BAblico%29 and http://ecbc.eu/framework/39/Mortgage_CB_%28Obriga%C3%A7%C3%B5es_Hipotec%C3%A1rias%29

3.23 ROMANIA

By Irina Neacsu, Banca Comerciala Romana,
Adrian Sacalschi, FHB Bank and Martin Schweitzer, Erste Group

I. FRAMEWORK

In Romania, the legal basis for Covered Bond issuance is the Mortgage Bonds Law from March 2006. This law supersedes the general bankruptcy regulation.

The legal framework for covered bonds is currently under revision in Romania. Below we will refer also to some important features which are under discussion with the Romanian supervisory authorities for being amended.

II. STRUCTURE OF THE ISSUER

The issuer can only be a credit institution (as defined by Romanian Banking Law, which is in line with the EU Directive). Therefore, all commercial or mortgage banks may be issuers and no other special covered bond license is required.

Mortgage banks are credit institutions, but their licensing is limited since this type of credit institutions are not allowed to receive deposits. The National Bank has not yet issued the set of applicable regulations for mortgage banks. Up to date no mortgage bank as such is incorporated under Romanian Law.

Pursuant to the Mortgage Bonds Law, the issuer holds the assets on its balance sheet. The covered bond issuer holds the ownership title over the portfolio. A direct legal link between single cover assets and covered bonds does not exist. All obligations from bonds are obligations of the issuing bank as a whole. However, under the current law there is a legal link between each bond issue and its pool of cover assets. In the event of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved for the claims of holders of the specific bond issue.

Assets servicing may be outsourced, but for covered bonds it is expressly regulated only in case of the issuer's bankruptcy.

The covered bonds are direct and unconditional obligations of the issuer. The claims of the holders of covered bonds are secured by a first rank security interest over the cover assets, which are segregated in bankruptcy. Each bond issue is guaranteed by a distinct pool of assets. In the event of bankruptcy, the bonds holders in a specific issue will have first priority over the pool of assets dedicated to the specific issue.

This legislative provision regarding separate cover pools for each covered bond issue will be set aside in the amended Romanian covered bond legal framework, which is currently under preparation in Romania.

III. COVER ASSETS

In the case of covered bonds structured under the Mortgage Bonds Law, only mortgage loans (i.e. residential or commercial mortgage loans) can be included in the cover pool. The cover pool could be replenished with other mortgage loans if some of the pledged loans don't fulfil the eligibility criteria anymore. Other eligible assets (besides mortgage loans) will only be used for supplementing the cover pool if the issuer has no other mortgage loans that could be used for such a purpose. The list of these other eligible assets which can be included in a cover pool is to be established by the National Bank.

In terms of derivatives allowed to be included in the cover pool, no special provisions are contained in this respect in the Mortgage Bonds Law. However, the National Bank is entitled to regulate the categories of eligible assets that can be used for supplementing the cover pool in case the issuer has no other mortgage loans. The only restriction in this respect imposed by the Mortgage Bonds Law stipulates that the general maximum ratio allowed for supplementing the portfolio and the substitution of the mortgage loans in a cover pool with eligible assets may not exceed 20% of the portfolio value.

The mortgage loans must fulfil several eligibility or performance criteria imposed by the Mortgage Bonds Law in order to be included in the cover pool:

> The pool is homogenous comprising of only one type of mortgage loan according to its investment destination;

> The weighted average of the maturities of the mortgage loans included in the cover pool securing an issue is higher than the maturity of the mortgage bonds secured by such a cover pool; the weighted average of maturities shall be calculated by weighting the outstanding life time of the loans included in the cover pool with the nominal value of the loan as of the date of issue;

> The updated value of mortgage loans securing an issue of mortgage bonds has to be at least equal with the updated value of the payment obligations of the issuer towards the bondholders;

> The aggregated value of the mortgage loans secured with mortgages on properties with no constructions built on them and of those secured with mortgages on immovable assets in the process of being built does not exceed 20% of the value of the portfolio;

> Each mortgage loan in the cover pool meets the general eligibility criteria provided by this law and the performing criteria established through the prospectus;

> The nominal value of a mortgage loan does not to exceed, in case of a residential mortgage loan, 80% of the reference value of the immovable asset over which the security interest was created and, in case of a commercial mortgage loan, 70% of the reference value of the immovable asset over which the security interest was created;

> The amount representing the principal granted through a mortgage loan agreement has been fully disbursed to the beneficiary;

> The amount granted to a single beneficiary or to a single beneficiary and all affiliated persons of the beneficiary does not exceed 10% of the value of the cover pool;

> The receivables deriving from the mortgage loans are not subject to a security interest in favor of any other person;

> The mortgage loan must not register delayed payments exceeding 61 days; and

> The real estate over which a security has been created for the reimbursement of the mortgage loan is insured against all risks for an amount equal with the reference value of the immovable established on the date of the mortgage agreement.

In terms of geographical coverage, the sole restriction imposed under the Mortgage Bonds Law provides that, in order to be included in the cover pool, the mortgage loans should be granted for real estate investments on the territory of Romania or on the territory of member states of the European Union or the European Economic Area.

The Mortgage Bonds Law generally stipulates that the cover pool is static. The replacement of the mortgage loans included in the cover pool is prescribed as an obligation only when certain mortgage loans no longer comply with the eligibility criteria, have become non-performing in the meaning of this law or determine the reduction of the weighted average of the maturities of the mortgage loans included in the cover pool, of the value of the mortgage loans included in the pool or of the interest amount, according to the limits provided by law.

In the amended Romanian covered bond legal framework it is intended to have only two cover pools (a mortgage cover pool and a public sector cover pool), which will be dynamic.

Regarding the **disclosure requirements**, detailed information concerning the assets included in the cover pool has to be provided in the offering circular, such as: the value of the mortgage loans included in the cover pool; the reference value of the collateral created for the reimbursement of the mortgage loans as established at the conclusion of the collateral agreement against the nominal value of the issue; the interest coverage provided by the cover pool; geographical dispersion of the mortgage loans, maturity, interest, interest computational method and payment schedule as well as prepayment conditions under the respective mortgage loans.

The internal cover register shall contain detailed information on the cover pool and a separate section for registering the substitute assets included in the cover pool. The internal cover register shall be kept and filled in by the issuer with respect to any amendments or changes to the data since the initial registration.

IV. VALUATION AND LTV CRITERIA

Property valuation is regulated and is required to be undertaken by an authorized real estate appraiser. The reference for a property value is considered to be the market value as opposed to the mortgage lending value. Details about the valuation process and the qualifications of valuers are regulated by the Romanian Association of Evaluators (ANEVAR). The legal framework does not incorporate any special monitoring requirement.

The Mortgage Bonds Law stipulates limits for maximum LTVs on both commercial and residential loans at 70% and 80%, respectively. *These are absolute LTVs referring to the loans granted. No provision is made regarding a relative limit.*

The current draft of the amended Romanian covered bond legal framework stipulates a relative lending limit of 60% of the reference value of the collateral, so that mortgages may be used as cover only up to the first 60% of the value of the property. Also, it is under discussion if other LTVs ratios will be introduced (80% for residential mortgages, 70% for commercial mortgages).

V. ASSET - LIABILITY MANAGEMENT

The Mortgage Bonds Law stipulates that the net present value of the outstanding bonds must be covered at all times by the net present value of the assets and that the weighted average term to maturity of the assets should be higher than the bonds' maturity. The issuer can provide overcollateralization up to a maximum ratio of 20% of the cover pool value.

If any of these limits are breached, the bondholders may request that the bonds are immediately repaid, unless the breach is redressed within 30 days.

The amended Romanian covered bond legal framework will introduce details about the calculation of a stress-tested net present value, the liquidity needed and hedging with derivatives.

VI. TRANSPARENCY

In the current Romanian legal framework on mortgage covered bonds there are no provisions on transparency.

There are disclosure requirements only regarding the information to be provided in the offering circular and concerning the assets in the cover pool.

Under the amended legislation issuers of covered bonds would be obliged to prepare and publish quarterly reports on the total volume of the issued covered bonds and the structure of the two cover pools, including the nominal value of the receivables in the pools, their residual value and the structure of maturities of the receivables in the pool.

The supervisory authorities would be entitled to draft regulations regarding the content, the terms and publication of the quarterly reports.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Under the Mortgage Bonds Law, the activity of a mortgage bond issuer is monitored by the National Securities Commission (CNVM) and the National Bank (BNR). For mortgage bonds, the law provides for the mandatory appointment of an agent. The agents have to be authorised jointly by the National Securities Commission and by the National Bank. Initially, the agent shall be appointed by the issuer from a list of agents, approved by the National Bank (mandatory pre-requisite for the issuance of mortgage bonds). Upon subscription of the mortgage bonds by the investors, the revocation/appointment of the agent shall be made exclusively by the general meeting of bondholders.

The agent's main role is to monitor the cover pool on behalf of the bondholders. Its monitoring obligations shall be performed on a monthly basis, based on the synthetic documentation provided by the issuer. The agent has to observe issuer's compliance with the law and prospectus requirements. Based on the documentation provided by the issuer, the agent shall issue a certificate attesting the issuer's compliance with the provisions of the law and with the offering curricular regarding the cover pool structure. The agent shall be jointly and severally liable towards the bondholders with the issuer, with the financial investment services company handling the sale and with the issuer's financial auditor for the damages caused by non-fulfilment of several duties provided for under the law (including the obligation to monitor the issuer's compliance with the requirements related to the cover pool).

The qualification, role and duties of the agent will be clarified in the amended Romanian covered bond legal framework.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

A cover register allows for the identification of the cover assets for each issue. The issuer has the obligation to keep a cover register for each mortgage bond issue.

Registration in the cover register reflects the structure and dynamic of the portfolio at any time throughout the life of the issue. The cover register contains information with respect to each mortgage loan included in the cover pool (i.e. type: commercial or residential, beneficiary of the loan, immovable asset over which the security for reimbursement of the mortgage loan has been created, land book number, value of the mortgage loan and reference value of the immovable asset, any other collateral and its nominal value) and substitute assets.

Registration in the cover register triggers an obligation for the issuer to have a security interest, which is registered with the Electronic Archive and covers each and all assets registered in the register. These assets are specifically registered in the accounting books of the issuer and segregated from the estate of the issuer in the event of bankruptcy. The cover register is kept by the issuer and subject to checks by the agent and supervision by the National Bank of Romania.

Asset segregation

By registration of the security interest over the pledged cover assets and the entry into the internal cover register of the mortgage loans or other assets included in the cover pool, such assets are segregated from the other assets of the issuer. The segregation of the cover assets from the insolvent estate of the issuer is thus a consequence of a contractual pledge and the operation of the law.

After the launching of the insolvency proceedings, a special portfolio management company carries out the administration of the cover assets. The appointment of the cover pool manager is made by the general meeting of bondholders.

Impact of insolvency proceedings on covered bonds and derivatives

Mortgage bonds do not automatically accelerate when the issuing institution becomes insolvent, but the bondholders could be obliged to accept payments in advance, with the corresponding recalculation of their rights if the cash-flows in the cover pool allow that.

The amended Romanian covered bond legal framework will clarify the asset segregation provisions, set aside the de facto acceleration provision and will also clarify the regime of derivatives registered in the cover register.

Preferential treatment of covered bond holders

Mortgage bond holders enjoy preferential treatment as the law stipulates the separation of the cover assets from the insolvent issuer’s estate.

In the event that the cover assets of a specific issue are not sufficient to cover the payments of that issue, the Mortgage Bonds Law provides for a cross-subsidy principle amongst different issues of cover bonds of the respective issuer if there is a surplus after payment of all the obligations towards the bondholders in a specific issue. If the cover assets are not sufficient, the bondholders have an unsecured claim towards the bankrupt estate for the difference.

A moratorium on the insolvent issuer’s estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of covered bond holders.

A special insolvency procedure could be commenced against the cover pool only by the bondholders.

Access to liquidity in case of insolvency

After bankruptcy proceedings are opened, with the appointment of an asset management company as the cover pool administrator, the right to manage and dispose of the recorded assets is transferred to this company by law. Thus, the cover pool manager first has access to the cover assets and collects the cash flows according to their contractual maturity and pays the amounts due by the issuer to the bondholders.

There are no specific regulations expressly addressing the issue of voluntary overcollateralisation in insolvency. It may be argued that voluntary overcollateralisation is part of the cover pool with all legal consequences regarding segregation in the event of bankruptcy applicable to the respective pool.

The draft of the amended covered bond law stipulates minimum and maximum overcollateralization levels (minimum 2%, maximum –under discussion– 25%).

Sale and transfer of mortgage assets to other issuers

A bankrupt issuer cannot be liquidated until it has assigned the cover pool to another issuer. The portfolio of assets may be sold to other issuers in a transaction concluded after the launching of the bankruptcy proceedings if the liquidator’s report provides the sources from which the insolvent issuer may pay in full the amounts due to the bondholders and if the bondholders in each issue (if more than one) have decided in the general meeting of bondholders to accept payment in advance under the terms provided in the liquidator’s report.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The covered bonds issued under the Mortgage Bonds Law fulfil the UCITS 52(4) criteria. The law requires such bonds to be issued by a credit institution, which is subject by law to special public supervision designed to protect bondholders (i.e. supervision by the National Bank of Romania and respectively by the National Securities Commission) and provides coverage by law of the claims attaching to the bonds in the event of failure of the issuer, on a first priority basis for the reimbursement of the principal and payment of the accrued interest.

Covered bonds under the Mortgage Bonds Law also comply with the CRD Directive Annex VI, Part 1, Paragraph 68 a) to f).

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/99/Obligatiuni_Ipotecare_-_Mortgage_Covered_Bonds

3.24 RUSSIA

By Tim Lassen[1], EUROHYPO AG, Representative Office, Moscow

I. FRAMEWORK

One of the countries with the largest potential for mortgage securities is without any doubt Russia. Mortgage lending grew from RUB 152.5 bn (EUR 3.5 bn) in 2009, RUB 380.1 bn (EUR 9.4 bn) in 2010 to RUB 713.0 bn (EUR 17.1 bn) in 2011.[2] The completed housing construction in 2011 (62.3 m sqm) nearly reached the number of 2008 (64.0 m sqm).[3] It is the aim of the government, that housing mortgage lending shall have a GDP share of 7.2% (2015), 10.7% (2020) and 15.5% (2030).[4] Furthermore, in 2015, 50% of all housing mortgage loans shall be funded by mortgage obligations and other mortgage securities, 55% in 2020 and 66% in 2013.[5] Further measures to enhance housing finance and construction are foreseen in a presidential decree, enacted on the day of inauguration of the new president.[6]

Obviously, the country needs large investments in building of new and renovation of existing housing. All these investments need mortgage securities as funding tools.[7]

This article shall give an overview over the the legal framework for mortgage obligations. The legal basis is the Law on Mortgage Securities.[8] This law is supported by rules in the Mortgage law, the Bankruptcy law, the Credit organisations bankruptcy law and the Securities market law.

In addition, the Central Bank of the Russian Federation (CBRF) issued the Mortgage cover mandatory requirements instruction[9]. The Federal Financial Markets Service (FSFR) released:

> The Mortgage cover determination order[10];

> A joint order containing (i) the Special depositor decree and (ii) the Register maintenance rules[11]; and

> The Mortgage cover administrator/special depositor data reporting decree[12].

Further rules are in general regulations of the CBRF and the FSFR.

[1] Special thanks go to the collegues from AIZhK, DeltaCredit Bank and VTB Capital for proof reading and commenting on this article.

[2] Exchange rates of the Central Bank of the Russian Federation (CBRF) as of 31 Dec of the respective year.

[3] Numbers for mortgage lending and dwelling completion from Lyubimtseva, Anna: Russian Mortgage Market on the Up; EMF Mortgage. Info.03.2012, p 5,6.

[4] Schedule to the "Strategy for Development of Housing Mortgage Lending in the Russian Federation until 2030", confirmed by the government's order dated 19 July 2010, no 1201-r (SZ, 2010, No 30, item 4118) ("Housing Strategy").
The estimated GDP 2012 is USD 2,117.3 bn (EUR 1,568.0 bn) and USD 2,342.1 bn (EUR 1,734.5 bn) in 2013 (International Monetary Fund, World Economic Outlook Database, September 2011 (USD/EUR exchange rate of the European Central Bank as of 30 September 2011)).

[5] Schedule to the Housing Strategy.

[6] Decree of the President of the Russian Federation dated 7 May 2012 no 600 "On measures to secure for citizens of the Russian Federation affordable and comfortable housing and increasing the quality of the housing communal services" (SZ, 2012, no 19, item 2337).

[7] See as well: Lassen, Tim: Development of the Russian Mortgage obligation Market; EMF Mortgage.Info.04 (April).2012, p 5 – 7 and The Cover: "Russia aims to broaden market with tighter law"; May 04, 2012.

[8] A list of the legal framework is attached to the country report in ECBC Fact Book 2010, p 274 – 276.

[9] Instruction of the CBRF dated 31 March 2004 No 112-I "On mandatory requirements for credit organisations, issuing securities with mortgage cover".

[10] Order dated 1 November 2005 No 05-59/pz-n "On confirmation of the Decree on the method of determination of the mortgage cover".

[11] Order dated 1 November 2005 No 05-60/pz-n "On confirmation of the Decree on the activity of the special depositar for the mortgage cover and the Rules of the maintenance of the register of the mortgage cover".

[12] Order dated 15 December 2009 No 09-57/pz-n "On confirmation of the Decree on data reporting of the administrator of the mortgage cover and the Decree on data reporting of the specialised depositor of the mortgage cover"

II. STRUCTURE OF THE ISSUER

The Russian Law on Mortgage Securities foresees three types of securities:

- Two types of "mortgage obligations"[13] (art. 7 sec 1[14]): Obligations[15] issued

  a) by a credit organisation (mortgage obligations) or

  b) by a SPV ("mortgage agent") (MBS).

- Mortgage participation certificates (art 17 – 31). These certificates a similar to investment fund certificates, giving a direct share in the mortgage secured loans. Due to their different structure in this article we will not look after them.[16]

Obviously the mortgage obligations issued by credit organisations, are oriented on the European covered bond model, those mortgage obligations issued by SPVs on the MBS model. As many rules in the law apply similarly for both types of securities, for a better understanding they will be presented here together.

As a general rule, mortgage obligations are secured by basically static cover pools (other as dynamic cover pools in most other European countries[17]). Even if the Russian Law on Mortgage Securities allows several issues from one cover pool, the cover for every issue is static and can be modified only in some cases, stipulated by the law. Nevertheless, different from classic MBS structures, a dynamic element is implemented: For already issued mortgage obligations, permanently new mortgage secured claims have to be added, to secure the volume of the cover pool (art 13 sec 1 para 2).[18]

Credit organisations (art 7 sec 2)

A credit organisation has to comply with the Banking law and the rules, set up by the Central Bank for credit organisations. If the credit organisation does not fulfil the statutory requirements, the licence can be revoked (art 20 sent 1 no 10 Banking law).

By pt 2 and 3 Mortgage cover mandatory requirements instruction[19] the CBRF has set up special regulations for[20]:

- Minimal ratio between the cover pool and the equity of the credit organisation (N17): 10% (pt 2.3 Mortgage cover mandatory requirements instruction),
- Minimal ratio between the volume of the cover pool and the volume of the issued mortgage obligations (N18): 100 % (pt 2.4 Mortgage cover mandatory requirements instruction),
- Maximum ratio of all claims against the credit organisation, privileged before the mortgage obligation holders and the equity (N19): 50% (pt 2.5 Mortgage cover mandatory requirements instruction).[21]

[13] Language of the law: "Obligations with mortgage cover".

[14] Law citations without link are citations of the Law on Mortgage Securities.

[15] A special type of mortgage obligations are "Housing mortgage obligations" (in Russian "zhilishchnaya obligatsiya s ipotechnym pokrytiem"): Their cover pool consists only of claims, secured by mortgages over housing premises (art 3 pt 5).

[16] For details see: Gabov, Andrey V.: Tsennye bumagi (Securities), Moscow 2011, p 518 – 525.

[17] European Central Bank: Mortgage obligations in the EU Financial System, December 2008, p 7.

[18] This rule of adding new mortgage secured claimes to the cover pool to replace repaid cover mortgages may be abolished by a draft law (see below V. Asst-Liability Management).

[19] Instruction of the CBRF dated 31 March 2004 No 112-I "On mandatory requirements for credit organisations, issuing securities with mortgage cover", based on art 7 sec 2 para 1 and 2 Law on Mortgage Securities.

[20] On the bases of art 7 sec 2 para 2 – 4.

The Central Bank has not used its right to set a special limit for covered bond issuers of the interest rate and foreign exchange risk.[22]

SPVs (mortgage agents, art 8)

The mortgage agent has to be a joint stock company, its only task is the purchase of mortgage secured credits (loans) and issuance of mortgage obligations (art 8 sec 1 para 1). This has to be foreseen in its charter, theses parts of the charter cannot be changed or amended later (art 8 sec 1 para 4).

In the founding documents of the mortgage agent has to be stipulated the number of mortgage securities' issues, this agent is founded for. After this issuance(s), the mortgage agent has to be liquidated (art 8 sec 1 para 6).

A mortgage agent is not allowed to have employees. As executive organ a commercial organisation has to act, the bookkeeping has to be done by a specialized organisation (different from the executive organ organisation). If the commercial organisation, acting as executive organ, exercises transactions which are not on the list of allowed transactions, these transactions will be on account of the commercial organisation, not of the mortgage agent (art 8 sec 2).

The mortgage agent is not allowed to sign contracts against payment with physical persons or to perform commercial activities other than stipulated in the Law on Mortgage Securities. In case of breach of this rule, the FSFR may apply for liquidation of the mortgage agent (art 8 sec 3).

The FSFR has the right to set up rules on capital requirements, field of activities, bookkeeping and accounting of mortgage agents (art 43 sec 1).

According to a new draft law for mortgage agents, it shall be allowed to borrow money under loan/credit agreements for the purposes stated in its charter (i.e. bridge financing). A volunteer liquidation of a mortgage agent shall be only allowed after repayment of all outstanding mortgage obligations.[23]

[21] The ratios N17 and N19 are abolished by the Federal law "On declaration of loosing force of article 7 section 2 paragraph 2 and 4 of the Federal law "On mortgage securities"" dated 25 June 2012 No 83-FZ (published "Rossiyskaya gazeta", 27 June 2012, No 144; former draft law 495103-5). The changes come into force on 06 July 2012.

Motivation to abolish the ratio N17 is, that it hinders well capitalized banks to issue mortgage obligations (on balance mortgage obligations) as it sets a high minimum volume for obligations (Official Opinion of the government to the draft law, dated 6 July 2011, supported by the Conclusions of the Financial Markets' Committee of the State Duma as of 20 September 2011 and 24 January 2012).

Annulment of ratio N19 is motivated by the regulation of art 16.1 Law "On Mortgage Securities": In case of bankruptcy of the issuing credit organisation, the cover pool is excluded from the bankruptcy estate. Therefore there are no other privileged creditors. The Explanatory Memorandum of the authors of the draft dated 01 February 2011 explicitly names deposit holders – as they are mentioned in art 64 sec 1 para 6 Civil code (and art 50.36 sec 3 and 4 Credit organizations bankruptcy law) - as not privileged to the mortgage obligations' holders, as the cover pool is excluded from the general bankruptcy estate. This view of the Explanatory Memorandum is support by the Government of the Russian Federation (Official Opinion dated 6 July 2011) and the Conclusions of the Financial Markets' Committee of the State Duma as of 20 September 2011 and 24 January 2012.

Thus the question described in earlier editions of the ECBC Fact Book (see Country Report "Russia", 2011, p 332, fn 14) of the ranking between physical deposit holders and mortgage securities' holders is by the opinion of the government and the parliament's committee in charge solved in favor of the bond holders.

[22] But issuing credit organisations have to describe the f/x and the interest rate risk in the prospectus (annex 5 pt 3.5.3.2 and 3.5.3.3 Instruction 128-I/2006). For f/x risk see: Efimova, L. G.: Bankovskoe pravo (Banking law) – Tom (volume) 1, Moscow 2010, p 88 et seq.

[23] Draft law no 594840-5, adopted by the State Duma on 2 November 2011 in first reading, art 8 sec 1 para 3 and sec 4/new.

Protection of terms

Due to art 6 the words "obligation with mortgage cover" (in Russian "*obligatsiya s ipotechnym pokrytiem*"), mortgage participation certificate ("*ipotechnyj sertifikat uchastiya*"), mortgage cover ("i*potechnye pokrytie*"), mortgage agent ("*ipotechnyj agent*") and "mortgage specialized organisation" ("*ipotechnaya spezializirovannaya organisatsiya*")[24] may be used only for the purposes of the Law on Mortgage Securities.[25]

III. COVER ASSETS

Eligible assets under the Russian Law on Mortgage Securities are mortgage secured claims under a loan or credit agreement, including interest (art 3 sec 1). These secured claims may be certified by mortgage certificates ("*zakladnaya*", art 13 – 18 Mortgage law)[26] or mortgage participation certificates under the Law on Mortgage Securities.

Eligible are also money in Russian and foreign currency, state bonds and real estate (art 3 sec 1). Real estate can only be used as cover, if it is purchased in foreclosure of a cover mortgage (art 3 sec 1; 13 sec 1 para 3).

Requirements for eligible mortgage secured claims are:

> The mortgage shall content a prohibition on sale of the mortgaged property by the mortgagor without consent of the mortgagee (art 3 sec 2 pt 2).

> The property has to be insured to the benefit of the mortgagee for the whole term of the loan to an amount not less than the mortgage secured claim (art 3 sec 2 pt 3).

> The share of mortgage secured construction claims is limited to 10% of the cover pool (art 3 sec 3 para 3). For Housing mortgage obligations mortgage secured construction claims are not eligible (art 3 sec 3 para 1 sent 2).

> Claims, secured by a second ranking mortgage are eligible, as far as they do not exceed the LTV limit of 70% (art 3 sec 3 para 2).

One asset may only be used for one cover pool. A mortgage participation certificate cannot be part of the cover pool, where it represents a share in the mortgage secured claims. (Art 3 sec 5)[27]

IV. VALUATION AND LTV CRITERIA

Due to art 3 sec 2 para 2 the LTV limit is 80% of the market value of the property. If a second ranking mortgage is used for cover, the LTV limit is 70% of the market value (art 3 sec 3 para 2). In both cases, the valuation has to be made by an independent valuer.[28]

The law does not contain special regulations on valuation for the purpose of mortgage securities.

[24] "Mortgage specialized organization" is another allowed name for "mortgage agent" (art 8 sec 1 para 5).

[25] The words "Obligation with mortgage cover" have to be shown on the title page of a prospectus, the words "Housing obligations with mortgage cover" can be shown (pt 3.14 sec 1 and 2 Order FSFR No 06-117/pz-n/2006; annex 5 Instruction CBRF 128-I/2006).

[26] A mortgage certificate is only eligible, if it is not pledged for another purpose (art 3 sec 3 para 1).

[27] The cover pool itself is defined in legal literature as "specific type of property", sustaining of different elements but used as unitary "other property" according to art 128 Civil code, see Efimova, Olga V.: Ipotechnoe pokrytie kak osobyy vid imushchestva [Mortgage cover as specific type of property"], Yurist No 24/2011, p 19 – 22 (p 22).

[28] The valuers profession is regulated in the Valuation law.

V. ASSET-LIABILITY MANAGEMENT

Art 3 sec 4 stipulates, that the amount of the cover is defined by summing up the mortgage secured claims, amount of money in the cover and value of other assets.

Details are set up by the FSFR in the Mortgage cover determination order. The mortgage secured claims are defined as the outstanding capital and interest[29], as defined in the credit or loan agreement (pt 2.1 Mortgage cover determination order). The volume of the cover has to be accounted in RUB, as far as the mortgage securities are not nominated in foreign currency. If this is the case, the cover has to be accounted in the foreign currency. In both cases, for including cover assets, nominated in another currency than the accounting currency, in the calculation, the exchange rate of the CBRF of the calculation date has to be used. (Pt 2.5 Mortgage cover determination order)

The following claims shall not be encounted by summing up the mortgage cover:

- No payment made on the claim for more than six months;
- Loss of the mortgage object, including if the mortgage was declared void by a court;
- Secured obligation declared void by a court;
- Bankruptcy of the debtor; and
- No insurance of the mortgage object for more than six months.

Only in the above cases, and when the cover asset does not fit to the general rules for eligible claims, cover assets can be replaced by other assets (art 14 para 1; art 3 sec 4). Cover assets may be deleted from the cover pool in case of their exchange or sale or if the secured obligation is terminated (art 4 sec 1).

At the moment of submission of documents for state registration of the issue, the outstanding amount of the mortgage claims in the cover pool has to be not less than the nominal value of the mortgage obligations (art 13 sec 3 para 1).

The decision of the terms of issue of the mortgage obligations may stipulate an excess cover. In this case the excess cover has to be kept during the whole maturity of the mortgage obligations. (Art 13 sec 2 para 2 sent 2 and 3) For credit organisation the excess amount of the cover pool shall not be more than 20% (art 13 para 3 sec 2).

For proper performance of the obligations under the mortgage obligations[30], the amount of the cover pool for the whole maturity of the bonds shall not be lower than the aggregate outstanding nominal value of the bonds (art 13 sec 2 para 2 sent 1).

This is further defined in the Instruction 128-I/2006 of the CBRF, which foresees that the cover pool has to secure completeness of payment and timely payment[31] (pt 6.4.2 sent 8 Instruction 128-I/2006):

Completeness of payment is secured, when the amount of the cover pool on every day until repayment covers the amount (sum) of unfulfilled obligations under the mortgage securities (pt 6.4.2 sent 9).

[29] Mortgage obligations have to bear interest, to be paid at least once a year (art 10). Draft law no 594840-5 forsees, that in case of senior and junior tranches in an issue, this rule will be only adopted for the senior tranche (art 10 sec 2 sent 2/new).

[30] In Russian "nadlezhashchoe ispolnenie obyazatel'stv po obligatsiyam s ipotechnym pokrytiem".

[31] In Russian "polnota i svoevremenost' ispolneniya obyazatel'stv po obligatsiyam s ipotechnym pokrytiem".

Timely payment is secured, when

> At the starting date of the next period (coupon period), at the end of which the investors have to be paid the respective return (interest (coupon) return) the

a) amount of mortgage secured claims which have to be performed until this payment date,

b) together with the cash money and the value of the state securities in the cover pool,

> It covers the amount (sum) of the return to be paid to the investors at the end of the next period (coupon period) (pt 6.4.2 sent 10).

One cover pool can secure two or more issues of mortgage obligations (art 11 sec 2 para 1; 12 sec 2). In this case, the rules on calculation of the necessary cover for one issue apply similarly (art 11 sec 2 para 1). Among the two or more issues, the issuer may define an order of priorities: The performance of claims of one issue is only allowed after proper performance of the claims of the higher ranking issue(s) (art 11 sec 2 para 2 and 3). If mortgage securities are issued in several issues on the basis of one cover pool, the volume of the cover pool has to be not less than the nominal value of last priority rank and the foregoing ranks (art 13 sec 2 para 3).[32]

The decision on the issue shall define the maturity and denomination on the day of maturity (art 13 sec 3).

At least 80% of the cover pool has to be mortgage secured claims. If this ratio is lower than 80% within three months the issuer has to increase the share of mortgage secured claims. This can be done by obtaining new mortgage secured claims and/or by prepayment of outstanding mortgage obligations (art 13 sec 1 para 2).[33]

Money received from the repayment of the mortgage secured claims has to be included in the cover pool as far as this is necessary to fulfil the legal stipulations on the volume of the cover pool (art 13 sec 4).

The mortgage securities' holders have the right to claim for prepayment of the mortgage obligations in the following cases (art 16): Breach of the rules regarding[34]:

> Volume of the cover pool;

> Replacement of cover assets;

> Proper fulfilment of obligations under the mortgage obligations;

> The issuer is active in fields not allowed for it; and

> Other reasons stipulated by the decision on issuing mortgage obligations.

[32] Draft law no 594840-5 foresees, that the rule, that for all tranches at any time the cover rules are fulfilled, can be excluded for the junior tranch by the decision on the issue (art 11 sec 2 para 1; 13 sec 6/new).

[33] Draft law no 594840-5 aimes to abolish this rule (cancellation of art 13 sec 1 para 2). Under the new regulation only at the moment of formation of the cover pool, it has to sustain for 80% out of mortgage loans. After issuing the bonds, due to amortisation of the cover pool, this share will reduce. To avoid the consequence of necessary prepayment of the issue, and the risk that potential new cover mortgage loans will not fit to the parametres, the draft will allow to keep the money from regular repayments of the mortgages as eligible cover assets for a share of up to 100% of the cover pool. See pt 5 Explanatory Memorandum of the authors of the draft dated 19 August 2011.

[34] Draft law no 594840-5 is to introduce a time limit of 30 days from the moment of disclosure or information about the breach, differentiated by tranches with different rights (art 16 sec 1 sent 2; sec 2; sec 3 and sec 4/new).

VI. TRANSPARENCY

The Law on Mortgage Securities stipulates a wide range of information to be published on the mortgage obligations by the issuer (art 37 – 41). In addition to the main rules, according to the Securities market law (art 37 para 1; 40 sec 1) an important information is an account report on performance of the cover assets (art 40 para 4 sec 2). Credit organisations issuing mortgage obligations have special reporting duties to the Central bank (art 7 sec 1 para 3; pt 3.1 – 3.5 Mortgage cover mandatory requirements instruction).[35]

Main points for publishing information are:

> If the mortgage obligations are rated by a rating agency, this rating has to be published (art 37 para 2).

  Interested people have the right to get information on the cover register (art 39 para 1).[36] The issuer is obliged to allow all interested people to access the information contained in the cover register.[37] After obtaining the state registration of the issue, the issuer is obliged to publish the cover register as of the registration for a term of three months on its internet site (pt 10.3.4 sec 1 and 2 Order FSFR No 06-117/pz-n/2006).

  The regulators set up further special rules for mortgage obligation issuers in the general acts on disclosure of information.[38] Issuers of mortgage securities have – in addition to the general requirements – to disclose quarterly (i) information that might have significant influence on the value of the mortgage securities and (ii) information contained in the cover register and the note on the volume of the securities' cover pool.[39]

> If the issuer is a credit organisation, it has to give in the prospectus information on fulfilment of the special ratios for mortgage securities' issuers, set up by the Central Bank.[40]

  Mortgage securities qualify as secured bonds.[41] The pledge over the cover pool has to be named as security for the bonds.[42]

The prospectus has as well to show information on the specialized depositar, on the planned issues and fulfilment of the cover mortgage assets, on insurance of the issue and a servicing agent (both if applicable) and composition, structure and volume of the cover pool[43], also information on the structure of the mortgage secured claims[44]. Similar information has to be shown in the quarterly data report.[45]

[35] Instruction of the CBRF dated 31 March 2004 No 112-I "On mandatory requirements for credit organisations, issuing securities with mortgage cover".

[36] The cover register contains information on the mortgage claims on the loan-level basis (art 5).

[37] For credit organisations as issuers explicitly stipulated in pt 14.5 Instruction CBRF 128-I/2006.

[38] FSFR: Order No 06-117/pz-n/2006 and Order No 07-4/pz-n/2007. Central Bank: Instruction No 128-I/2006.

[39] Pt 10.1.1; 10.3.5 Order FSFR No 06-117/pz-n/2006

[40] Annex 5 pt 5.2 sec 4 Instruction CBRF 128-I/2006.

[41] In Russian: "Obligaciya s obespecheniem". Pt 6.4 Instruction 128-I/2006.

[42] Annex 8 pt 10.3.2 sec 2 subsec 14; annex 8 pt 10.5 Order FSFR No 06-117/pz-n/2006; pt 6.4.2 Instruction CBRF 128-I/2006. As well in the prospectus: Annex 5 pt 10.3.2 sec 13 FSFR Instruction 128-I/2006.

[43] Annex 8 pt 9.1.5.1 – 9.1.5.5; annex 8 pt 10.5.1 Order FSFR No 06-117/pz-n/2006; annex 5 9.1.5.1 – 9.1.5.5 (publishing information on the issued securities) and – regarding depositar, insurance, service agents and cover pool - pt 10.5.1 lit a – g (publishing information on the issuing credit organisation) Instruction CBRF 128-I/2006.

[44] Annex 8 pt 10.5.1 sec 2 no 2.2; pt 3 -5 Order FSFR No 06-117/pz-n/2006; annex 5 pt 9.1.5.5 lit g – zh (publishing information on the issued securities) and pt 10.5.1 lit g no no 2.2 – 5 (publishing information on the issuing credit organisation) Instruction CBRF 128-I/2006.

[45] Annex 10 pt 8.5; 8.5.1 Order FSFR No 06-117/pz-n/2006.

The mortgage securities can only be distributed, after the issuer made the access to the information in the cover register possible, in line with the Law on Mortgage Securities.[46]

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Cover Pool Monitor

The cover pool is controlled by a cover monitor (the "specialized depositar of the mortgage cover"[47]), art 33 sec 1. The cover monitor has to be a commercial organisation[48], licensed for (i) activity as special depositary for investment funds, non-state pension funds and on the securities market as well as for (ii) performance of depositary activities on the securities' market (art 32 para 2). The FSFR has published the Special depositar decree.

The specialized depositar is acting on the bases of a contract with the issuer (pt 1.2 Special depositar decree). The monitor is acting solely in the interests of the holders of mortgage securities (art 35 para 1). He is controlled by the FSFR (art 43 sec 1 pt 7, sec 2 para 1) and is obliged to inform the FSFR on breaches of the Law on Mortgage Securities (art 35 para 3; pt 4.14 Special depositar decree) and on the elimination of breaches (pt 4.15; 4.16 Special depositar decree).

Task of the cover monitor is to control the fulfilment of the Law on Mortgage Securities and other corresponding legal acts (art 34 sec 1 para 1). He has to determine the volume of the cover pool (4.5 sec 1 Special depositar decree) and sign the prospectus (pt 12.4 sec 6 Instruction CBRF 128-I/2006). One cover pool may be only administrated by one monitor (art 33 sec 3 para 1).

Every cover monitor has to implement a reglament[49], to be registered by the FSFR, describing the procedure of control, of schedule and time frames for registration in the cover register, disposal of cover assets and the overall course of working (pt 2 Order FSFR No 05-60pz-n/2005). The reglament also stipulates the rules for the exchange of documents between the issuer, the specialized depositar and mortgage securities' holders (pt 1.4 Register maintenance rules).

For the cover monitor it is forbidden to give his consent to disposal of cover assets (including cash collateral), if this disposal is in contradiction to the Law on Mortgage Securities or other legal acts (art 34 sec 1 para 3).[50]

The cover monitor is obliged to (art 35 sec 2):

- > Safekeeping of the documents confirming the mortgage secured claim (pt 2.1 – 2.3; 3.1 – 3.5 Special depositar decree),
- > Deciding on consents for the disposal of cover assets (pt 2.4 Special depositar decree),[51]

[46] Pt 6.7.4.1 Order FSFR No 07-4/pz-n/2007.

[47] In Russian "spetsializirovannyj depozitariy ipotechnogo pokrytiya".

[48] Not affiliated with the issuer (art 33 sec 3 para 2).

[49] In Russian "reglament spetsializirovannogo depozitarya".

[50] In case of non-fulfillment of these tasks the cover monitor has a shared responsibility with the issuer in front of the mortgage obligations' holders (art 34 sec 2).

[51] Consents to disposals have to be registered in the recording journal for disposal consents (in Russian "uchëtnyy zhurnal o vydache soglasiya na sovershenie sdelki"), pt 2.4 Special depositar decree.

> Submission of data information to the FSFR,[52]

> Information of the mortgage securities' holders of their right to claim for prepayment of the mortgage obligations according to art 16 (pt 4.7 Special depositar decree).

For safekeeping e. g. mortgage certificates, evidencing a mortgage secured claim, have to be kept by the depositar (pt 3.4 sec 2 Special depositar decree).

For including assets into the cover the cover pool monitor has to control, e. g. if the assets are eligible under the Law on Mortgage Securities, if the issuer is the holder of the claim and if the mortgage is registered (pt 4.2 Special depositar decree). The accordance of the cover pool structure with the Law on Mortgage Securities has to be verified by the monitor daily (pt 4.3; 4.4 Special depositar decree).

The payment of the monitor can be done on the account of the cover pool. Nevertheless the rules on necessary volume of the cover pool have to be observed. (art 13 sec 5)

The monitor has also to control the payment of other costs, which have to be borne by the cover pool (e. g. for the specialized depositar, for the registrar of bearers securities etc.). This includes also controlling the amount of the costs. (Pt 4.11; 4.12 Special depositar decree)

The monitor may insure his responsibility in front of the mortgage obligation holder on his own account (art 36).

Cover register

Cover assets have to be registered in a "register of mortgage cover"[53] (art 5). The FSFR has adopted Register maintenance rules.

The register of mortgage cover is maintained by the cover monitor (art 33 sec 1). Maintenance means, among others, bringing in entries in the register, granting of information from the register and safekeeping of documents (pt 1.2 Register maintenance rules).

Cover assets are enclosed in the cover pool by bringing in a respective entry[54] in the cover register (pt 4.1 Register maintenance rules). Basis for the entry is a disposition[55] of the issuer (pt 4.2 Register maintenance rules). Simultaneously with a new entry, the cover pool monitor has to register the value of the mortgage cover[56] (pt 3.8 Register maintenance rules).[57]

Within three working days the entry in the cover register has to be done or the issuer has to be informed about a refusal of entry by the monitor (pt 4.20 – 4.22 Register maintenance rules).

The cover register itself has to contain information on the issuer (pt 3.1 Register maintenance rules) and on the different types of cover assets (pt 3.2 Register maintenance rules).

[52] The FSFR adopted for this purpose the Mortgage cover special depositor data reporting decree. The data has to be provided to the FSFR quarterly (pt 3 Mortgage cover special depositor data reporting decree).

[53] In Russian "reestr ipotechnogo pokrytiya".

[54] In Russian "zapis'".

[55] In Russian "rasporyazhenie". Documents to be added to the disposition are named in pt 4.9 Register maintenance rules.

[56] This has to be done also when changes to the cover assets are entered into the cover register. For these entries regarding the mortgage cover value a disposition of the issuer is not necessary (pt 6.3 Register maintenance rules). Details are foreseen in the Mortgage cover determination order.

[57] Similar rules exist for deletion (pt 5.1 – 5-11 Register maintenance rules) and replacement (pt 6.1 – 6.9) of cover assets.

A copy of the register has to be given to the issuer monthly (pt 7.2), to state authorities on request (pt 7.3).

Register maintenance ends – based on the disposition of the issuer – in cases, when the issue will not take place or when all mortgage securities have been repaid (pt 1.9 Register maintenance rules).

Supervision

State regulation of issuing mortgage securities is done by the FSFR in co-ordination with the Central Bank of the Russian Federation (art 42).

Banks, issuing mortgage securities, are supervised by the Central Bank (art 7 sec 2), mortgage agents are by the FSFR (art 43 sec 2).

Issuing of mortgage obligations

Normally the volume of possible issues of securities is limited to the amount of the charter capital and/or the amount of security provided by third parties. Obligations (bonds) with mortgage cover are exempt from this rule.[58]

For issuing securities, Russian law foresees a four step process:[59] (i) Decision on issue[60], (ii) state registration of issue, (iii) distribution of securities and (iv) state registration of the report on results of the issue.[61] For these general steps the FSFR and the CBRF set up special requirements for the issue of mortgage securities.

The decision on the issue[62], taken by the issuer, has to show, that the issuer is a credit organisation,[63] contain information of the security for the bonds,[64] of composition, structure and volume of the cover pool[65], procedure for exclusion and replacement of cover assets[66], on the special depositar[67], on the bonds[68], insurance of the issue and service agents (if applicable)[69] and procedure of prepayment[70]. The decision has to foresee interest payments to the investors, not less than once a year[71] and can foresee

[58] Restrictions by art 102 sec 2 subsec 2 sent 3 Civil code; art 27.5-4 sec 3 subsec 1 Securities market law; art 33 sec 3 sent 3 JSC law and art 31 sec 2 sent 3 LLC law do not apply for the issuance of mortgage obligations.

[59] Pt 2.1.1 Order FSFR No 07-4/pz-n/2007.

[60] The decision sustains of two parts: Taking the decision and approval of the decision.

[61] In Russian: (i) "Reshenie o vypuske" (sustaining of: "prinyatie resheniya" and "utverzhdenie resheniya", (ii) "gosudarstvennaya registraciya vypuska", (iii) "razmeshchenie obligaciy", (iv) "gosudarstvennaya registraciya otchëta ob itogakh vypuska".

[62] The form of the decision is stipulated in annex 4 (7) Order FSFR No 07-4/pz-n/2007; for credit institutions: Annex 4, esp. pt 10.6.2.3 Instruction CBRF 128-I/2006.

[63] Pt annex 4 Pt 10.6.1 sec 5 Instruction CBRF 128-I/2006.

[64] The pledge over the cover pool (pt 6.7.2.2 lit a – n Order FSFR No 07-4/pz-n/2007; annex 4 pt 10.6.2.3 no 1 Instruction CBRF 128-I/2006), including description of the procedure, how investors can foreclose into the cover pool (pt 6.7.2.2 lit m Order FSFR No 07-4/pz-n/2007; annex 4 pt 10.6.2.3 no 8 Instruction CBRF 128-I/2006).

[65] The cover register as of the date of the decision's confirmation has to be added (pt 6.7.2.3 lit a Order FSFR No 07-4/pz-n/2007; annex 4 pt 10.6.4.2 Instruction CBRF 128-I/2006).

[66] Pt 6.7.2.4 Order FSFR No 07-4/pz-n/2007. The replacement procedure shall contain a regulation, that purchase of a mortgage security by an investor means also giving the consent to this procedure (pt 6.7.2.4 sec 7). Similar regulations in annex 4 pt 10.6.2.3.2 Instruction CBRF 128-I/2006.

[67] Pt 6.7.2.5 Order FSFR No 07-4/pz-n/2007; annex 4 pt 10.6.2.3.3 Instruction CBRF 128-I/2006.

[68] E. g. number of issues, number of bonds, volume of interest and maturity, pt 6.7.2.6 Order FSFR No 07-4/pz-n/2007; annex 4 pt 10.6.2.3.4 Instruction CBRF 128-I/2006.

[69] Pt 6.7.2.7; 6.7.2.11 Order FSFR No 07-4/pz-n/2007; annex 4 pt 10.6.2.3.5 and 10.6.2.3.6 Instruction CBRF 128-I/2006.

[70] 6.7.2.8 Order FSFR No 07-4/pz-n/2007.

[71] 6.7.2.9 Order FSFR No 07-4/pz-n/2007; annex 4 pt 13.2.5 Instruction CBRF 128-I/2006.

costs to be paid from the cover pool[72]. On the first page of the decision has to be written “Obligations with mortgage cover”, it has to be signed by the special depositar.[73] The prospectus has to be signed as well by the auditors and – if stipulated by the FSFR – the independet valuer, to prove true the authenticity in the respective parts of the prospectus (pt 12.4 para 2 Instruction CBRF 128-I/2006).

For state registration of the issue the contract with the special depositar and the notes of the special depositar on overall volume (sum) of mortgage secured loans and on the volume of the mortgage cover[74] (on the date of presentation) have to be presented.[75] Credit organisations also have to present the fulfilment of the mandatory requirements of the CBRF and the coverage regulation according to art 13 Law on Mortgage Securities.[76]

The state registration has to be refused, when the cover pool is not in line with the Law on Mortgage Securities, especially not able to secure the fulfilment of the claims of the bond holders and when no right to interest payments at least once a year is foreseen.[77] For credit organisations additional reasons to refuse the registration are the non fulfilment of the CBRF mandatory requirements for credit organisations, issuing mortgage securities and the coverage rules according to art 13 Law on Mortgage Securities an the day of approval of the issue.[78]

For state registration of the results of the issue a copy of the cover register and a note of the specialized depositar on the volume of the cover pool, a note from the issuer on obeying the rules to secure the due performance of the obligations under the mortgage securities[79], all as of seven days before applying, but later than the factual end of the distribution, and evidence on publication of information have to be presented.[80] Credit organisations have to show as well fulfilment of the CBRF mandatory rules for credit organisations, issuing mortgage securities and the coverage regulations according to art 13 Law on Mortgage Securities.[81]

The state registration has to be refused, if based on changes in the cover register the cover assets are not securing the proper performance of the mortgage securities.[82] For credit organisations the state registration has to be refused as well in case of non fulfilment of the mandatory requirements of the CBRF for credit organisation, issuing mortgage securities and the coverage regulations according to art 13 Law on Mortgage Securities.[83]

[72] E. g. for the special depositar, administration costs for the cover pool. The costs have to be set in a fix number or in a procedure, how to assess it later. Pt 6.7.2.12 Order FSFR No 07-4/pz-n/2007.

[73] Pt 6.7.2.12; 6.7.2.14 Order FSFR No 07-4/pz-n/2007; pt 12.4 para 6, annex 4 part A Instruction CBRF 128-I/2006.

[74] In Russian: “Spravka o sovokupnom razmere (summe) obespechenykh ipotekoy trebovaniy” and “spravka o razmere ipotechnogo pokrytiya”.

[75] Pt 6.7.3.1 Order FSFR No 07-4/pz-n/2007; pt 13.3 sent 2 sec 1 and 2 Instruction CBRF 128-I/2006.

[76] Pt 13.3 sent 2 sec 3 and 4 Instruction 128-I/2006.

[77] Pt 6.7.3.3 Order FSFR No 07-4/pz-n/2007; pt 13.10 sent 2 sec 3 and 4 Instruction CBRF 128-I/2006.

[78] Pt 13.10 sent 2 sec 1 and 2 Instruction CBRF 128-I/2006.

[79] This note has to contain information on the volume of non performing obligations under the mortgage securities and the respective amount of cover, pt 6.7.5.1 sec 4 Order FSFR No 07-4/pz-n/2007.

[80] Pt 6.7.5.1 Order FSFR No 07-4/pz-n/2007.

[81] This has to include notes on completeness of payments and timely payment, annex 8 I B pt 8 sec 2 Instruction CBRF 128-I/2006.

[82] Pt 6.7.5.2 Order FSFR No 07-4/pz-n/2007.

[83] Pt 16.18 sent 2 sec 11 Instruction CBRF 128-I/2006.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF MORTGAGE OBLIGATIONS REGULATED

The claims of the mortgage securities' holders are secured by a pledge over the cover pool (art 11 sec 1).

Asset segregation

In case of bankruptcy the cover pool is excluded from the bankruptcy estate of the issuer (art 16.1 para 1 Law on Mortgage Securities; 131 sec 2 Bankruptcy law; art 50.35 sec 2 and 4 Credit organizations bankruptcy law).

The insolvency administrator is obliged to open special bank accounts for the cover pool to collect the money paid on the mortgage secured claims or from realization of these claims and to make payments to the mortgage obligations' holders (art 133 sec 4 Bankruptcy law). A special administrator of the cover pool, different from the insolvency administrator of the general bankruptcy estate is not foreseen.

Impact of insolvency proceedings on Mortgage obligations

The Law on Mortgage Securities stipulates two possibilities of realization of the cover pool in case of bankruptcy of the issuer (art 16.1 para 2):

> Change of the issuer ("zamena ėmitenta obligaciy s ipotechnym pokrytiem"): The cover pool will be sold with the obligation for the buyer to fulfil all conditions of the decision on issuing the mortgage obligations. Details have to be stipulated by a federal law. This federal law has not been enacted yet.

> Selling of the cover pool ("prodazha ipotechnogo pokrytiya"): The cover pool assets will be sold and the money received will be distributed among the mortgage obligations' holders.

The decision which type of realization will be used is made by the bankruptcy administrator (art 16.1 para 3). After adjudication in bankruptcy the exchange of cover assets in the cover pool is forbidden (art 16.1 sec 4).

Costs in connection with the realization, including payment of the bankruptcy administrator, will be covered out of the cover pool in accordance with the Bankruptcy law (art 16.1 para 8).

Preferential treatment of mortgage obligations' holders

Mortgage obligations' holders enjoy preferential treatment as the Russian law stipulates the separation of the cover pool from the general insolvency estate of the issuer (art 16.1 para 1 Law on Mortgage Securities; 131 sec 2 Bankruptcy law; art 50.35 sec 2 and 4 Credit organizations bankruptcy law).

In case they are not satisfied in the realization of the cover pool, the mortgage obligations' holders may ask for satisfaction from the general bankruptcy estate of the issuer (art 16.1 sec 1 para 3).

They also enjoy a preferential treatment against deposit holders, as the cover pool – securing mortgage obligations – is excluded from the general bankruptcy estate – securing depositors on a preferential basis.[84]

[84] See the Explanatory Memorandum of the authors dated 01 February 2011, the Official Opinion of the Government of the Russian Federation dated 6 July 2011 and the Conclusions of the Financial Markets' Committee of the State Duma as of 20 September 2011 and 24 January 2012 to the Federal law dated 25 June 2012 No 83-FZ.

Access to liquidity in case of insolvency

Change of issuer

Details have to be stipulated in a federal law (art 16.1 sec 2 para 2).

Selling the cover pool

In this case further liquidity is not needed, as the claims of the mortgage obligations' holders are becoming due, the cover assets are sold and the return is used to satisfy the bond holders' claims.

Sale and transfer of mortgage assets to other issuers

Change of issuer

Details have to be stipulated in a federal law (art 16.1 sec 2 para 2).

Selling the cover pool

The process of "selling the cover pool" is described in detail in art 16.2.

The bankruptcy administrator has to sell the cover assets not later than nine month after the adjudication in bankruptcy (art 16.2 sec 1). The assets have to be sold under the rules of the Bankruptcy law (art 16.2 sec 2). If the mortgage obligations have been issued with different priorities, the claims will be satisfied in these priorities (art 16.2 sec 3 para 2).

Cover assets or proceeds from their sale, remaining after the satisfaction of the claims of all mortgage securities' holders and of the costs of realization will be included in the general bankruptcy estate of the issuer (art 16.2 sec 4).

Enforcement into the cover pool

The Russian Law on Mortgage Securities gives to the mortgage obligations' holders the right to foreclose into the cover pool, based on the pledge over the cover pool assets. This is stipulated by law (art 15) and further described in the bylaws, set up by the CBRF[85] and the FSFR[86].

If the issuer does not or not properly fulfil his obligations in front of the holders of the mortgage obligations, the holders have the right for enforcement into the cover pool based on a court decision.[87] As the cover pool is pledged to the mortgage obligations' holders, the rules on the Mortgage law apply to this foreclosure and realisation, as far as special regulations in the Law on Mortgage Securities do not exist.[88]

The realisation of the cover pool is in detail described in the ECBC Fact Book 2011, p 342, 343.

[85] Pt 6.4.3; annex 4 B pt 10.6.2.3 no 8 and 9 Instruction CBRF 128-I/2006.

[86] Pt 6.7.2.1 lit m and n; annex 4 (7) B pt 12.2.1 lit k and l Order FSFR No 07-4/pz-n/2007.

[87] Art 15 sec 1 para 1 Law on Mortgage Securities. Due to pt 6.7.2.1 lit m para 1 and annex 4 (7) B pt 12.2.1 lit k para 1 Order FSFR No 07-04/pz-n/2007 this has to be shown in the decision on the issue. Pt 6.4.3 para 1 Instruction CBRF 128-I/2006 stipulates differing, that the cover is subject to realisation, when a bondholder claims for this in written form, sent to the issuer and the person, named in the decision on the issue as person, being in charge for realisation. Annex 4 B pf 10.6.2.3 no 8 para 1 Instruction CBRF 128-I/2006 stipulates, that the decision on the issue has to show, that the enforcment has to be based on a court decision.

[88] Art 15 sec 1 para 2 Law on Mortgage Securities.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

No special treatment for mortgage obligations is foreseen.

Russian mortgage obligations (mortgage obligations, issued by credit organisations) comply with the requirements of Article 52(4) UCITS and partly with those of the Directive of the business of credit institutions[89], Annex VI, Part 1, Paragraph 68 a) to f) and the ECBC Label Convention; where the only exclusion is, that Russia is not a member state of the European Union (EU) or the European Economic Area (EEA).

Art 52 sec 4 UCITS

Bonds are issued by a credit institution which

1. *has its registered office in a EU/EEA Member State.*

   Bank mortgage obligations are issued by a credit institution (art 7 sec 1),

   Registered office in a Member State: Not applicable.

2. *is subject by law to special public supervision designated to protect bond holders,*

   Credit organizations, issuing mortgage obligations, are supervised by the Central Bank and have to fulfill additional requirements (art 7 sec 2).

   State regulation of issuing mortgage obligations is done by the FSFR in co-ordination with the Central Bank (art 42).

   The FSFR can set up further rules (art 43 sec 1) and conduct on-site inspections in the premises of the issuer and the cover monitor (art 43 sec 2).

3. *in particular, sums deriving from the issue of those bonds shall be invested in accordance with the law in assets which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds*

   The cover pool has to sustain for 100% of eligible assets (art 7 sec 2 para 3; pt 2.4 Mortgage cover mandatory requirements instruction: Minimal ratio between the volume of the cover pool and the volume of the issued mortgage obligations: 100%).

   Money received from the repayment of mortgage secured claims in the cover pool has to be included into the cover pool as far as this is necessary to fulfil the legal stipulations on the volume of the cover pool and – if applicable – higher conditions in the decision on the issue (art 13 sec 4).

   For already issued mortgage obligations, permanently new mortgage secured claims have to be added, to secure the minimum 80% share of mortgage Secured claims in the cover pool[90] (art 13 sec 1 para 2).

4. *and which, in the event of failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of accrued interest.*

[89] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, Official Journal L 177 as of 30 June 2006. Detailed analyses to be published later.

[90] Another possibility to secure the 80% is prepayment of outstanding mortgage obligations (Art 13 Sec 1 Para 2).

In case of bankruptcy the cover pool is excluded from the bankrutcy estate of the issuer. The Law on Mortgage Securities describes two possibilities for realization of the cover pool in this case: (1) Change of the issuer and (2) selling of the cover pool.[91]

The ECBC Label Convention[92]

1. Legislation safeguards

   a. *The Covered Bond programme is embedded in a dedicated national Covered Bond legislation;*

   Bases is the Federal law "On Mortgage Securities" and other detailed regulations.[93]

   b. *The bond is issued by - or bondholders otherwise have full recourse, direct or indirect[94], to - a credit institution which is subject to public regulation and supervision;*

   Bank mortgage obligations (mortgage obligations) under Russian law are issued by credit organisations.

   c. *The obligations of the credit institution in respect of the cover pool are supervised by public supervisory authorities.*

   State regulation of issuing mortgage obligations is done by the FSFR in co-ordination with the Central Bank of the Russian Federation (art 42).

   Banks, issuing mortgage obligations, are supervised by the Central Bank (art 7 sec 2), mortgage agents are by the FSFR (art 43 sec 2).

   Furthermore the cover monitor is acting solely in the interests of the holders of mortgage securities (art 35 para 1). He is controlled by the FSFR (art 43 sec 1 pt 7, sec 2 para 1) and is obliged to inform the FSFR on breaches of the Law on Mortgage Securities (art 35 para 3; pt 4.14 Special depositar decree) and on the elimination of breaches (pt 4.15; 4.16 Special depositar decree).

2. Security features intrinsic to the Covered Bond product

   a. *Bondholders have a dual claim against:*

      i. *The issuing credit institution as referred at the point 1 b);*

      Mortgage secured obligations are obligations in the meaning of art 816 Civil code: It states the fact of a loan agreement and proofs the right of its holder to get from the issuer in the agreed time principal and agreed interest.

      ii. *A cover pool of financial assets[95] (mortgage[96], public sector or ship assets), ranking senior to the unsecured creditors.*

[91] Art 16.1; 16.2 Law on Mortgage Securities; 131 sec 2 Bankruptcy law; 50.35 sec 2 and 4 Credit institutions bankruptcy law. For details please see chapter VIII.

[92] http://j7.agefi.fr/documents/liens/201110/10-tqjxqkt1pof7p5d.pdf <http://j7.agefi.fr/documents/liens/201110/10-tqjxqkt1pof7p5d.pdf

[93] See country report "Russia" in the ECBC Fact Book 2010, p 274 – 276.

[94] Including pooling models consisting only of covered bonds issued by credit institutions.

[95] The financial assets eligible for the cover pool (inclusing substitution asets and derivative instruments) and their characteristics are defined in the national covered bond legislation which complies with the requirements of Article 52(4) of the UCITS Directive.

[96] This includes French guaranteed housing loans eligible under the French CB legislation and Finnish housing companies' loans eligible under the Finnish CB legislation.

The cover pool secures the mortgage obligations in case of bankruptcy of the issuer (see chapter VIII). If the issuer does not or not properly fulfil his obligations in front of the holders of the mortgage obligations, the holders have the right for enforcement into the cover pool based on a court decision (art 15).

Eligible assets and their characteristics are defined in the Law on Mortgage Securities (see detailed description above: III. Cover Assets; IV. Valuation and LTV Criteria).

Art 52 sec 4 UCITS is fulfilled (apart from Russian EU or EEA membership).

b. *The credit institution has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times.*

At the moment of state registration of the issue, the volume of the cover pool has to be not less than the nominal value of the mortgage obligations (art 13 sec 3 para 1). For already issued mortgage obligations, permanently new mortgage secured claims have to be added, to secure the volume of the cover pool (art 13 sec 1 para 2).

c. *Issuers are committed to providing regular information enabling investors to analyse the cover pool, following the guidelines developed at national level.*

For the details on transparency rules under Russian law see above: VI. Transparency.

X. ADDITIONAL INFORMATION: INVESTMENT REGULATIONS

The EU investment regulations for mortgage obligations are not transferred into Russian law. Nevertheless different investment rules and privileges for mortgage securities exist. In any case, the investment rules always include further requirements for mortgage securities to be eligible for investment[97] and the CBRF's Lombard list[98].

Taxation of Mortgage Obligations

For interest paid on mortgage obligations issued before 1 January 2007 tax privileges have been introduced: For physical persons the income tax rate is 9% instead of 13%, for legal persons 9% instead of 20%.

For interest income from mortgage obligations issued after 1 January 2007 the same privilege as for state bonds applies: 15% instead of 20%.[99]

Special tax regulations are foreseen for mortgage agents.[100]

Risk weighting of Mortgage Obligations

Banks, investing in mortgage obligations, enjoy a risk weighting privilege: Mortgage obligations are weighted with 100% instead of 150% for other bonds. The same rule applies for foreign securities with mortgage cover. Risk weighting for federal state bonds is 0%.[101]

[97] For details, see ECBC Fact Book 2010, p 269 – 271 (regarding pension funds, investment funds, insurance companies and other institutional investors).

[98] For details, see ECBC Fact Book 2011, p 343, 344.

[99] Art 224 sec 5; 284 sec 4 para 1 and 2 Tax code of the Russian Federation.

[100] Art 259 pt 18; 251 sec 1 pt 29 Tax code of the Russian Federation.

[101] Pt. 2.3.4, Schedule 1 Designation code "8815" General mandatory requirements instruction (CBRF Instruction No 110-I dated 16 January 2004). For state bonds cl. 2.3.1, code 8902 of the named Instruction.

Purchase Programs for Mortgage Obligations

VEB

The state owned development bank VEB has initiated the "Program for Investments in Projects of Construction of Affordable Housing and Mortgage for the Years 2010 – 2013", which contains a purchase program for mortgage obligations.[102]

VEB set up detailed rules for these mortgage obligations and an order of co-operation between VEB, AIZhK and other participants. The bank is ready to invest own capital up to RUB 50 bn (EUR 1.17 bn) in mortgage obligations with a coupon of 3% p. a. and RUB 100 bn (EUR 2.34 bn)[103] of pension savings[104] in mortgage obligations with a coupon of 9% p. a. In addition the average weighted coupon of the mortgage obligations shall not exceed 7% p. a. The mortgage cover of such obligations has to consist of mortgage claims originated for newly constructed houses.

The total amount of RUB 150 bn is already designated to 11 banks and the AIZhK by a decision of VEB as of 28 June 2011.[105] Largest shares are assigned to OAO Gazprombank and OAO Sberbank – RUB 30 bn each (EUR 748.3 m), AIZhK – RUB 25 bn (EUR 623.6 m), OAO Bank Uralsib – RUB 20 bn (EUR 498.8 m) and ZAO Bank VTB 24 – RUB 18 bn (EUR 449.0 m).[106]

The issues of VTB 24 as of 21 September 2011 and AIZhK as of 01 December 2011[107] are already structured under these conditions.

Agency for housing mortgage lending (AIZhK)

On 13 April 2012 the AIZhK took the decision for the "3rd Program on purchase of obligations with mortgage cover"[108].

The Program defines special requirements:

> Term of the program is 1 April 2013 to 27 December 2013.

> Maximum amount of mortgage obligations to be purchased by the AIZhK: RUB 20 bn[109].

> Senior tranches from one originator shall not be more than RUB 5 bn[110].

> If the mortgage obligations are not issued on balance, at least 10% of the cover pool has to be structured as a junior tranch and until distribution of the securities to be held by the originator(s). The AIZhK will only obtain the senior tranche.

[102] For details, see Lassen, Tim: Development of the Russian Mortgage obligation Market; Mortgage.Info.04 (April).2012, p 5 - 7.

[103] CBRF exchange rate as of 19 Nov 2009.

[104] VEB is the fiduciary administrator of the Russian state pension fund.

[105] Full list: http://www.veb.ru/agent/mrtg/prg/.

[106] CBRF exchange rate as of 28 June 2011.

[107] AIZhK issued on 01 Dec 2011 via an off balance structure mortgage securities with the following parameters: (1) Volume 3,764.6 mRUB (90.2 mEUR), thereof (a) tranche A1: 2,258.0 mRUB (54.1 mEUR), interest rate 9,00%, (b) tranche A2: 1,129.0 mRUB (27.0 mEUR), interest rate 3,00%, (c) tranche B: 377,6 mRUB (9.0 mEUR); (2) maturity 15 Feb 2044. (F/x rates of the CBRF as of date of issue.) For details: Lassen, Mortgage.info 04.2012, p 5 and 6.

[108] http://www.ahml.ru/common/img/uploaded/files/participants/polit/icb/prog3_130412.pdf.

[109] 514,79 mEUR, CBRF exchange rate as of 13 April 2012.

[110] 128,70 mEUR, CBRF exchange rate as of 13 April 2012.

> The issuer/the issue of the mortgage obligations needs to have a minimum rating of BBB- (Fitch, Standard & Poor's) or Baa3 (Moody's) of its long term credit ability in foreign currency by the international scale, at least from one of the three agencies or alternatively the bonds are secured by a joint suretyship of the AIZhK.

> Currency of the mortgage obligations is Russian rouble.

> At the fixing date of the cover pool the minimum amount shall be not less than RUB 1 bn[111].

> The Program allows for a joined cover pool of several originators, what is an invention in the Russian mortgage obligations' market.

> Interest rate to be fixed and paid at least quarterly. The coupon interest rate of the mortgage obligation depends on the duration of its senior tranche and can be specified as follows:[112]

a) On the date of closing of the contract of organising the issue between the AIZhK and the organiser of the issue. Depending on time to distribution of the bonds and the proposed duration of the senior tranche, the coupon interest can differ from 8.50% to 10.00%.

b) At any date after closing of the contract of organising the issue between the AIZhK and the arranger of the issue (margin depending on time to distribution and proposed duration):

- Either depending on the yield of Federal Loan Obligations[113], defined on the state bond yield curve, accounted by the Moscow International Currency Exchange (MICEX[114]) plus a margin from 1.25% to 2.00%.
- Either depending on the average interest rate of MosPrime Rate 3M over the last 30 days before fixing the coupon rate, plus a margin from 2.00% to 3.50%.

> The securities have to be offered at MICEX. If they are not (fully) bought by market participants, the AIZhK will purchase (in full or the remaining part, as the case may be).

> The AIZhK provides interim financing for originators to set up the cover pool. A privilege margin for this financing is forseen for debut issuers.

Also special requirements to the eligible mortgages have been set up:

> Currency of the eligible mortgage loans is Russian rouble.

> LTV of cover mortgages shall not be higher than 80% and valuation of the real estate object shall be made by an independent valuer, not more than 6 month before signing the credit agreement. For parts of the credit above 70% LTV a finance risk insurance of the creditor is recommended, if this risk is not covered by the borrower's liability insurance or the creditor's financial risk insurance.

> Payments on principal and interest of the mortgage loans to be made at least every month. Negative amortization or any other delay of interest payments is not allowed for the mortgage loans included in the mortgage cover.

[111] 25,74 mEUR, CBRF exchange rate as of 13 April 2012.

[112] Schedule 2, 3 and 4 of the Program.

[113] Russ.: „Obligatsiya federal'nogo zayma (OFZ)".

[114] In Russian: MMVB.

Already on 30 September 2010 the 1st Program was launched. Term is until 31 December 2012. Volume of the Program was RUB 20 bn[115]. Bidding process ended on 31 December 2010, bids were given in a volume of RUB 39.31 bn[116].

The 2nd Program was started on 29 September 2011, term until 27 December 2013. Volume was as well RUB 20 bn[117]. Bidding process ended on 15 November 2011, bids were given in a volume of RUB 51.1 bn[118].

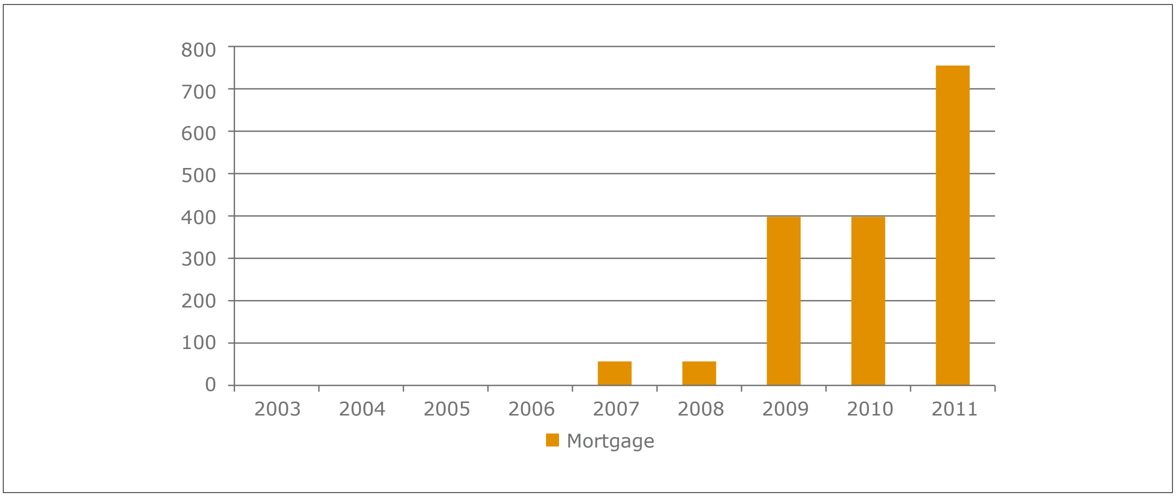
[115] EUR 483.70 m, CBRF exchange rate as of 30 September 2010

[116] EUR 974.63 m, CBRF exchange rate as of 31 December 2010.

[117] EUR 462.73 m, CBRF exchange rate as of 29 September 2011.

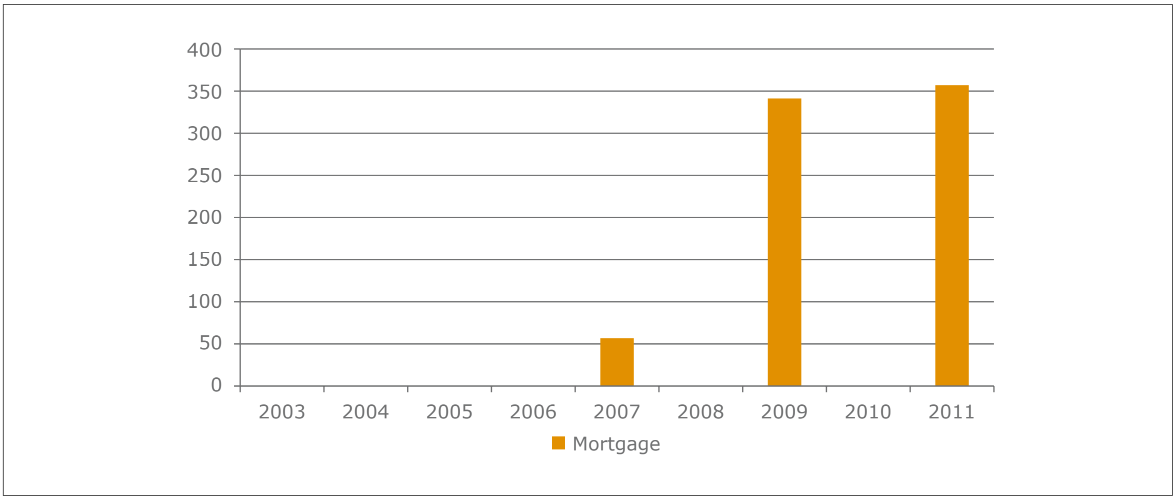
[118] EUR 1,226.48 m, CBRF exchange rate as of 15 November 2011.

> Figure 1: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EUROHYPO

> Figure 2: Covered Bonds Issuance, 2003-2011, EUR m



Source: EUROHYPO

Since 2007 five issues of bank mortgage obligations took place with a total volume of RUB 32,000 m (EUR 755.1 m).

ECBC Comparative Database: http://ecbc.eu/framework/41/Mortgage_Obligations_ and http://ecbc.eu/framework/103/Nemytysheva.

3.25 SLOVAKIA

By Viktória Múčková and Jaroslav Sobolič, CSOB

I. FRAMEWORK

According to §§14-17 of the Act on Bonds, a mortgage bond, or *Hypotekárny Záložný* List (HZL) in Slovak, is a bond which both in terms of face value as well as in terms of interest payment is guaranteed by a claim against a bank (§ 16 Subsection 4) or a branch of a foreign bank as well as by mortgage loans secured by a pledge on real estate or through a substitute coverage (collateral) (§ 16 Subsection 5). In order to become a mortgage bond issuing institution, the respective bank has to apply for a license. The minimum amount of cash contribution to the bank's equity capital necessary to establish a mortgage bond issuing institution is SKK 1,000,000,000 (EUR 33 m) or an equivalent amount in fully convertible foreign currency, which is twice the amount necessary to establish a non-mortgage bond issuing bank. Furthermore, the licence application has to contain details on the minimum requirements, as outlined in Section II.:

> Article 16
>
> (4) The total par value of issued mortgage bonds must be covered at least in the same amount and at least with the same yield as the par value of the mortgage bank's receivables from mortgage loans, and this shall represent due (ordinary) coverage.
>
> (5) Due coverage of issued mortgage bonds may be replaced by substitute coverage at most up to the level of 10% of the total par value of issued mortgage bonds.

> The methods of keeping a mortgage register;

> The proposal for appointment of the mortgage controller (trustee) and his/her deputy;

> The real estate assessment methods (valuation); and

> The method of keeping a separate analytical record of mortgage activities within the bank's accounting system.

As the criteria indicated in the criteria above, in order to be distinguishable from the insolvency estate of the bank, the mortgage loans serving as due (ordinary) coverage for mortgage covered bonds, just as all other items serving as substitute collateral, have to be recorded in separate mortgage (coverage) register by the issuing bank.

With respect to the general approach to covered bonds the model, applied by Slovakian lawmakers is similar to common practice in Germany and Spain.

However, what is significantly different is the introductory period. In order to allow for a smooth start of the covered bond business after a covered bond issuing license has been granted, the Slovakian covered bond law defines the conception of temporary mortgage bonds.

Within eighteen months following the effective date of mortgage business license, a bank may issue, upon a decision taken by its general meeting, temporary mortgage bonds in form of bearer securities with a total nominal value not exceeding 50% of the bank's basic capital. The bank is obliged to exchange such temporary mortgage bonds for mortgage bonds covered in accordance with § 16 Subsections 4 and 5 (full collateralisation including maximum share of substitute collateral) of the covered bond law within two years of issue thereof. The provisions of the covered bond law shall not apply in time from issue of temporary mortgage bonds until their exchange for mortgage bonds covered in accordance with the above mentioned paragraphs.

Should a bank fail to exchange the temporary mortgage bonds for mortgage bonds covered within two years following issue of relevant temporary mortgage bonds, the bank is obliged to repay such temporary mortgage bonds in their nominal value including yields for the period from issue until repayment. In practise the conception of temporary mortgage bonds has not been realised up to now.

Another specialty of Slovakian Covered Bonds lies in the fact that a covered bond issued by a specific institution terminates automatically when bought back by the issuer. Hence, activities like market making in own issues or minor price nursing is very restricted. Certainly, this is not an issue for the time being as Slovakian Covered Bonds are not heavily traded products. However, this might become an issue in the future when the euro will be the dominating predominant currency and bonds might be placed more with international investors.

II. STRUCTURE OF THE ISSUER

The mortgage bonds issuers are universal credit institutions. In accordance with Act on Banks, No. 483/2001, amendments, and with relevant decree the minimum requirements to obtain and keep the special licence are as follows:

> The minimum amount of cash contribution to the bank equity capital, is SKK 1,000,000,000 (EUR 33,193,919) or an equivalent amount in fully convertible foreign currency;

> The methods of keeping a mortgage register;

> The proposal for appointment of the mortgage supervisor (trustee) and his/her deputy;

> The real estate assessment methods (valuation); and

> The method of keeping a separate analytical record of mortgage activities within the bank's accounting system.

Basic principles (rules, limits) of mortgage transactions are included in Part Twelve Mortgage Banking, Articles 67 – 88.

The issuer holds the cover assets on his balance sheet. A subsequent transfer of the cover assets to another legal entity does not take place. Given that a direct legal link between single cover assets and Hypotekárny záložný list (HZL) does not exist, all obligations relating to HZL are obligations of the issuing bank as a whole, to be paid from all the cover assets of the issuer.

III. COVER ASSETS

Slovak covered bonds benefit from coverage in the form of original collateral as well as substitute collateral. The latter must not exceed 10% of the total nominal value of mortgage bonds issued. The definition of ordinary collateral is based on the definition of mortgage loans stipulated in Art. 68 of the Slovak Banking Act Nr 483/2001. According to this article, a mortgage loan is defined as a loan with a maturity of at least four years and a maximum of thirty years, secured by the right of lien established upon a domestic real estate, (including on an uncompleted unfinished construction, which is at least to the amount of 90% complete), ***unless this Act requests otherwise***, financed by the issue and sale of mortgage bonds by a mortgage bank pursuant to the Slovak covered bond regulation. *The National*

Bank of Slovakia may, by its decision issued on the basis of an application of mortgage bank for reasons worthy of special attention maximum for a maximum period of two years stipulate special conditions for financing of mortgage and municipal loans, ***at least 70 %****, even repeatedly. A reason worthy of special attention is in particular an attempt to maintain the stability of the financial sector.*

The loan in question is supposed to finance one of the following items:

> Acquisition of domestic real estate or any part thereof;

> Construction or modification of existing structures;

> Maintenance of domestic real estate; or

> Repayment of an outstanding loan drawn for purposes above;

> Repayment of an outstanding loan drawn for purposes mentioned above.

In order to be eligible for collateral (coverage) purposes, the LTV of a mortgage loan is capped at 70%. A bank may grant loans also above this limit, however, the total amount of loans with LTV ratios larger than 70% are capped at 10% of the total amount of mortgage loans granted by the bank. These mortgage loans do not serve as mortgage bonds coverage, and therefore, the part above 70 % reduces relevant cover pool. A mortgage loan may not be secured by a lien on the real estate, on which a lien has already been established and continues in favour of a third party. As already indicated, substitute collateral may be used up to a share of 10% of the total nominal value of issued covered bonds. The following property values belonging to the mortgage bank may be used for the substitute coverage:

> Deposits in the National Bank of Slovakia;

> National Bank of Slovakia bills;

> Deposits in banks with registered offices in the Slovak Republic;

> Deposits in branches of foreign banks in the Slovak Republic;

> Cash;

> Treasury bonds;

> Treasury bills; and

> Covered bonds issued by another bank;

It is important to note that neither ABS nor derivatives qualify for the cover pool.

IV. VALUATION AND LTV CRITERIA

Property valuation is regulated in the Act on Banks, Article 73: (1) For the purposes of this Act, the value of real estate shall be determined by a mortgage bank on the basis of an overall assessment of the real estate concerned. In determining the value, the mortgage bank may only take into account permanent features of the real estate and benefits that can be derived by the owner from the real estate in the long run. For real estate burdened by a lien or transfer restrictions in accordance with Article 74, paragraph 2, a mortgage bank shall lower the value of the real estate by the amount of claims guaranteed by such lien or transfer restrictions. Article 73 (2) A mortgage bank shall only be bound by its own valuation of real estate.

Monitoring requirements result from the Decree of the National Bank of Slovakia of 13 March 2007 on banks' own funds of financing and banks' capital requirements and on securities dealers' own funds of financing and securities dealers' capital requirements, Article 110, letter a) – d):

a) Legal certainty exists, meaning that the bank's right arising under an agreement on establishing a lien or under an agreement on pledging a right or assigning a receivable is enforceable in all jurisdictions relevant in regard to the collateralising and payment function of the respective credit protection;

b) The property values are monitored, meaning that the value of the property is monitored on a sufficiently frequent basis and at a minimum once every once every three years for residential real estate. More frequent monitoring is carried out where the market is subject to significant changes in market conditions. Statistical methods may be used to monitor the value of the property and to identify property that needs revaluation. The property valuation shall be reviewed by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices. For loans exceeding EUR 3 million or 5% of the own funds of the bank, the property valuation shall be reviewed by an independent valuer at least every three years.

c) The types of residential real estate accepted by the bank under its lending policy are documented;

d) Procedures are in place to monitor that the property taken as collateral (or the object of a pledged right) is adequately insured against damage.

For both commercial and residential property, the LTV limit is 70% of the mortgage lending value of the property. This LTV is a relative limit, i.e. when the loan exceeds the 70% limit, the part of the loan up to 70% LTV remains eligible for the cover pool. Over this limit a bank may grant mortgage loans exclusively if their total value does not exceed 10% of the total amount of mortgage loans granted by the bank.

V. ASSET-LIABILITY MANAGEMENT

Article 16 (4) of the Act on Bonds stipulates that the total volume of HZL outstanding must be covered at all times by assets of at least the same amount and with at least the same interest income. Thus, the nominal value of the cover assets must permanently be higher than the respective total value of the HZL and the interest yield must be at least the same.

Cash flow mismatch between cover assets and cover bonds is furthermore reduced by the prepayment rules applicable to fixed interest rate mortgage loans. Prepayments of mortgages during fixed rate periods are only permitted in cases of 'legitimate interest' of the borrower or after a period of the fixation term (This is a part of loan agreement). If the mortgage is prepaid, the borrower has to compensate the damage of the lender caused by the prepayment.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

A cover pool monitor (mortgage trustee, mortgage controller) supervises the cover pool. He/she is appointed by the National Bank of Slovakia (central bank) and must possess the expertise and experience necessary to fulfil all duties. A mortgage controller or his deputy may only be a natural person who has the necessary professional competence and integrity to carry out this activity. A natural person with completed university education, who has at least five years experience in economics or law in the banking sector, shall be deemed professionally competent. A person shall be deemed to have the necessary integrity if he has not been lawfully sentenced for a criminal offence committed in the discharge of a management office or any intentional criminal offence.

Article 80, Act on Banks:

1) A mortgage controller shall supervise the issuance of mortgage bonds and municipal bonds with regard to their particulars and coverage pursuant to a separate regulation.
2) Prior to each issue of mortgage bonds or municipal bonds, a mortgage controller shall be obligated to issue a written certificate testifying that they are covered in accordance with a separate regulation, and that an entry was made in the register of mortgages.
3) A mortgage controller shall check whether a mortgage bank provides mortgage and municipal loans, including their securing through mortgage and whether a mortgage bank meets its obligations in respect of the mortgage register in accordance with this Act and other generally binding regulations.
4) If requested by a mortgage bank, a mortgage controller shall be obligated to assist in activities related to the performance of mortgage operations, which could not be completed by the mortgage bank without his assistance.

VII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

A cover register permits the identification of the cover assets. The register records the cover assets being used to cover HZL. A list of mortgage and municipal loans and their amounts, liens and claims of a mortgage bank under mortgage and municipal loans that serve to cover mortgage and municipal bonds, or other assets serving as substitute coverage, must be kept separately by a mortgage bank in its *register of mortgages* (Article 76 paragraph 1, Banking Act). The register of mortgages and the documents on the basis of which the entries have been made in the register of mortgages must be kept by a mortgage bank separately from other documents and protected against misuse, destruction, damage or loss (Article 76 paragraph 2, Banking Act). By the end of January and July of each calendar year, a mortgage bank shall be obligated to notify the National Bank of Slovakia and the Ministry of all entries made in the register of mortgages in the last six months (Article 76 paragraph 3, Banking Act). The due form and method for keeping the register of mortgages pursuant to paragraph 2 and the due form of information disclosed pursuant to paragraph 3 shall be determined in detail by the National Bank of Slovakia and the Ministry of Finance by means of a generally applicable regulation (Decree No. 661/2004 Coll. on mortgages register and details over position and activities of a mortgage trustee (supervisor)).

Asset segregation

The cover pool is a part of the general estate of the bank as long as the issuer is solvent. If insolvency proceedings are launched, the assets recorded in the cover registers are governed by the Act No 7/2005 Coll. on bankruptcy (§8, §§ 28 (2), § 50, § 67), also § 72 (3) of Act on banks. See also preferential treatment of covered bond holders.

Impact of insolvency proceedings on covered bonds

Covered bonds do not automatically accelerate when the issuing institution is insolvent, but will be repaid at the time of their contractual maturity.

Preferential treatment of covered bond holders

Privilege right of mortgage (municipal) bonds owner is specified explicitly in the Slovak relevant acts:

"*Mortgage (municipal) bonds owners shall have pre-emptive security right to assets used to secure issued mortgage (municipal) bonds, including the right of lien to real estate pursuant to Act on banks (Article 74); this security right in procedure according to Act on banks, No. 483/2001 Coll., or separate regulations - for instance, Article 8, Article 28 par. 2, Articles 69 and 176 to 196 of Act No. 7/2005 Coll. on bankruptcy as amended – shall secure secured receivables of mortgage (municipal) bonds owners against the mortgage bank for the payment of the nominal value and yields upon mortgage (municipal) bonds*".

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Slovak "*Hypotekárny záložný list*" fully comply with the requirements of Art. 22 par. 4 UCITS Directive.

Article 45 (7) and (11) of Collective Investment Act

(7) The value of bonds issued by a single bank, or by a foreign bank in a Member State which is subject to supervision that protects the interests of bondholders, may not constitute more than 25% of the value of an open-end fund's assets. Funds raised by the issue of bonds shall be invested in such assets which, until the maturity of the bonds, cover the issuer's liabilities related to the bond issue and which may, in the event that the issuer becomes insolvent, be used to redeem the nominal value of the bonds and to pay the income on them. The aggregate value of bonds acquired for an open-end fund's assets under the first sentence may not exceed 80% of the value of the open-end fund's assets.

(11) Bonds which are issued in the Slovak Republic and meet the criteria laid down in paragraph (7) shall be deemed to include **mortgage bonds** and **municipal bonds** (municipal debt) issued by a bank which, with the funds raised from their sale, provides a municipal loan to a municipality or higher territorial fund share, and provided that these municipal bonds are guaranteed in accordance with the conditions stipulated by a separate law (Act on Bonds).

With regard to the bonds mentioned in paragraph (7) that are issued in a Member State, the management company shall take into account the similar list of bonds compiled in accordance with the law of this Member State, provided that such a list exists.

Finally, Slovak institutional investors investment legislation allows:

> Mutual funds to invest up to 25% of their assets in HZL;,

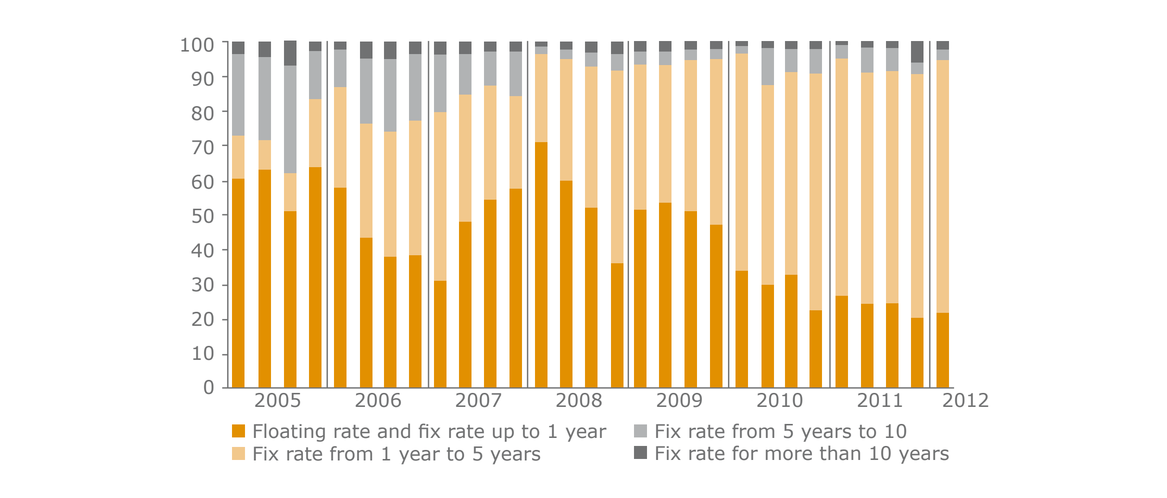
> Insurance companies up to 20 % of their technical reserves in HZL; and,

> Pension funds up to 15 % of their assets in HZL.

IX. ADDITIONAL INFORMATION

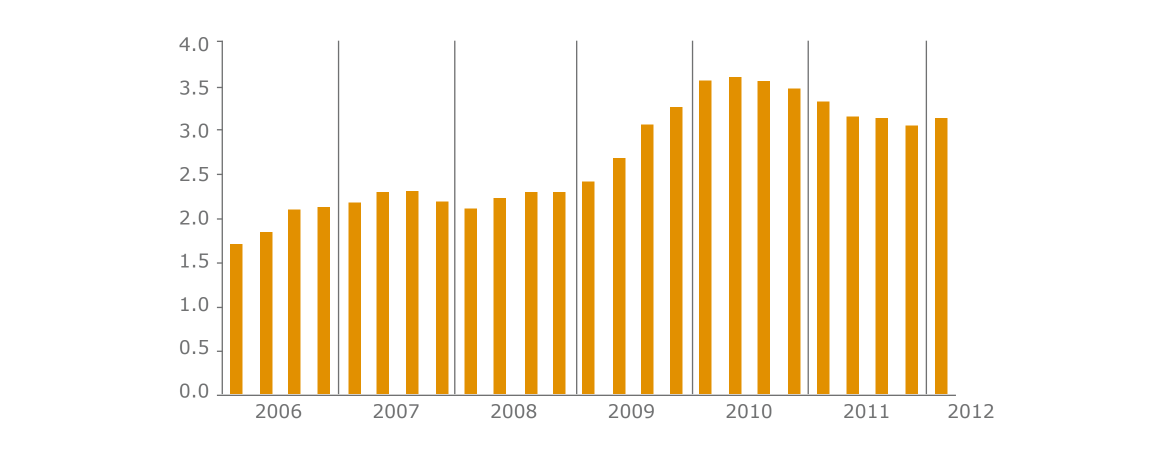
Development of the Slovak mortgage market

> Figure 1: The Proportion of Fixation of Interest Rate Real Estate Loans (%)



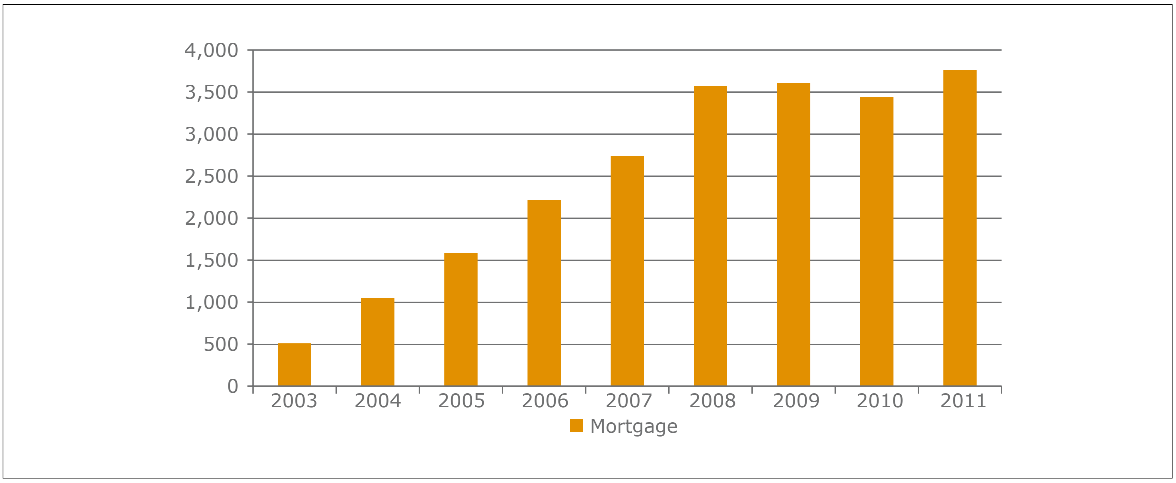
Source: NBS

> Figure 2: The Proportion of Defaulted Real Estate Loans to Total Loans on Real Estate (%)



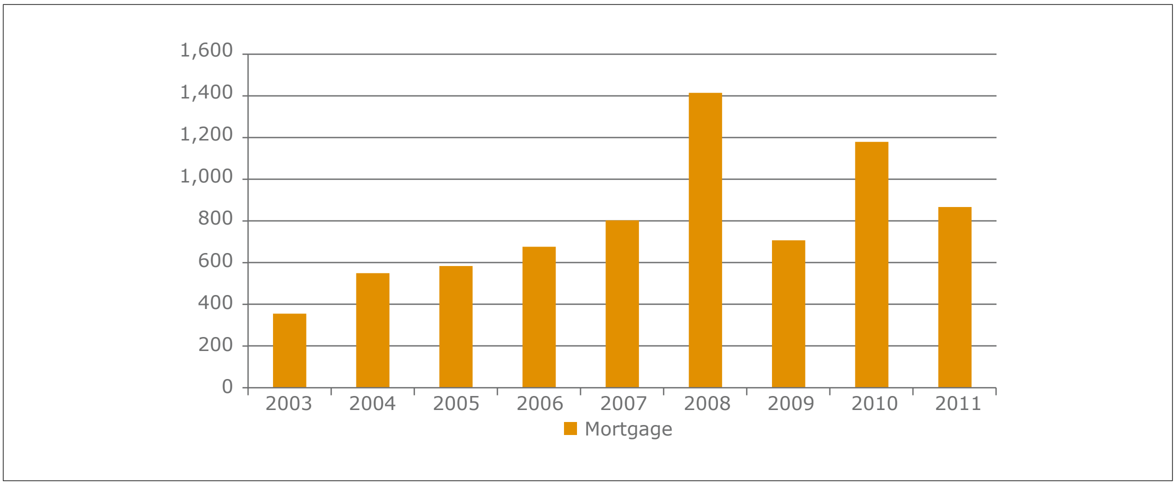
Source: NBS

> FIGURE 3: COVERED BONDS OUTSTANDING, 2003-2011, EUR M



Source: EMF/ECBC

> FIGURE 4: COVERED BONDS ISSUANCE, 2003-2011, EUR M



Source: EMF/ECBC

Issuers: There were eight issuers in Slovakia as of the end of 2011: CSOB, Dexia Banka, Istrobanka, Volksbank, OTP Banka Slovensko, Slovenská sporitelna, Tatra Banka, UniCredit Bank (Slovakia) and Všeobecná úverová Banka.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/42/Slovakia

3.26 SLOVENIA

By Sonja Anadolli, Bank Association of Slovenia

I. FRAMEWORK

Legal basis for cover bond issuance in Slovenia is **Mortgage Bond and Municipal Bond Act** (ZHKO, Official Gazette of Republic of Slovenia, No. 17/06, dated 17.6.2006). Together with a secondary legislation it represents a sufficient legislative framework for mortgage and municipal bonds. Secondary legislation governing the issue of mortgage and municipal bonds with regard to the Mortgage Bond and Municipal Bond Act comprises:

> **Regulation on the conditions for acquiring an authorisation to issue mortgage bonds and municipal bonds** (Official Gazette of Republic of Slovenia, No. 78/06, dated 25 July 2006), which regulates in detail how it is determined for banks whether the conditions for acquiring an authorisation to issue mortgage or municipal bonds have been met. Bank shall demonstrate its capability to have adequate systems for identifying, measuring, controlling and assessing all risks linked to covered bond issue, first of all credit, liquidity, operational, interest-rate and market risks. Taking the business plan into account, the bank shall have organizational and technical qualification, rules regarding conducting of cover register;

> **Regulation on the calculation of the net present value of cover assets** (Official Gazette of Republic of Slovenia, No. 78/06, dated 25 July 2006), which determines detailed rules for matching cover assets and liabilities from issued mortgage or municipal bonds based on the net present value principle, and other rules for matching the maturities, interest rate and currency exposure of the cover assets with the liabilities from issued mortgage or municipal bonds;

> **Regulation on the inclusion of derivatives in cover assets** (Official Gazette of Republic of Slovenia, No. 78/06, dated 25 July 2006) sets out the maximum level of the inclusion of derivatives in cover assets, the type and credit ratings of the parties conducting such transactions, and other detailed instructions for the use of derivatives;

> **Regulation on custodian of the cover register** (Official Gazette of Republic of Slovenia, No. 78/06, dated 25 July 2006) regulates the conditions for appointing the custodian of a cover register and for acquiring a Bank of Slovenia's authorisation to act as the custodian of a cover register.

II. STRUCTURE OF THE ISSUER

The issuer of mortgage and municipal bonds can be a bank with license of Bank of Slovenia pursuant to a Banking act (ZBan-1). A bank which has intention to issue covered bonds according to the Mortgage Bond and Municipal Bond Act (ZHKO, Article 9) should meet the following conditions in order to obtain a special license of Bank of Slovenia:

> A bank shall have adequate systems for managing risks connected with issue of mortgage and municipal bonds and risks connected with cover assets;

> A bank shall insure an adequate number of qualified employees and shall be organizationally and technically qualified for issuing mortgage and municipal bonds and financing of real estate and public sector entities;

- A bank should ensure ongoing business activities concerning granting mortgage loans and loans to public sector entities and issuing mortgage and municipal bonds apart from the other business activities;
- A bank shall prepare rules regarding conducting a cover register;
- A bank shall prepare rules concerning assessment of real estate and employ an appraiser who is independent from the credit decision process (persons who are licensed independent appraisers pursuant to the law governing auditing shall be considered to have necessary qualifications, ability and experience for the assessment);
- A bank shall give a statement to the Bank of Slovenia that it has appropriate contractual relations with its creditors. It means that concluded agreements (contracts) do not contain clauses that allow creditor to rescind a contract to an extent which could threaten a liquidity or solvency of the bank.

The issuer holds cover assets on his balance sheet and at the same time ensures separate activity according to the 3rd indent of this section. A subsequent segregation of the cover assets and obligations from the other assets and obligations of the issuer takes place only in the case of insolvency or dispossession of a special license of Bank of Slovenia (ZHKO, Article 15, 47). In these cases Bank of Slovenia names a receiver of cover assets (ZHKO, Article 48). A transfer to another legal entity is possible only in the case of insolvency on the basis of the contract which is a subject of the written approval of the Bank of Slovenia (ZHKO, Article 50). There is no direct legal link between single cover assets and bonds, all obligations related to bonds are obligations of the issuing bank as a whole, and have to be paid from all the cover assets of the issuer.

III. COVER ASSETS

Cover assets are produced by mortgage and public sector lending. In accordance with the Mortgage Bond and Municipal Bond Act (ZHKO, Article 19-24) cover pool of mortgage bonds may consist of receivables related to credits secured by mortgages on residential properties, credits secured by mortgages on commercial properties, substitutional cover assets (up to 20% of cover assets), financial derivative instruments. Real estate shall be located in area of EEA and Switzerland.

Cover pool of municipal bonds may consist of receivables related to credits granted to public sector entities (state, local community or other public sector entities with a guarantee of the state), substitutional cover assets (up to 20% of cover assets), financial derivative instruments.

Substitutional cover assets comprise:

- Cash on the account at Bank of Slovenia,
- Marketable securities issued by Member state EEA or its central bank or ECB,
- Other debt securities issued by EIB, EBRD or other bank according to criterion of ECB

Issuer may apply financial derivative instruments if they contribute to the reduction of risks connected with cover assets. Financial derivative instruments may present not more than 12% of cover assets pursuant to the "Regulation on the inclusion of derivatives in cover assets" (Point 8-9).

There are certain limits concerning cover assets which comprise cover pool:

> Credits secured by mortgages on residential property under construction shall not exceed 5% of cover assets,

> Credits secured by mortgages on commercial property shall not exceed 20% of cover assets,

> Credits secured by mortgages on property outside Republic of Slovenia shall not exceed 50% of cover assets,

> Credits to affiliated parties shall not exceed 20% of cover assets and shall never exceed the maximum allowable exposure according to ZBan-1 and Regulation on large exposures of banks and savings banks (Article 8).

IV. VALUATION AND LTV CRITERIA

Mortgage lending value is the value of the property determined by a prudent assessment of its future marketability, taking into consideration the long-term sustainable aspects of the property, the normal and local market conditions and the current and alternative appropriate uses of the property. Persons who are licensed appraisers pursuant to the law governing auditing (Slovenian Institute of Auditors) shall be considered to have necessary qualifications, ability and experience to assess mortgage lending value of the property. Every issuer of mortgage and municipal bonds shall apply methodology for valuation of mortgage lending value in the special document Rules of valuation. This document has to be confirmed by Slovenian Institute of Auditors (ZHKO, Article 25-27).

The value of receivables related to an individual mortgage credit, which could be considered as the cover asset, may not exceed 60% of the mortgage lending value of the pledged property.

All other details about the valuation process, qualifications of appraisers, valuation and monitoring are prescribed in the Mortgage Bond and Municipal Bond Act (ZHKO, Article 28). Monitoring requirements are in accordance with the Capital Requirements Directive (once a year for commercial real estate and once every three years for residential real estate), in addition Mortgage Bond and Municipal Bond Act explicitly requires a review of the underlying assumptions of the mortgage lending value when the market value of the property has declined for more than 10%.

V. ASSET - LIABILITY MANAGEMENT

Total volume of cover bonds outstanding must be covered by assets of at least the same nominal value at all times. At the same time, the congruence between bonds and assets should be assured on the basis of net present value principle (ZHKO, Article 22).

“Regulation on the calculation of the net present value of cover assets” determines rules for matching cover assets and liabilities from issued mortgage bonds or municipal bonds based on the net present value principle, and other rules for matching the maturities, interest rate and currency exposure of the cover assets with the liabilities from issued bonds. (Point 1-3)

The calculation of net present value shall be carried out for all kinds of bonds every day. If the net present value of mortgage bonds or municipal bonds exceeds the net present value of cover assets, the issuer has to cover the difference with additional funds. In addition, stress tests shall be performed at least once a week. The difference between current net present value and net present value on the basis of stress test shall be covered with immediate enhancement of cover assets. (Point 10-11)

Yield curve which can be used for the calculation of net present value shall be shifted with application of static or dynamic approach in order to assess the influence of change in interest rates. Issuer can use internal model for the assessment of interest rate and foreign exchange risk on the basis of previous notification at Bank of Slovenia and under certain conditions which should be fulfilled. The difference between the net present value of cover assets and the net present value of covered bonds shall be calculated also for individual currencies. (Point 12-23)

VI. COVER REGISTER, CUSTODIAN OF COVER REGISTER AND BANKING SUPERVISION

A cover register enables the identification of cover assets and covered bonds. Covered assets are recorded on the individual basis (individual receivables which arise from mortgage or municipal credits, substitutional cover assets and financial derivative instruments). Nominal value of cover assets and covered bonds outstanding shall be known at all times (ZHKO, Article 38). Issuers are obliged to manage their cover registers and they shall not turn the business over to another transactor. Every issuer shall have an independent custodian of cover register. He is appointed by the issuer and has to be either an authorized auditor who must comply with conditions in accordance to the law governing auditing or he must possess other necessary expert qualifications. Custodianship is possible only on the basis of license from Bank of Slovenia (ZHKO, Article 40-41).

Cover assets could be recorded in the cover register only on the basis of the custodian's approval. Receivables from mortgage credits which beside the registration of mortgage in the land register include a note in the land register, that a secured receivable is earmarked for the registration in the cover register, are eligible receivables for the cover register (ZHKO, Article 39).

Pursuant to the Mortgage Bond and Municipal Bond Act (ZHKO, Article 52) and "Regulation on the conditions for acquiring an authorisation to issue mortgage bonds and municipal bonds" cover register should be managed separately for mortgage bonds and municipal bonds, whereas particular cover register should consist of at least 4 sub-registers: sub-register of mortgage or municipal credits, sub-register of substitutional cover assets, sub-register of financial derivative instruments and sub-register of mortgage or municipal bonds issued by the bank. Each sub-register should have its own analytical support. According to the "Regulation on the calculation of the net present value of cover assets" the calculation of net present value of cover assets should be carried out for each kind of mortgage and municipal bonds separately and should take into consideration characteristics of a particular sub-register. "Regulation on custodian of the cover register" regulates conditions for appointing the custodian of a cover register and conditions for acquiring an authorisation of Bank of Slovenia to act as the custodian of a cover register. (Point 18-22)

The custodian of cover register supervises the cover pool. He has to ensure that prescribed cover for the covered bonds exists at all times and that the cover assets are recorded correctly in the cover register. Without his approval, no assets may be removed from the cover pool and no mortgages may be erased from the land register. If cover assets are not sufficient to cover bonds outstanding and issuer has not assured additional assets, a custodian of the cover assets is obliged to inform Bank of Slovenia. (ZHKO, Article 39, 42)

Issuer shall submit to the Bank of Slovenia an extract of the cover register (signed by the custodian of the cover register) within 10 days after expiration of the quarter for the report as of the last day of the quarter. Issuer's annual report shall include a number of mortgage credits, amounts of mortgage credits with regard to mortgage on commercial and residential properties, a number of sales based on compulsory executions and a number of compulsory executions started in the previous year, a number of closed executions in the previous year. Annual report should provide information separately for commercial and residential properties. Bank of Slovenia as the banking supervisor supervises banks which issue mortgage and municipal bonds. Securities Market Agency shall exercise supervision over the initial public or non-public offering of mortgage bonds or municipal bonds, prospectus for public offering, resolution of bond issue. (ZHKO, Article 53-54)

VII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Cover assets could be simply identified in case of insolvency of the issuer on the basis of the record of cover register, where cover assets are stated in contrast to mortgage or municipal bonds issued. In addition, mortgage assets could be identified by means of a special notice in the land register, that a secured receivable is earmarked for the registration in the cover register. Note in the land register indicates that compulsory execution of the collateral and any change in the mortgage are possible only on the basis of written confirmation by the custodian of the cover register. (ZHKO, Article 35, 38)

The legal effect of registration is that in the case of insolvency of the issuer, the assets which form part of the separate legal estate can be identified: All values contained in the register would be qualified as part of the separate legal estate.

Asset segregation

Assets from the cover pool are a part of the issuer’s assets as long as the issuer is solvent. In case of insolvency of the issuer, cover assets recorded in the cover registers (including financial derivative instruments) are segregated from the insolvency estate and designated for further uninterrupted repayment of holdersof the mortgage or municipal bonds. Bankruptcy senate names a receiver of cover assets upon the proposal of Bank of Slovenia. Receiver of cover assets carries out the administration of the cover assets and shall not be the same person as the bankruptcy receiver. (ZHKO, Article 47-48)

Receiver of cover assets is entitled to administer that part of receivables related to the mortgage or municipal credits that is not a part of cover assets (the value of receivables related to an individual mortgage or municipal credit, which exceeds 60% of the mortgage lending value of the encumbered property). Such residual is transferred into insolvency estate. (ZHKO, Article 49)

Impact of insolvency proceedings on covered bonds and derivatives

Covered Bonds do not automatically become due when the issuing institution is insolvent, but will be repaid at the time of their contractual maturity (ZHKO, Article 47). The same applies to derivatives which are registered in the cover register and form part of the cover pool. Receiver of cover assets represents holders of the mortgage or municipal bonds in court (ZHKO, Article 49).

Preferential treatment of covered bond holders

Covered bond holders have preferential rights to be repaid (including costs) from the cover assets prior to any other creditors of the issuer (ZHKO, Article 46). If cover assets are not sufficient for further uninterrupted repayment of total debt from the mortgage or municipal bonds, Bank of Slovenia shall institute separated bankruptcy proceedings above cover assets of the issuer. If holders of the mortgage or municipal bonds in separated bankruptcy proceedings are not fully repaid from the cover assets, remaining receivables may participate in the regular bankruptcy proceedings of the issuer. (ZHKO, Article 51).

Sale and transfer of cover assets to other issuers

Receiver of cover assets may transfer entire cover assets and liabilities from issued covered bonds to another issuer on the basis of the contract which is a subject of the written approval of the Bank of Slovenia. (ZHKO, Article 50).

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk weighting of Covered Bonds is regulated by the "Regulation on the calculation of capital requirements for credit risk under standardised approach for banks and savings banks", transposing the Capital Requirements Directive into Slovene legislation.

Risk weight shall be assigned to exposures in the form of covered bonds with regard to the risk weight of the credit institution that issued them. For instance, covered bonds of the credit institution with 20% risk weight would have a 10% risk weighting.

In accordance with the Investment funds and management companies Act (ZISDU-1, Article 69, Paragraph 3-4) an investment fund may invest up to 25% of its assets in certain types of bonds issued by the same issuer, which is a bank with a registered office or branch in the Republic of Slovenia or in a Member State, and which is subject to special public supervision intended for the protection of the rights of bond holders. The monetary assets or the assets gathered with the sale of bonds must be placed only in assets which would over the entire period of validity, up to the time the bonds shall be due, enable the issuing institution to pay its obligations arising from these bonds and which shall be used to purchase the principal and repay the accrued interest in the case of the issuer's default.

Insurance act (Zzavar, ZZavar B, 121-122) regulates the types of investments permitted and restrictions on the individual investments. The value of individual types of investment of the assets covering technical provisions must not exceed 5%of the total technical provisions and for bonds or other debt securities traded on an organised securities exchange in the Republic of Slovenia, a Member State or an OECD Member State, may reach 40% of the technical provisions if such securities meet conditions from Article 121.

3.27 SPAIN

By Gregorio Arranz, Spanish Mortgage Association

I. FRAMEWORK

The legal framework for Spanish covered bonds --Cédulas Hipotecarias (CHs) -- is determined by:

> the Law 2/1981, of 25 March, on the regulation of the mortgage market (hereinafter, "Law 2/1981");

> the Law 41/2007, of 7 December, by which *Law 2/1981, of 25 March, regulating the mortgage market and other rules of the mortgage and financial system are modified, reverse mortgages and long-term care insurance are regulated and certain tax regulations* are established (hereinafter Law "41/2007"); and

> the Royal Decree 716/2009, of 24 April, which develops certain aspects of Act 2/1981 and other rules of the mortgage and financial system (hereinafter "RD 716/2009").

Regarding bankruptcy regulation, article 14 of Law 2/1981 (modified by the 19th final provision of Law 22/2003, of 9 July hereinafter, the "Insolvency Law" and by Law 41/2007) provides for a special treatment for the holders of the CHs in case of insolvency of the issuer. According to this article, CH holders have special privileged claims (*créditos con privilegio especial*) as established in article 90 of the Insolvency Law.

Article 12 of Law 2/1981 defines that the capital and interests of the CH are secured by the entire mortgage loan book registered in favour of the CH issuer (excl. loans used in securitisations or loans securing mortgage bonds).

Moreover, article 14 of Law 2/1981 determines that in case of issuer insolvency, claims of CH holders shall be treated as privileged claims against the insolvency estate (*créditos contra la masa*). It shall be considered as credits against the mass: all the payments which correspond to the repayment of the capital and interest of the issued cédulas hipotecarias and, if any, to the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to the issues. (art. 14 Law 2/1981) Pursuant to article 84.2.7, in combination with article 154, of the Insolvency Law, claims against the insolvency estate have to be paid on their respective due dates without delay of payment, regardless of the status of the bankruptcy proceedings.

In addition, the second additional provision of the Insolvency Law, modified by Royal Decree – Law 3/2009, of 27 March, establishes that in case of insolvency of credit institutions their specific legislation, specifically articles 10, 14 y 15 of Law 2/1981 of mortgage market, shall be applicable. As a result, the mortgage market law supersedes the Insolvency Law.

II. STRUCTURE OF THE ISSUER

Issuers of CHs have to be credit institutions, entitled to participate in the mortgage market and thus, to grant the mortgage credits or loans that comply with the requirements of the Spanish Mortgage Market Legislation. In practice, issuers of CH are mainly: Commercial Banks, Saving Banks and Cooperative Banks.

The issuer of the CHs holds the cover assets on its balance sheet and they are not transferred to a different legal entity.

The CHs, in addition to being direct, unconditional obligations of the issuer and without prejudice to the unlimited universal nature of the liability, comprise a special privileged credit right of its holder against the issuer and, if any, against the substitution assets which backup the *cédulas hipotecarias* and the economic flows generated by the financial instruments linked to each issue. This right is guaranteed by the entire mortgage loan book registered in favour of the issuer. The effectiveness of this right is also guaranteed by the existence of mandatory over-collateralisation.

Although there is no direct link between the covered bonds and the underlying mortgaged properties, there is a direct link between CHs and the cover assets.

Due to the status of the issuer as a credit institution, one of the requirements to conduct business is to have adequate human and material resources pursuant to the credit institution legislation.

The degree of outsourcing covered bond issuance activities is quite low, almost irrelevant. Usually, the outsourced service has to be provided by a well-known servicer with an adequate rating. In any case the issuer is responsible and liable for the performance of the service.

Additionally, several entities can group their CHs issuances in a CDO structure (called multi-seller structure). This is based on the issuance of securitisation bonds, backed by the cash-flow generated by such CHs, by an open vehicle that, under Spanish law, is created as a separate fund without legal personality, serviced by a securitisation fund trustee or management company. The bondholders of each of the series issued by the fund will bear the risk of default on the CHs backing the bonds. The holders of these securities, known as *cédulas multicedentes* enjoy all of the advantages of the covered bond but as well of a higher degree of risk diversification.

It is important to point out that there is another type Spanish covered bond called *Cédulas Territoriales* (CTs) with the same special privilege claim status as CHs. In this case, the cover asset pool consists of all loans to the Spanish State, its autonomous communities and local authorities, as well as their entities and dependent public companies and entities of a similar nature in the European Economic Area. The credit institutions may issue CTs up to 70% of the eligible public loan portfolio, resulting in a minimum over-collateralisation of 43%. A last type of covered bonds is the *Bonos Hipotecarios* that, although contemplated in Law 2/1981, have not been used for the time being. These bonds have specific mortgages as collateral and not the whole portfolio.

III. COVER ASSETS

A distinction shall be made between cover assets and eligible assets.

Cover assets consists of the entire mortgage loan book registered in favour of the issuer. The special privileged claims of the holders of CHs are guaranteed by the cover asset pool and, if any, by the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to each issue.

The Law 2/1981 does not establish specific requirements for mortgage loans that constitute the cover asset pool.

For issuance purposes and their limits, it shall be considered as eligible assets in order to determine the maximum amount of CH issued and outstanding for a particular issuer.

All mortgage loans which comply with the following criteria are taken into account for the calculation of the maximum amount of CH issued and outstanding:

- The object of the loan or credit must be the financing of the construction, reconstruction, or acquisition of residential premises, zoning works and social equipment, construction of agrarian buildings, tourist, industrial and commercial and any other activity or work and any other loan, regardless its purpose.
- The mortgage that guarantees the loan or credit must be a first-ranked mortgage.
- The loan or credit guaranteed may not exceed 60% (art. 5 Law 2/1981 modified by Law 41/2007) of the mortgage lending value of the mortgaged asset, except for the financing of the construction, reconstruction or acquisition of residential premises, in which case it may reach 80% of such value.

  The 80% limit in the ratio between the guaranteed loan or credit and the value of the mortgaged home mentioned in the previous section can be exceeded, without under any circumstances exceeding 95%, if the mortgage loan or credit has a bank guarantee provided by a different credit institution to the creditor or is covered by credit insurance. The bank guarantee or insurance shall be direct and will cover at least the amount of the guaranteed loan or credit which exceeds 80% of the valuation of the mortgaged asset and interests (Art. art. 5 RD 716/2009)

  Notwithstanding, mortgaged loans or credits that initially exceed these percentages can be used as cover assets for the issuance of CHs when, as a consequence of the repayment of their principal amount or the modification of the market value of the mortgaged properties the values do not exceed said LTV, in relation to the initial or revised valuation of the mortgaged asset.
- The mortgaged properties must have been valued previously by the so-called sociedades de tasación or by the valuation services of the issuer.
- The mortgaged assets must be insured against damages.
- All mortgage loans that do not fulfil at least one of the above mentioned criteria cannot be taken into account for the calculation of the maximum amount of CH.

Excluded from cover asset pool are special types of mortgage credits or loans, such as:

- Those documented by way of registered securities, either to the order or bearer securities.
- Those which are partially or totally due.
- Those which have already been the subject of mortgage participations (participaciones hipotecarias, i.e. loans used in securitisations).
- Those subject to senior mortgages or seizure.

The right to use and enjoy (*derecho de usufructo*) administrative concessions, rights to extended areas (*derechos de superficie*) and real estate properties which do not have building codes (i.e. those which are outside the zoning regime) are excluded as well.

The cover asset pool is defined as a dynamic cover pool. ABS/MBS or other assets are not allowed in the cover pool, but mortgages are allowed.

It is market practice for the issuer to hedge the interest rate risk by using the corresponding derivative instrument.

The institution issuing the cédulas hipotecarias will keep a special accounting register of the loans and credits that serve as collateral of the issues of cédulas hipotecarias and, if any, of the substitute assets fixed that cover them, as well as the derivative financial instruments linked to each issue. The annual accounts of the issuing institution shall contain the essential details of said register (art. 12 Law 2/1981, art. 21 RD 716/2009 and Circular 7/2010 of 30 November of the Bank of Spain).

In order to guarantee the transparency of the cover assets, the issuers have to provide the Bank of Spain with a monthly cover pool report. Moreover, there is a general duty of disclosure as a result of the continuous supervisory power of the Bank of Spain.

IV. VALUATION AND LTV CRITERIA

According to mortgage market legislation, the value of the mortgaged property has to be appraised prior to the issuance of the CHs by specialised companies, the so-called *Sociedades de Tasación* or by the valuation services of the issuers.

If, for market reasons or due to any other circumstances, the value of the mortgaged asset drops below the initial valuation by more than 20%, and therefore exceeds, according to the capital outstanding, the issuance limits referred to in article 5.1 of Law 2/1981, the issuer, following valuation performed by an independent *sociedad de tasación*, can demand from the debtor the extension of the mortgage to other assets sufficient in order to cover the required ratio between the value of the asset and the loan or credit that it guarantees (Art.5 of Law 2/1981 and Art.9 of RD 716/2009).

In the event that the debtor is an individual, the drop referred to in the previous paragraph must have remained for a period of one year counting from the time when the creditor institution has recorded said drop in the special accounting register of the loans and credits that serve as collateral of the issues.

The debtor, after being requested to make the extension, can opt to refund the entire loan or credit or the part of it which exceeds the amount resulting from applying to the current value the percentage used to initially determine its amount.

If within the period of two months from the extension request, the debtor has neither done this nor refunded the part of the loan or credit referred to in the previous paragraph; it will be considered that he/she has opted to refund all of the loan or credit, which can be immediately demanded by the creditor institution.

The mortgage market legislation also determines the regulation for the appraisal service and the requirements with which the specialised companies have to comply, such as, an exclusive corporate object, minimum corporate capital requirement, registration with the corresponding registry at the Bank of Spain. Moreover, those entities are supervised and subject to inspection by the Bank of Spain. These rules were developed by the Ministerial Order of 27 March of 2003 in relation to the appraisal of real estate goods.

V. ASSET - LIABILITY MANAGEMENT

The volume of CHs issued and outstanding by a particular issuer cannot exceed 80% (art. 16 Law 2/81) of the sum of the unpaid principal amounts corresponding to all the mortgage credits or loans included in the issuer's portfolio that comply with the requirements mentioned above under section III on cover assets. The issuer cannot issue CHs beyond these percentages at any time.

The *cédulas hipotecarias* can be backed up to a limit of 5% of the issued capital by substitution assets (fixed income securities issued by the State and other EU Member States, *cédulas hipotecarias*, mortgage bonds, securities issued by Mortgage Securitisation Funds or Asset Securitisation Funds and other fixed-income securities listed on an official secondary market or on a regulated market, with a credit rating equivalent to that of the Kingdom of Spain –art. 15 and 17 Law 2/1981).

Notwithstanding this general statement, if the limit is surpassed due to increases in the redemption of the Elegible Assets or any other event whatsoever, the issuer shall re-establish due balance by means of any of the following actions:

> Cash deposit or deposit of government paper in the Central Bank of Spain.

> Acquisition of CHs in the relevant marketplace.

> Execution of new mortgage loans or acquisition of mortgage participations, provided that they are eligible to cover CHs.

> Redemption of CHs by the pertinent amount until balance has been reinstated, which, if necessary, can be executed through early redemption and drawing the number of securities to be redeemed by lot.

As a general remark it should be noted that it is market practice for the issuer to hedge interest rate risk.

Moreover, regulation provides for some particular rules in this respect that can be summarised as follows: Issuers shall adopt the necessary measures to avoid inappropriate imbalances between the flows from the cover portfolio and those derived from the payments due for the *cédulas* that they issue (article 17.6 of RD 716/2009).

Concerning foreign exchange risks, there is no legal provision in relation to the following areas

> The currency of the covered bonds

> Limiting FX risks between cover assets and the CHs

> Limiting, managing or hedging the exchange risk as in the case of the interest rate risk. Notwithstanding, it is universal market practice to denominate the CHs in Euro if the currency of the cover assets is Euro.

Other risks such as early repayment, reinvestment, etc. are also mitigated by the 25% overcollateralisation as well as by the dynamic nature and structure of the cover pool.

VI. TRANSPARENCY

As mentioned above (Section III, cover assets), the Spanish legislation obliges Spanish issuers of covered bonds to keep a special and very complete register of their loans and credits. The annual accounts have to contain, additionally, the essential details of said register.

On top of that, the main Spanish issuers of CH, coordinated by the Spanish Mortgage Association, and since the end of 2011, are endeavouring to create a transparency template, consistent with the guidelines of the ECBC Label Initiative. Said template is expected to be finalised before August 2012 and it shall be adopted by most Spanish credit institutions.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The institution issuing the *cédulas* will keep a special accounting register. Please refer to Section III on cover assets. The Spanish legislation does not require a special pool monitor other than the prudential supervision on a continuous basis by the Bank of Spain which includes the periodic disclosure of information regarding cover assets by credit institutions.

The Bank of Spain is responsible for supervising compliance with the limits and regulatory requirements and is entitled to adopt measures in order to mitigate any breach or deviation from the regulation, including sanctioning such breach or failure in accordance with article 5 of the Law 26/1988, of 29 July.

The issuer is also responsible and liable for cover and eligible assets pool monitoring. The quantitative mandatory limits have to be maintained at all times, thus the monitoring is carried out continuously by the issuer as a part of the risk management and auditing of its activity.

The "special" supervision - as per reference to UCITS Art. 52 (4) - is carried out by the *Comisión Nacional del Mercado de Valores* (hereinafter, "CNMV"). The CNMV may also monitor and supervise compliance with statutory requirements and limits upon approval of the issuance and clearly supervise the placing process

The role of the rating agencies shall be decided by the issuer on a case-by-case basis, either for commercial or market reasons, although as matter of fact most issues are rated.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Identification of the cover assets

Any mortgage that is originated in Spain must be registered in the Land Registry. Consequently, the Land Registry is the cover registry which records all the mortgages serving as the collateral for the CHs. The institution issuing the cédulas will keep a special accounting register.

Asset Segregation from the insolvency's estate.

Article 14 of the Law 2/1981 of the regulation of the mortgage market stipulates that the institution issuing the cédulas will keep a special accounting register. This provides the legal framework regarding the position of the rights of the holders of the CHs in case of insolvency of the Spanish issuer.

In this respect, it is worth pointing out the following relevant issues:

1. According to article 14 of Law 2/1981 claims of CH holders have to be treated as privileged claims against the insolvency estate (*créditos contra la masa*). Article 84.2.7 and article 154 of the Insolvency Law require that claims against the insolvency estate have to be paid by the insolvency administrators on their respective due dates without delay of payment, regardless of the status of the bankruptcy proceedings.

   In the case of CH, the claims of the CH holders are secured by the entire mortgage loan book registered in favour of the CH issuer (article 12 of Law 2/1981) and, if any, by the substitution assets which backup the *cédulas hipotecarias* and the economic flows generated by the financial instruments linked to each issue. The definition as stated by the Insolvency Law implies the application of the special rule of payment without enforcement of the collateral.

   The Insolvency administration is not entitled to adopt any decision against said legal provision and has to use the proceeds from the issuer's mortgage loan book to satisfy CH principle and interest payments on their respective due dates without delay of payments.

2. The Insolvency administrators are obliged to pay such amounts as long as the cash flows produced by the cover assets are sufficient to meet the CHs payments pursuant to article 84.2.7 of the Insolvency Law.

   In this respect, the Insolvency Law provides a clear definition of the claims of CH holders as special privileged claims without enforcement of the collateral. It also provides an unequivocal classification of the claims of CH holders, as claims against the insolvency estate and clear identification of the cover assets, which are reserved to meet the claims of the CH holders.

Thus, the clarity of the provision leaves no room for a different interpretation. In other words, the same legal provision that states the privilege, states the extent and limits of the same.

All of the holders of *cédulas hipotecarias*, whatever their date of issue, shall have the same preference over the loans and credits covering them and if any, to the substitution assets which backup the *cédulas hipotecarias* and the economic flows generated by the financial instruments linked to each issue.

3. The payments to be effected by the debtor comprise all those deriving from principal and interest of the issued and outstanding CHs on the date on which the Insolvency is declared. All CH payments have to be met on their respective due dates, regardless of the status of the bankruptcy proceedings. In the case where the cover assets are insufficient to meet the CH payments, the claims of the CH holders will be realised. This realisation will not be subject to the 1 year term (or to the approval of the convention, if before) of "suspension or delay" provided for the execution of guaranties in rem pursuant to article 55.1 of the Insolvency Laws in the event of the alienation of properties and rights affected to the *cédulas hipotecarias*. The payment to all of the *cédulas hipotecarias* owners shall be done on a pro rata basis, regardless of the issue date of their securities. (art. 14 Law 2/1981). In the case of insufficient cover assets, all CH holders' claims will be met on a pro-rata basis together with ordinary claims (Art. 157.2 of the Insolvency Law).

   A judicial stay (moratorium) on the insolvency's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of interest and the principle on CHs.

   In case of insolvency of the issuer, liquidity is ensured by the means discussed above, by the flows derived from the Cover Assets.

   In order to comply with the payment obligations to the holders of the *cédulas hipotecarias* in the event of a temporary gap in the revenue received by the debtor, payments shall be made by means of liquidating the substitution assets serving as collateral of the issue. If this was insufficient, payments shall be made by means of funding operations via subrogation of the debtor in the position of the holder of the cédulas (art. 14 Law 2/1981).

Administration of the cover assets

In case of insolvency, it is the normal insolvency administrator who administrates the cover assets. In this respect, under Spanish Insolvency Law, the bankruptcy is directed by commercial court of competent jurisdiction and managed by a specific body called the "bankruptcy authority" (*administración concursal*) comprising three persons: an attorney, an auditor or accountant and a creditor with ordinary debt or general privilege.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk weight of the CHs that comply with the requirements of Law 2/1981 is dependent on the risk weight against the issuer, according to the following table:

Risk Weight against the issuer	CH's Risk Weight
20	10
50	20
100	50
150	100

(Rule 16, section L "Covered Bonds" of the Circular 3/2008, of 22 May, of the Bank of Spain)

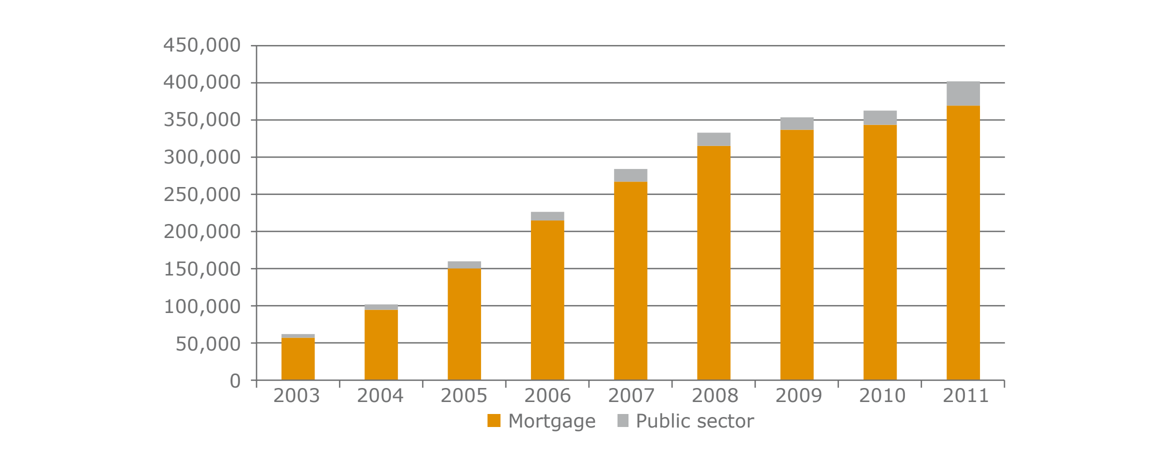
The CHs listed on a recognised secondary market (as AIAF) are eligible for investing the assets of the UCITS up to 25% of its net worth.

Provided that the requirements of the Law 2/1981 are met, the CHs are eligible as “Covered Bonds”. The applicable law comprises Law 36/2007, of 16 November, and Royal Decree 216/2008, of 15 February, by which Directives 2006/48/EC and 2006/49/CE, of 14 June 2006, are transposed into the Spanish Law.

The CHs are also eligible in repo transactions with the Spanish Central Bank and the European Central Bank provided that they comply with the requirements of the Law 2/1981.

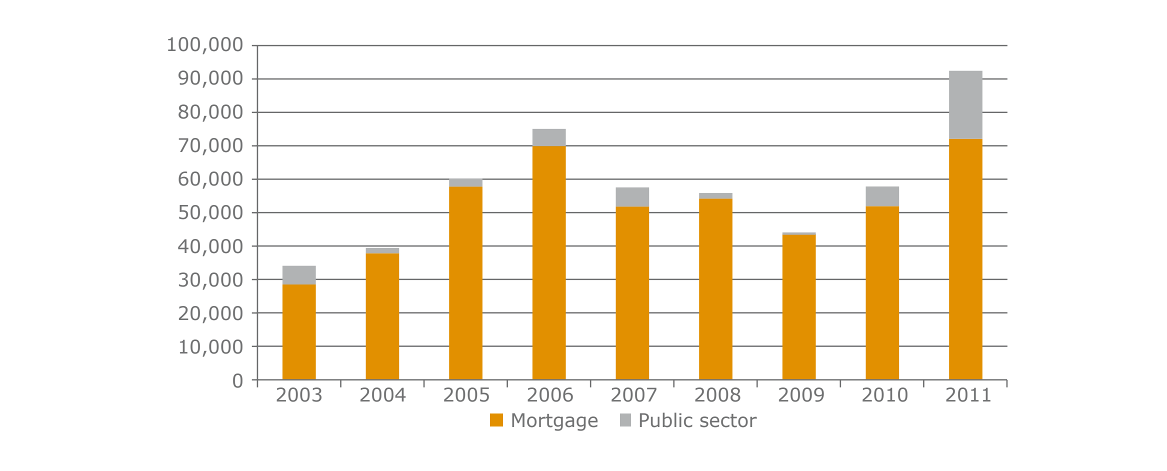
Finally, the CHs upon being listed or applied for listing are eligible for: i) investment by insurance companies of their technical provisions obligations; ii) the investment by mutual guarantee companies; iii) investment by Pensions Funds.

> Figure 1: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/45/C%C3%A9dulas_Hipotecarias

3.28 SWEDEN

By Jonny Sylvén, Association of Swedish Covered Bond Issuers (ASCB)

I. FRAMEWORK

In Sweden, the issuance of covered bonds is governed by the Swedish Covered Bonds Issuance Act, which came into force on 1 July 2004 (Lag 2003:1223 om utgivning av säkerställda obligationer, hereinafter the 'CBIA')[1]. The CBIA supersedes the general bankruptcy regulation and grants covered bond investors a priority claim on eligible cover assets (CBIA: Chapter 4, Section 1). Regulatory provisions (FFFS 2004:11, hereinafter 'CBR')[2] established by the Swedish Financial Supervisory Authority (Finansinspektionen, hereinafter 'SFSA') complement the legislation. These regulations define in more detail the criteria for obtaining an issue licence, the universe of eligible cover assets, valuation procedures for eligible cover assets, asset and liability management, and the form and maintenance of the cover register.

II. STRUCTURE OF THE ISSUER

The CBIA does not apply the specialised banking principle but allows all banks and credit institutions to issue covered bonds provided they have obtained a special licence from the SFSA (CBIA: Chapter 2, Section 1). The issuer must meet certain criteria to qualify for the licence. These criteria include the submission of a financial plan proving the issuer's financial stability for the next three years, the conversion of outstanding mortgage bonds into covered bonds, and the conduct of business in compliance with the CBIA. The SFSA has the right to withdraw the licence should the institution be in material breach of the CBIA or have failed to issue covered bonds within one year of receiving the licence (Table 1). If the SFSA withdraws a licence, it must determine a plan to wind down the operation.

> Table 1: Licence needed to issue covered bonds

Requirements for issuance licence:

- The institution's articles of association, by laws or regulations must comply with the CBIA.
- The issuer must conduct the covered bond business according to the CBIA and related regulatory provisions.
- Outstanding mortgage bonds to finance loans that may be included in the covered pool must be converted into covered bonds or administerd in an equivalent manner with respect to the creditors.
- The issuer must submit a financial plan for the next three financial years indicating that it is sufficiently stable so that the interest of other creditors is not jeopardised when it issues covered bonds. The report must be substantiated by auditors.
- The issuers must submit an operational plan that calls for sound management and supervision of the covered bond business (including information of the IT business).

The SFSA may withdraw a licence if:

- The institution is in material breach of its obligations puruant to the CBIA; and/or
- The institution has failed to issue a covered bond within one year of receiving the licence

Source: Lag 2003:1223, FFFS 2004:11

[1] Lag 2003:1223 *om utgivning av säkerställda obligationer* [Covered Bonds Issuance Act].

[2] FFFS 2004:11 Finansinspektionen's Regulations and General Guidelines Governing Covered Bonds.

Prior to the CBIA, commercial banks were restricted on their mortgage lending activities, and mortgage loans were extended by specialised mortgage institutions, which were allowed to issue mortgage bonds. Most of the Swedish mortgage credit institutions have a strong affiliation with Nordic universal banking groups, outsourcing their activities to their respective parent. The degree of outsourcing varies among issuers. The SFSA has published general requirements regarding outsourcing.

The cover assets represent claims of the covered-bond-issuing entity and remain on the balance sheet. There is no subsequent transfer of cover assets to another legal entity. The covered bonds are direct, unconditional obligations on the part of the issuer. Outstanding covered bonds are backed in their entirety by the cover pool. Hence, there is no direct legal link between single cover assets and particular covered bond series. In the event of issuer insolvency, the cover pool is bankruptcy-remote from the general insolvency estate of the issuer and exclusively available to meet outstanding claims of covered bond holders. Moreover, covered bond investors enjoy ultimate recourse to the insolvency estate of the issuer, ranking pari passu with senior unsecured investors.

III. COVER ASSETS AND COVER REGISTER

Eligible cover assets are mortgage loans and public-sector assets (CBIA: Chapter 3, Section 1). The CBIA does not specify separate cover pools for mortgage and public sector cover assets. Both asset classes are mixed in one cover pool. However, the main emphasis of Swedish issuers are on mortgage covered bonds (approximate 90 % of cover pools).

Eligible assets are mortgages:

- on real estate intended for residential, agricultural, office or commercial use;
- on site-leasehold rights intended for residential, office or commercial use;
- pledged against tenant-owner rights; and
- against similar foreign collateral.

The CBIA restricts mortgages against offices and commercial property to 10% of the total cover pool. Mortgage loans can be secured only with collateral comprising property located in Sweden and the European Economic Area (EEA)[3]. Neither asset-backed securities nor mortgage-backed securities are permissible as cover assets. The mortgage loans must meet valuation procedures and certain loan-to-value ratios defined by the CBIA and the CBR (see section IV).

Eligible public-sector assets are defined as securities and other claims:

- issued by or guaranteed by the Swedish state, Swedish municipality or comparable public body;
- issued by or guaranteed by a foreign state or central bank, where the investment is in the foreign state's currency and is refinanced by the same currency[4];
- issued by or guaranteed by the European Communities, or any of the foreign states, or central banks as prescribed by the Swedish government; or guaranteed by a foreign municipality or public body that has the authority to collect taxes.

[3] Countries belonging to the European Economic Area are the 27 EU countries plus Norway, Iceland, Liechtenstein.

[4] The law does not provide for any explicit geographic restriction.

The cover pool is a dynamic pool, and nonperforming loans due over 60 days cannot be recognised for the purposes of meeting the matching requirements set forth by the CBIA (CBR: Chapter 3, Section 4).

Derivative contracts

The CBIA provides for the use of derivatives for hedging interest and currency risk. The derivatives must be structured such that premature termination is not triggered by an issuer default or on demand of the counterparty. Derivative counterparties must have a minimum long-term rating of A3/A-/A- (Moody's/S&P/Fitch) or a short-term rating of P-2/A-2/F2. The law stipulates asymmetrical collateralisation, in that it requires collateral, a guarantee or replacement language in the event that the counterparty's rating falls below the minimum rating level. There is no reciprocal requirement by the covered bond issuer, given that derivative counterparties have a priority claim on the cover pool (CBR: Chapter 4, Sections 5 to 7). The use of derivatives is not limited to a maximum percentage of the cover pool since they are not included in the nominal matching calculation. Their use is limited to serve the balance between cover assets and outstanding covered bonds when creating a balance in respect of net present value of assets and liabilities.

Substitute assets

Highly liquid assets can serve as substitute assets for up to 20% of the mortgage cover pool. The SFSA can temporarily raise the limit to 30%. Eligible substitute assets include eligible public sector assets plus cash, cheques and postal money orders. These assets qualify for a 0% risk weighting. The SFSA has the discretion to extend the universe to eligible substitute assets (CBIA: Chapter 3, Section 2).

IV. VALUATION AND LTV CRITERIA

The CBIA defines valuation principles for properties that act as collateral for mortgages in the cover pool (CBIA: Chapter 3, Section 4). The valuation relating to residential properties may be based on general price levels. The valuation of any other eligible property class must be based on the market price, which must be determined by individual appraisal by qualified professionals. The market value should reflect the price achievable through a commercial sale, without time pressure and excluding any speculative or temporary elements. Issuers must monitor the market value of the property regularly, and in the case of serious decline must review the valuation, and ensure that the loan to value (LTV) of the related mortgage loan remains within the defined maximum limit (CBR: Chapter 3, Section 7, Chapter 5, Section 4). The valuer is normally an employee of the issuer, but external valuers are also used.

For the various mortgage types eligible as cover, the following maximum LTV ratios apply (CBIA: Chapter 3, Section 3):

> 75% of the value for real estate, site-leasehold rights and tenant-owner rights where the property is intended for residential use;

> 70% of the value for real estate intended for agricultural use;

> 60% of the value for real estate, site-leasehold rights and tenant-owner rights where the property is intended for office or commercial use.

These LTV limits are relative, not absolute, limits. A loan with a higher LTV ratio can be included in the cover pool up to the legal threshold. The balance must be refinanced with other funding instruments (e.g., senior unsecured funding) (CBR: Chapter 5, Section 3).

V. ASSET - LIABILITY MANAGEMENT

The CBIA requires that the nominal value of the cover assets at all times exceeds the aggregate nominal value of claims arising from outstanding covered bonds against the issuer (CBIA: Chapter 3, Section 8). In addition, the law requires that on a net present value (NPV) basis, cover assets, including derivatives, always exceed the corresponding value of the interest and principal of outstanding covered bonds, taking into account the effects of stress-test scenarios on interest and currency risk set by the SFSA. The SFSA defines the stress test for interest-rate risk as a sudden and sustained parallel shift in the reference swap curve by 100bps up and down, and a twist in the swap curve. Likewise, it defines currency risk as a 10% sudden and sustained change in the relevant foreign exchange rate between the currency of covered bonds and the currency of cover assets (CBR: Chapter 4, Section 2, Section 3). The CBIA does not require a mandatory level of minimum overcollateralization (OC). However, the issuer can adhere to a self-imposed OC level for structural enhancement, as the CBIA protects any OC in the cover pool in the event of issuer insolvency).

Finally, the issuing institution shall ensure that the cash flow with respect to the assets in the cover pool, derivatives agreements and the covered bonds are such that the institution is always able to meet its payment obligations towards holders of covered bonds and counterparties in derivatives agreements (CBIA: Chapter 3, Section 9). The issuer should be able to account for these funds separately.

VI. TRANSPARENCY

The issuers are already presenting information regarding their cover pool and outstanding covered bond every quarter. This information is today on the issuers' websites. This information will now be more comparable and in line with the request that ECBC have put forward in the work of achieving a national transparency template. The goal is to have this new way of presenting the information in function this year. The information will be reached from the issuers' website. Links to these pages will also be available on the web page of the Association of Swedish Covered Bond Issuers' (ASCB).

VII. COVER POOL MONITORING AND BANKING SUPERVISION

The covered bond issuers fall under the special supervision of the SFSA. The financial regulator monitors the institutions' compliance with the CBIA and other related regulatory provisions (e.g., CBR). If the covered bond issuer is in material breach of its obligations under the legal framework, the SFSA can issue a warning or revoke the issue license altogether. The SFSA may also revoke a license if the institution has declared that it waives the license or if the institution has not made use of the license within a year from the date of receiving the license. The revocation may be combined with an injunction against continuing the operations and with the imposition of a conditional fine. In any case, the SFSA must determine how the operations should be wound up (CBIA: Chapter 5, Sections 2 to 6).

For each issuing institution, the SFSA must appoint an independent and suitably qualified cover pool inspector (cover pool trustee), who is paid by the covered bond issuer. The duties of the cover pool inspector are to monitor the register and verify that covered bonds, derivatives agreements and the cover assets are correctly recorded. The inspector also ensures compliance with matching and market risk limits in accordance with the CBIA. The institution is obliged to provide the covered bond inspector with any information requested relating to its covered bond operations. The cover pool monitor must submit a report of the inspection to the SFSA on an annual basis, and must notify the SFSA as soon as he/she learns about an event deemed to be significant to the supervisory authority (CBIA: Chapter 3, Section 12 to 14, and CBR: Chapter 6, Sections 2 to 5).

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Cover register

The issuer must keep a register of eligible cover assets, substitute assets, derivative contracts, and outstanding covered bonds (CBIA: Chapter 3, Section 10). The law specifies the form and content of such a register, which must be easily accessible for the SFSA and the cover pool inspector. The registration legally secures covered bond holders and derivative counterparties a priority claim on the cover pool in the event of issuer insolvency (CBIA: Chapter 4, Section 4). Prior to an issuer being declared insolvent, cash flows accruing from the cover assets must be accounted for separately by the issuer. In the event of issuer default, covered bond investors and derivative counterparties have the same priority claim on these funds as they have on the cover pool. Moreover, cash flows accruing from the cover assets after issuer insolvency must be registered in the cover pool register.

Issuer is a subsidiary

Under the Swedish bankruptcy code, the mere insolvency of the parent company does not automatically trigger the insolvency of a subsidiary.

Issuer insolvency

In the event of issuer insolvency, the registered cover assets and the respective covered bonds are segregated from the general insolvency estate. Covered bonds are not accelerated as long as the cover pool fulfils the requirements set out in the CBIA, notwithstanding the existence of 'only temporary, minor deviations' (CBIA: Chapter 4, Section 2).[5] Also, mere issuer default does not trigger the premature termination of registered derivative contracts. Covered bond holders and registered derivative counterparties have a priority claim on the cover pool and cash that derives from the pool, ensuring timely repayment to original agreed terms, as long as the pool complies with the CBIA. However, the cover pool does not constitute a separate legal estate. According to legal opinion, the bankruptcy of the issuer should not lead to a debt moratorium on covered bonds.[6]

Cover pool insolvency and preferential treatment

In the event that the cover pool breached eligibility criteria, covered bonds would be accelerated. Covered bond investors and derivative counterparties would have a priority claim on the proceeds from the sale of the cover assets, ranking pari passu among themselves but prior to any tax claims and salary payments (pursuant to Section 3a of the Rights of Priority Act [SFS 1970:979]). If the proceeds are insufficient to repay all liabilities on outstanding covered bonds, covered bond investors and derivative counterparties would have an ultimate recourse to the insolvency estate of the issuer, ranking pari passu with senior unsecured investors.

Survival of OC

Any overcollateralisation (OC) present in the cover pool at the time of issuer insolvency is bankruptcy-remote provided it is identified in the cover pool register. Indeed, the CBIA requires full repayment of outstanding claims on covered bonds, and registered derivatives, before cover assets would be available to satisfy claims on unsecured creditors.

[5] According to preparatory works to the Act, this would be, for example, "temporary liquidity constraints".

[6] There are no means in the Act that could disrupt or delay payment to Covered Bondholders. However, the Act does not explicitly derogate from the general provision of the Code of Procedures 1948 or the Bankruptcy Act 1987, of which neither explicitly ensures the integrity of payments on Covered Bonds.

The law does not provide for the appointment of a special cover pool administrator. The receiver-in-bankruptcy represents the interests of both the covered bond investors and the unsecured investors. The receiver has the right to use OC to pay advance dividends to other creditors of the bankrupt issuer, if the pool contains more assets than necessary.[7] If the cover assets later prove to be insufficient, these advance dividend payments can be reclaimed.

Access to liquidity in case of insolvency

In the cases of issuer insolvency, the law does not enable the receiver-in-bankruptcy to refinance maturing covered bonds of the issuing institution by issuing new covered bonds against the cover pool. Likewise, the receiver is not able to substitute ordinary cover assets for alternative assets. However, the receiver can use available liquid substitute assets included in the pool. In addition, the receiver can sell part of the cover pool in the market to create the necessary liquidity without raising debt.

The receiver-in-bankruptcy has – as of 1 June 2010 - also got an express mandate, on behalf of the bankruptcy estate, to take out liquidity loans and enter into other agreements for the purpose of maintaining matching between the cover pool, covered bonds and derivative contracts. The receiver has an extensive mandate to enter into agreements, not only to achieve a liquidity balance but also to achieve a balance in respect of currencies, interest rates and interest periods. The receiver should only enter into agreements if, on the date of execution of the agreement, the agreement is deemed to favour bondholders and derivative counterparties and if the assets in the cover pool are deemed to fulfil the terms and conditions imposed in the Act. When the receiver enters into an agreement the contracting party receives a claim against the bankruptcy estate that ranks ahead of the secured creditors and creditors with rights of priority.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Swedish covered bonds comply with the criteria of UCITS 52(4) and with the covered bond criteria defined in the EU CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f). The CBIA explicitly lists mortgages against property for agricultural purposes, and mortgages against the pledging of tenant-owner rights as eligible cover assets, while the EU CRD does not. However, general opinion of the parties involved is that the EU CRD's term "commercial real estate" should be interpreted in a broader sense, including agricultural property. In addition, issuers can impose self restrictions to ensure that their covered bond issues comply with EU CRD. Swedish covered bonds are eligible for repo transactions with the Riksbank (the Swedish Central Bank). The share of the total collateral in relation to the payment system that can be comprised of covered bonds is 100%. This applies to covered bonds issued by the borrower or by an institution with close links to the borrower.

The Riksbank's collateral requirements are harmonised with those applied within the Eurosystem. Moreover, Swedish covered bonds denominated in euros are likely to qualify as Tier 1 assets with the ECB.[8]

Derivatives that are part of the cover pool do not benefit from any special capital treatment. They currently carry the same risk weighting as the credit institution counterparty. The implementation of EU CRD into Swedish law grant derivative contracts included in the cover pool the same capital treatment as covered bonds.

[7] According to legal opinion, the receiver-in-bankruptcy would have take into account a substantial safety margin to ensure that the cover pool's integrity and compliance with the Act is not jeopardized, which would be difficult to prove unless outstanding Covered Bonds were due to mature imminently.

[8] In general, the ECB grants marketable debt instruments the status of Tier 1 assets, if the security is denominated in euros, compliant with UCITS Art. 22 (4) and issued by a credit institution situated in the EEA area (ECB: "Implementation of Monetary Policy in the Euro Area", Feb, 2005).

Foreign covered bonds enjoy the same preferential capital treatment in Sweden if the foreign supervisory authority of that covered bond issuing institution has also assigned those covered bonds preferential risk weightings (principle of mutual recognition).

The law regulating insurance companies in Sweden (Försäkringsrörelselagen 1982:713) makes no distinction between mortgage bonds and covered bonds. Swedish insurance companies can invest up to a maximum of 25 % in the covered bonds of a single issuer. Swedish legislation on investment funds (Lag 2004:64 om investeringsfonder) allows mutual funds to invest up to 25% of their assets in Swedish covered bonds, instead of the 10% generally applicable to other asset classes.

X. ADDITIONAL INFORMATION

Issuing and trading of Swedish domestic covered bonds

In order to issue covered bonds mortgage companies and banks need an authorisation by the Swedish Financial Supervisory Authority (SFSA). Normally the bonds are registered at the Nordic Exchange Stockholm (NASDAQ OMX Group), although no actual bond trading takes place there. Offering circulars with the detailed issue conditions are following a standard based on the Prospectus Directive with acceptance from the SFSA, OMX and the market makers. The normally used technique for issues is "on tap".

The Swedish bond market investors appreciate liquidity. Because of these "requirements" the large issuers issue their bonds as benchmarks which mean that large amounts (SEK 3 billion and more) are issued and that a number of dealers, under normal circumstances, show both bid and offer prices. Also, only benchmarks are deliverable in the future contracts. When a new benchmark-loan is issued, the issuers make sure that the amount issued meets the requirements for a benchmark sized deal. After the initial day of issuance the issuer can, without further notice, issue "on tap" the size he requires to match the lending.

The bonds are sold into the primary market through banks acting as agents for the issuer. These banks also act as market makers in the secondary market. Currently, there are six banks and securities firms that act as market makers in covered bonds: Danske Bank, Nordea, Nykredit, SEB, Svenska Handelsbanken and Swedbank. The market for government and domestic covered bonds, as well as treasury bills, is a telephone and screen-based over-the-counter market. Market makers display indicative two-way prices on an electronic information system which is instantaneously relayed by Reuters. Fixed prices are quoted on request and most deals are concluded via telephone. Trading in the secondary market takes place on all business days between 09.00 and 16.15 (local time). The number of loans to be quoted is regulated in an agreement between the issuer and the market-maker.

Bonds are quoted on a yield basis with bid and ask spread of (under normal market conditions) 2 bp for the liquid benchmark bonds. The settlement day for bonds is three business days after the trading date. T-bills are quoted on a simple yield basis and are settled two business days after the trading day. The normal trading lot in government securities and liquid mortgage bonds is SEK 200-500m. Of course, prices are given for other lots as well.

Sweden has a liquid and smoothly operating repo market with almost all banks and broker firms involved in the trading. The repo market in Sweden started in the late 1980s, and has developed fast over the last few years. The Swedish Debt Office offers a repo-facility in government bonds and treasury bills and mortgage companies offer their market makers a repo-facility in their own bonds. The repo transaction is viewed as a 'sell-buy back' or 'buy-sell back' deal and the ownership of the security has to be transferred.

There are no standard conditions for a repo transaction and the counterparties have to agree on maturity, settlement day and delivery for each deal. Most often, though, repos are settled two banking days after the trading day. Repo rates are quoted as a spread vs the Riksbank repo rate.

Almost all public listed securities in Sweden are registered at the Euroclear Sweden. In general, Swedish bonds are domestically settled via the Euroclear. Domestic settlement requires a custodian account with one of the Swedish banks or securities firms. Foreign investors can either have a custodian service with a Swedish bank or securities firm or settle via Euroclear or Cedel.

Accrued interest is calculated from the previous coupon date to the settlement day. The interest rate is calculated by using ISMA's 30E/360 day count - "End-of-month" convention.

Swedish government and covered bonds have five ex-coupon days which means that there is negative interest when settlement occurs within five business days before the coupon date.

Most Swedish bonds pay coupon annually. There are, however, bonds that pay coupon semi-annually. All domestic banks act as paying agents.

Swedish krona bonds redeem at par upon maturity.

A special small bond Exchange called "SOX", is a special part of NASDAQ OMX Nordic. All bonds registered at "SOX" must have low denominations in order to be suitable for private investors. The trade in the "SOX" market is held by the Swedish Commercial banks and some stock brokers.

The trade in the SOX market is fully computer based. A normal "trading amount" in the SOX market is SEK 100.000 per transaction.

The activities of ASCB

The Association of Swedish Covered Bond issuers (ASCB), which was established in 2009, has an ongoing work to further improve the conditions for the Swedish covered bonds. Two recent results of these efforts are, firstly, an amendment of the law with the purpose to grant the receiver-in-bankruptcy access to short-term liquidity in case of insolvency (see chapter VII) and, secondly, an agreement on the method of calculating the LTV for the cover pool.

According to the agreement the Swedish covered bond issuers are recommended to calculate and present certain basic key statistics concerning their respective cover pools as uniformly as possible ("Max LTV per property").

> Cover pool data shall comprise only loans and collateral included in the pool. When a loan is only partially included in the pool, only the eligible part is accounted for.

> In case a loan is secured by both mortgage deeds and a guarantee from the state or municipality, the part of the loan with guarantee will be treated as a public loan, and not included in LTV calculation.

> Loan to Value will be calculated on the principal only.

> Calculation of the aggregate weighted average LTV for a cover pool, will follow a method called "Max LTV per property". The method is chosen because it is fairly simple and the result is independent of the number of loans or mortgage deeds charging a property. It is also independent of the order of priority for the individual mortgage deeds.

The weighted average LTV should be supplemented with a diagram showing the distribution of principal balance in "LTV buckets" based on the exact order of priority for the individual mortgage deeds. ASCB has initiated projects aiming at further improving transparency in the Swedish covered bond market in order to maintain the position of Swedish covered bonds as being a highly secure product for financing of mortgage and public lending.

The seven Swedish issuers of covered bonds made in April 2011 a joint road show in Frankfurt, Munich and Paris, which was followed by a presentation in London. Presentations were made by Mattias Persson, Head of the Department for Financial Stability at the Riksbank, chief economists at Swedish banks, Mattias Lampe, partner Mannheimer Swartling law firm and Per Tunestam, Head of Treasury, SBAB. The presentations concerned the Swedish economy, the housing market, the covered bond market, the legal framework and the credit infrastructure.

Further information concerning the road show, the LTV-method as well as the Swedish covered bond market is accessible at the website of ASCB (www.ascb.se).

Essential Terms and conditions of a typical Swedish market maker agreement

The market maker has a duty to:

> Help the issuer sell bonds via taps of the benchmark loans in the market;

> Actively support trading of these bonds in the secondary market; and

> Continuously quote indicative rates in the information systems used.

These obligations apply to a limited number of the issuer's loans – the benchmark-loans. Typically 5 to 8 loans of a big issuer have this status with respect to outstanding volume. Using the on-tap issuing technique a loan typically reaches bench-mark status when the outstanding loan amount is SEK 3-5 bn. (At the peak of the life of the bond it typically has a volume of SEK 50 to 70 bn. After that the volume falls due to active repurchase operations by the issuer. With one year to go to maturity a loan is no longer of benchmark status. This paves the way for a controlled redemption of the remaining part of the loan.)

The bid ask spread shall be in line with present market conditions and the trading lots shall typically exceed SEK 500 million.

The obligations of a market maker are conditional upon a number of things of which the following could be mentioned;

> that no change in the economic, financial or political conditions have occurred which in the reasonable opinion of the market maker would create a major obstacle to the fulfilment of the obligations;

> that the bonds, in the reasonable opinion of the market maker, cannot be placed in the primary or secondary market on normal market conditions.

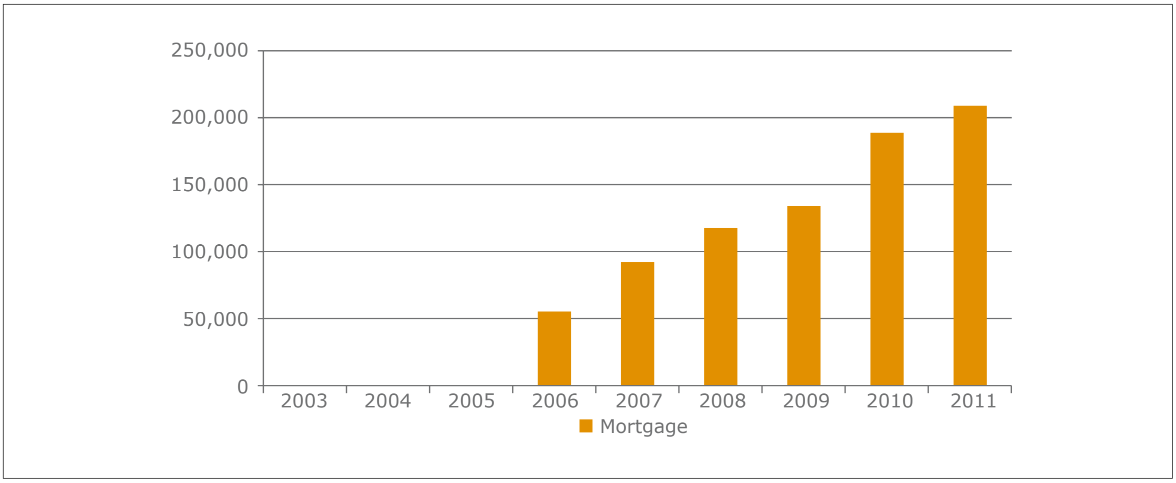
If so, the market marker shall notify the issuer and may withdraw from the duties wholly or in part for a shorter or longer time.

The market maker also has an obligation to trade two futures (2 and 5 year) of the issuer in a similar way as that of the benchmark bonds.

The issuer on his side has an obligation to (under normal market conditions) supply the market maker with a repo facility in the outstanding benchmark bonds. (This facility used to be unlimited. Today, however, the limit is set by the available cover in the cover pool of the issuer.)

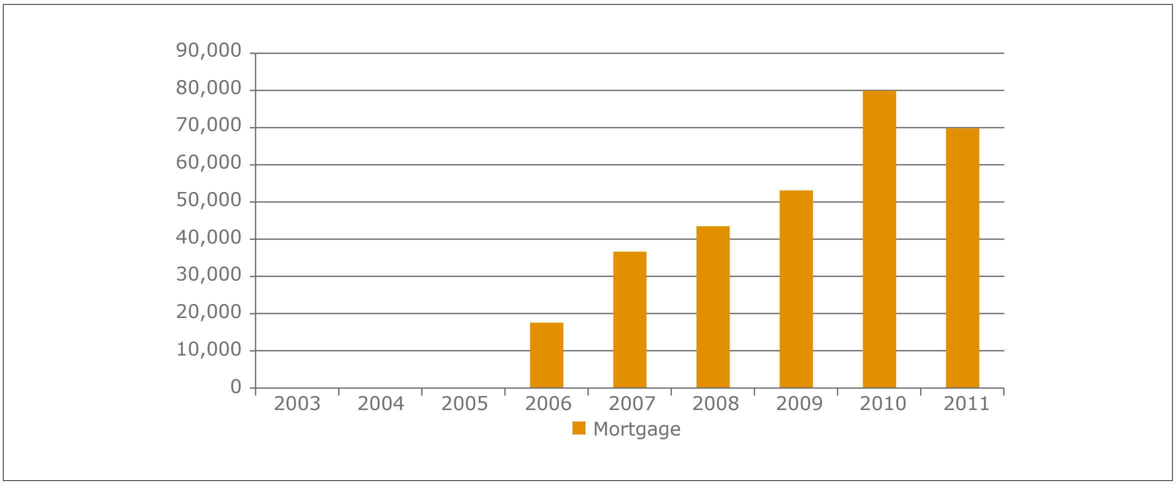
With respect to transparency the issuer shall make public at the end of each week figures on outstanding benchmark loans as of the last day of the previous week.

> Figure 1: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

Issuers: The Swedish covered bonds market in 2011 consists of seven issuers: Stadshypotek, Swedbank Mortgage, Nordea Hypotek, Swedish Covered Bond Corporation (SCBC), SEB, Länsförsäkringar Hypotek and Landshypotek. The market is dominated by the first five of them and the majority of their exposure is to domestic residential mortgages, with the remainder consisting of commercial property loans and public sector loans.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/47/Sweden

3.29.1 SWITZERLAND – SWISS PFANDBRIEFE

By Jörg Schmid, Pfandbriefbank schweizerischer Hypothekarinstitute AG

I. FRAMEWORK

The issuance of Swiss Pfandbriefe – a label protected by law - is governed by the ‘Pfandbriefgesetz’ (PfG) effective 25 June 1930. Since then the PfG was only marginally modified. It contains only 52 articles and is complemented by the ‘Pfandbriefverordnung’ (PfV) and the valuation regulations.

The Swiss Pfandbrief is more than a mere covered bond because in the case of the Swiss Pfandbrief the coverage is legally determined in comparison to a covered bond with a coverage which is only based on a private agreement between issuer und investor.

As of article 1 of the PfG the Pfandbrief institutes have the purpose to grant real estate owners long term mortgages at constant and cheap interest rates. Generally speaking, the Swiss Pfandbrief is a major means to close the refinancing gap of member banks.

II. STRUCTURE OF THE ISSUER

The PfG grants the right to issue Swiss Pfandbriefe exclusively to two Swiss Pfandbrief institutes, namely the Pfandbriefzentrale der schweizerischen Kantonalbanken AG (PBZ) and the Pfandbriefbank schweizerischer Hypothekarinstitute AG (PBB). The first operates as the Pfandbrief issuing vehicle of the Swiss cantonal banks and the latter of all other Swiss banks. The PfG grants these two institutes the right to merge. Both are special banks with their business scope limited to the issuance of Swiss Pfandbriefe, to granting loans to their member banks and to investing their share capital and reserves. They are owned by their member banks.

The cantonal banks are public-sector banks and majority-owned by the canton (Swiss region) in which they are incorporated. Most cantonal banks benefit from a state guarantee extended by their canton[1].

To issue Swiss Pfandbriefe the authorisation of the government is required. Both Pfandbrief institutes are supervised by the Swiss banking regulator, the Eidgenössische Finanzmarktaufsicht (FINMA).

Even if it looks like it at first glance, it is not a duopoly. The two Pfandbrief institutes are self-help-organizations, or in other words, the bond issuing departments and cover pool of their member banks outsourced to the Pfandbrief institutes. Switzerland is too small a country for every bank to issue Swiss Pfandbriefe. Pooling makes sense and is an additional strength.

PBZ was founded in 1931 and has 24 member banks. Only cantonal banks have the right to be members of the PBZ (PfG Art. 3). PBZ does not have its own staff but has fully outsourced its operations to Zürcher Kantonalbank. As of 31 March 2012 the total outstanding Swiss Pfandbriefe of PBZ amount to CHF 26.5 bn (EUR 21.8 bn).

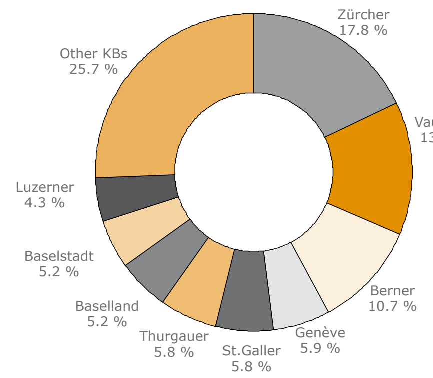
PBB was founded in 1930 and counts 260 member banks. Any Swiss bank has the right to become a member of PBB, provided that it is headquartered in Switzerland and that Swiss mortgages account for at least 60% of the bank’s balance sheet. The board of directors can accept banks with a lower mortgage/balance sheet ratio. As of 31 December 2011 the total outstanding Swiss Pfandbriefe of PBB amount to

[1] Three of PBZ’s member banks do not benefit from a cantonal guarantee or have a limited guarantee, namely Banque Cantonale de Genève AG (limited guarantee until 2016), Banque Cantonale Vaudoise AG (no guarantee) and Berner Kantonalbank (limited guarantee until 2012).

CHF 48.8 bn (EUR 40.1 bn). PBB operates with 8 employees, a cost income ratio of 6.1% and a profit of CHF 47.5 m (EUR 39.0 m) for the business year 2011.

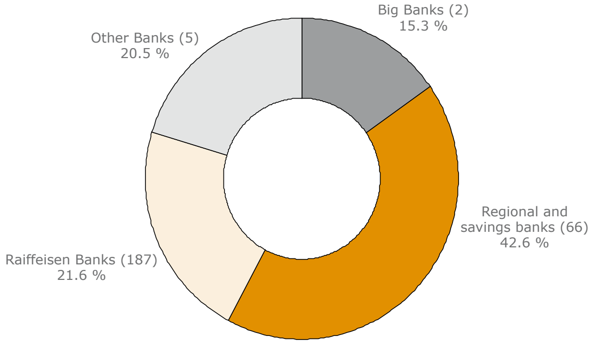
The chart below shows the structure of the shareholders:

> Figure 1: Shareholders of PBZ



Source: PBZ, as of 31.03.2012

> Figure 2: Shareholders of PBB



Source: PBB, as of 31.12.2011

From the beginning Moody's has rated Swiss Pfandbriefe with Triple A. The Swiss National Bank accepts Swiss Pfandbriefe as collateral for the repo pool.

Swiss Pfandbriefe are standardized to a great extent. They are a commodity, denominated only in Swiss francs, with a long-term duration of 3 to 30 years and always with a fixed coupon. They are issued at the due date of a matured Pfandbrief, if the conditions for a new issuance are favourable or tailor-made on the basis of an investor demand. The size of an issuance depends either on the demand of the member banks for loans or on the demand of the investors for Swiss Pfandbriefe, whichever is smaller. The average size is about CHF 569 m. Whenever possible, existing bonds are reopened. The maximum size should not exceed CHF 1 bn.

Swiss Pfandbriefe are issued either as public bonds or as private placements. Public bonds are issued through a banking syndicate at fixed conditions, while private placements are issued by the Pfandbrief institutes themselves.

The issuing price or investor's yield depends on the duration of the bond, the interest curve, the coupon and the issuing volume. Further pricing information is obtained from the secondary market of all other outstanding Swiss Pfandbriefe and from the comparison with other bond issuers. For example: on 12 April 2012 PBB issued series 561 with a duration of 5 years at Swap Mid plus 8.0 basis points.

All of the about 130 publicly issued Swiss Pfandbriefe are listed on the SIX Swiss Exchange. Swiss Pfandbriefe amount to 24.7% of all Swiss bonds listed (in Swiss francs). Private placements are not listed.

The total volume of all outstanding Swiss Pfandbriefe as of 31 December 2011 amounts to CHF 74.8 bn (EUR 61.4 bn). For years the two Swiss Pfandbrief institutes have been the major bond issuers in Switzerland, even more important than the government. In 2011 they issued Swiss Pfandbriefe amounting to CHF 15.8 bn (EUR 12.9 bn).

About 26% of investors in Swiss Pfandbriefe are insurances, 25% institutional investors (such as asset managers), 22% pension schemes, 17% banks and investment funds and the rest are retail investors and others.

III./IV. COVER ASSETS, VALUATION AND LTV CRITERIA

As a principle, Swiss Pfandbrief loans are only given against a pledge of first rank mortgages on Swiss properties. Within PBZ the cover pool is managed by the member banks.

PBB has got an electronic cover pool. Mortgages are pledged to PBB by member banks through entry of the "cover proposal" into the electronic pool register, which all 260 member banks are linked with. The system immediately evaluates the member bank's "cover proposal", which is then reviewed by one employee and authorized by another. The valuation of PBB is independent of the valuation of the member bank. Substantial cover proposals are reviewed by the cover pool committee. Member banks can check on their screen, whether its "cover proposals" are accepted or refused for improvement.

PBB supervises the cover pool electronically. If coverage tends to become insufficient, an exception list is produced and the member bank is informed automatically. Based on PfG member banks are obliged to increase coverage in case of impaired or non-performing mortgage loans or if total interest payable of the Pfandbrief loans is smaller than the total interest receivable on the pledged mortgages.

The cover pool of PBB consists of more than 114,000 individual mortgages all over Switzerland which provides a good diversification. 96% are residential and only 4% commercial properties.

The PfG defines the maximum loan to value (LTV) of two thirds (Art. 5 PfG) and the valuation principles which are detailed in the valuation regulations and approved by the federal council. FINMA can ask for a reassessment of the collateral, if its market value or other economic conditions have deteriorated substantially.

In total about 9% of all Swiss mortgages are financed through Swiss Pfandbriefe.

V. ASSET - LIABILITY MANAGEMENT

Cover principles

The PfG stipulates that the principal amount and interest payments of outstanding Pfandbriefe be at all times covered by an equivalent amount of loans to the member banks (PfG Art. 14). The Pfandbrief loans granted by Swiss Pfandbrief institutes to their member banks must be collateralised by eligible liens on real property (PfG Art. 19). The Pfandbrief institutes will only pay out Pfandbrief loans to member banks if the cover value of the cover register asset pool meets the criteria of the PfG.

Overcollateralisation

Additionally to eligibility and valuation principles (LTV legally at maximum 2/3, in reality less than 50% as mentioned above), the cover value of the cover register assets have to exceed the Pfandbrief loans given to member banks at least by 8% within PBB und by 15% within PBZ. The higher percentage of PBZ compensates the fact that PBZ does not have an electronic cover pool register.

Additional Risk Limits

Swiss Pfandbriefe are issued in individual series which must match the repayment profile of the Pfandbrief loans to member banks, eliminating interest rate and funding risks. Currency risk does not exist as both the loans to member banks and the Pfandbriefe are issued in Swiss Francs. Therefore, there is no need for derivatives to hedge market risks. Liquidity concentration risk is limited by individual limits for each member bank. The investment policy for free assets limits credit and market risks on counterparty and portfolio level. All Swiss Pfandbriefe are part of the Swiss National Bank repo basket and can immediately be pledged against cash to any Eurex Repo member.

Growth of the Pfandbrief institutes is limited as the required capital must exceed 2% of the total Pfandbrief issuance volume of the respective institute (PfG Art. 10).

VI. TRANSPARENCY

Key data	Units	PBB	PBZ
As of (year end closing)		31.12.2011	31.03.2012
Swiss Pfandbriefe outstanding	CHF m	48,781	26,545
Average interest rate for outstanding Pfandbriefe	%	2.186	2.348
Balance sheet total	CHF m	50,465	27,836
Free Assets	CHF m	1,133	488
Equity capital	CHF m	1,025	958
Moody's rating		Aaa (stable)	Aaa (stable)

Both institutes publish more information on the websites listed below.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

PBB valuates the cover pool independently of the member bank (who grants the mortgage to the house owner) and monitors eligibility and overcollateralization of the cover pool daily. All mortgages are backtested by a hedonic valuation model. Additionally, the cover pool committee reviews substantial mortgages and visits major properties.

Swiss government approves by-laws and valuation regulations and nominates one member of the board of directors.

External audit firms audit the financial statements and the cover pool of the member banks and the Pfandbrief institutes. The auditors report directly to the banking supervision (FINMA) and the general assembly.

In addition, Moody’s rates all Swiss Pfandbriefe with Aaa, investors analyse the annual reports of the Pfandbrief institutes, analysts of the big Swiss banks Credit Suisse, UBS and Zürcher Kantonalbank publish research reports and last but not least capital market values Swiss Pfandbriefe on a daily basis.

For the issuing of Swiss Pfandbriefe a special license of the FINMA is required. Swiss Pfandbrief institutes and their member banks are supervised by FINMA.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

In the event of insolvency of a member bank, the Pfandbrief institute has a priority claim on the registered collateral (PfG Art. 23). The insolvency of a member bank does not trigger the acceleration of outstanding Pfandbriefe because the investors have no direct contractual relationship with the member bank. In this respect, the Pfandbrief institute functions as a buffer between the investors and the member banks. FINMA cannot delay payments on the Pfandbrief institute’s claims, which are themselves backing the Pfandbriefe (BankG Art. 26, Abs. 1, h). Moreover, FINMA can demand the transfer of the collateral pool under its control and then act as fiduciary (PfG Art. 40) or arrange for a sale of the cover assets to other banks[2].

Timely payments on Pfandbriefe are ensured, even if one or several member banks default. First, the Pfandbrief institutes collect the interest on the member loans on a semi-annual basis while coupon payments on Pfandbriefe are annual. Second, the Pfandbrief institutes have own funds at their disposal and maintain a portfolio of liquid investments.

The insolvency of a Pfandbrief institute is highly unlikely as it could only occur if several member banks defaulted at the same time, combined with a severe deterioration of the cover pool. Moreover, FINMA is highly likely to use supervisory efforts to avoid a bankruptcy of a Pfandbrief institute. In the improbable scenario of bankruptcy of a Pfandbrief institute, Pfandbriefe would accelerate and Pfandbrief investors would rank pari passu among themselves on the proceeds of the asset sale (PfG Art. 29). Again, FINMA has the power to assume control of the respective cover pool and to act as fiduciary.

IX. RISK-WEIGHTING

Switzerland implemented Basel II into national law and modified it to account for national specifics contained in the Swiss Capital Adequacy Ordinance (CAO). The CAO has three approaches to measure credit risks in banking books: 1) The Swiss standard approach, 2) the BIS standard approach and 3) the internal ratings-based approach. Under the Swiss standard approach Swiss Pfandbriefe have a 25% risk weighting, while under the BIS standard approach they have a final risk weighting of 22% (taking into account a risk weighting of 20% and the multiplier of 1.1).

X. ADDITIONAL INFORMATION

Investor benefits

An investor in Swiss Pfandbriefe benefits from:

> The special bank principle with no currency and no interest change risk.

> The cover pool, which only includes mortgages on Swiss properties and thus excludes ship or airplane mortgages, derivatives, foreign mortgages etc.

> The fourfold security which is 1) the creditworthiness of the Pfandbrief institute, 2) the creditworthiness of the member bank, 3) the creditworthiness of the proprietor of the property and 4) creditworthiness of the property itself.

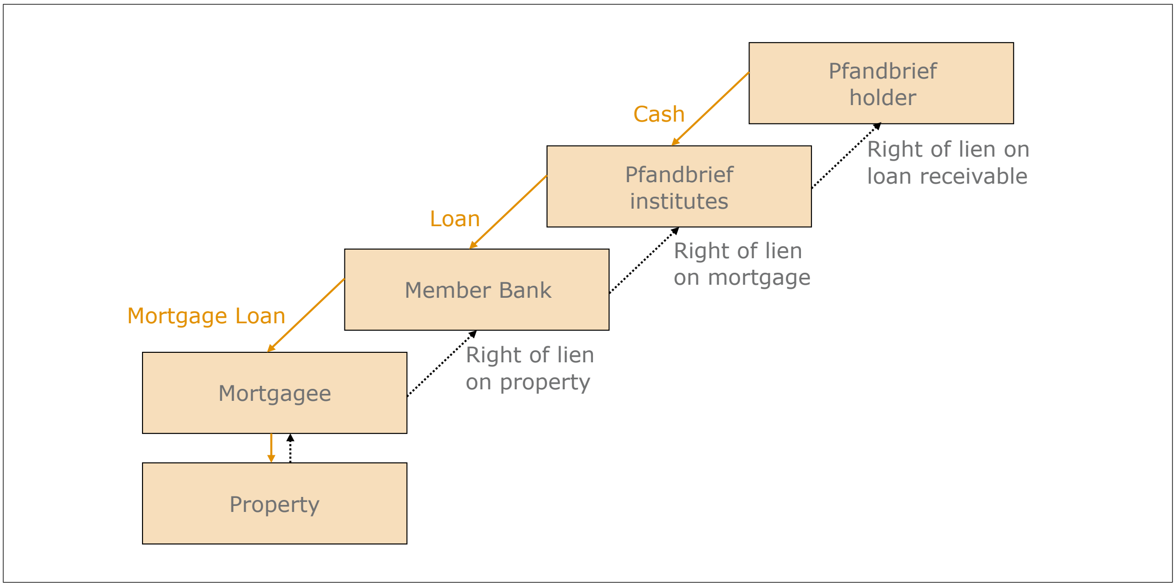
> In the case of PBZ: Explicit state guarantee for most of its member banks.

> In the case of PBB: The value of the property is determined by PBB and not by the member bank.

> The fact that since the establishment of the PfG in 1930 neither an investor nor a Pfandbrief institute have ever suffered a loss.

[2] In the early 1990s, Spar- und Leihkasse Thun, a member bank of PBB, no longer met regulatory capital requirements and was closed by the FINMA. Cover pool mortgages were sold to other banks and the proceeds were used to amortize the loans granted by PBB.

> FIGURE 3: THE SWISS PFANDBRIEF MODEL


Pfandbrief holder
Cash
Right of lien on loan receivable
Pfandbrief institutes
Loan
Right of lien on mortgage
Member Bank
Mortgage Loan
Right of lien on property
Mortgagee
Property

Source: Credit Suisse AG

Contact addresses

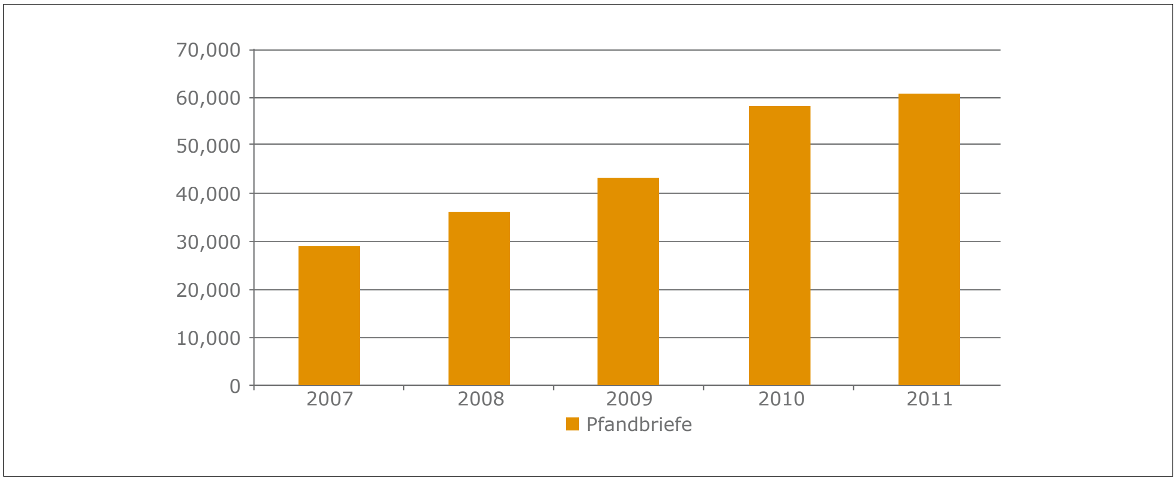
For PBB:

Pfandbriefbank schweizerischer Hypothekarinstitute AG
Nansenstrasse 16
CH-8050 Zürich (ZH)
+41 44 315 44 55
www.pfandbriefbank.ch

For PBZ:

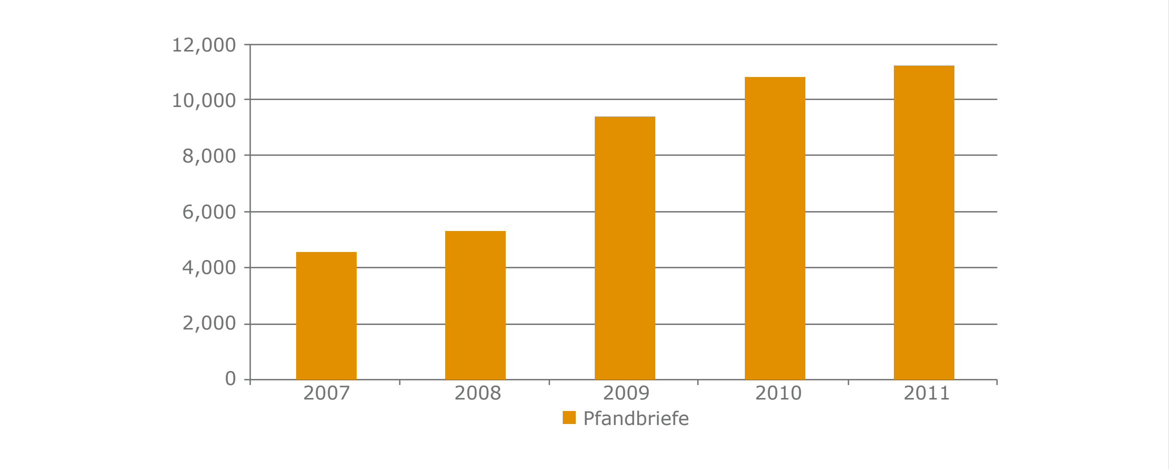
Pfandbriefzentrale der schweizerischen Kantonalbanken AG
Bahnhofstrasse 9
CH-8001 Zürich
+41 44 292 31 97
www.pfandbriefzentrale.ch
www.cldg.ch (French)

> Figure 4: Swiss Pfandbriefe Outstanding, 2007-2011, EUR m



Source: EMF/ECBC

> Figure 5: Swiss Pfandbriefe Issuance, 2007-2011, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/82/Swiss_Pfandbriefe

3.29.2 SWITZERLAND - STRUCTURED COVERED BONDS

By Richard Kemmish, Credit Suisse and Ulrike Hock, UBS

In addition to instruments issued under the Swiss covered bond act, the Swiss Pfandbriefe as described above, two Swiss banks (Credit Suisse and UBS) have chosen to establish covered bond programmes based on contractual agreements with the relevant parties. Instruments issued under such contractual agreements qualify as structured covered bonds that allow Credit Suisse and UBS to also access the deeper liquidity of the non-CHF denominated covered bond market.

In line with the Swiss Pfandbriefe, the programmes are both backed by prime Swiss domestic residential mortgage collateral.

Given that the two covered bond programmes are based on contractual agreements, the issuers have been free to include various structural features designed to enhance investor protection and ensure a robust AAA/Aaa rating. Both of the programmes launched to date have adopted very similar structures, the minor differences are highlighted where appropriate below.

I. FRAMEWORK

Although not relying on the Swiss covered bond act, both programmes use Swiss (as well as English) legal frameworks to ensure, inter alia, a segregation of the assets and the bankruptcy remoteness of the guarantor.

The issuers have separately mandated two Swiss-based special purpose companies (Credit Suisse Hypotheken AG and UBS Hypotheken AG) to guarantee their payment obligations for the benefit of the covered bondholders. The guarantee then comes into operation following an issuer event of default, subject to certain conditions. All covered bonds issued under the respective programme rank pari passu with each other and share equally in the security. Furthermore, the covered bonds are either fungible with an existing series, or constitute a new series with different terms.

The guarantors are ring-fenced, bankruptcy-remote entities that will be unaffected by the insolvency of the group to which they are consolidated (both guarantors are majority-owned by their respective issuer).

II. STRUCTURE OF THE ISSUER

Both issuers today are large financial institutions regulated by the Swiss banking regulator, “Swiss Financial Market Supervisory Authority” (FINMA).

The covered bonds issued by Credit Suisse and UBS are direct, unsubordinated, unsecured and unconditional obligations benefiting from a guarantee given by the respective guarantor vehicles. Before an issuer event of default, the issuers shall make all payments of interest and principal on the covered bonds.

III. COVER ASSETS

In both programmes, the collateral consists of Swiss mortgage loans to private individuals and the related mortgage certificates securing such mortgage loans. The geographical scope for the mortgage assets is limited to Swiss domestic mortgage loans.

Substitution assets can be included in the cover pool. Their aggregate value can make up to a maximum of 15% of the cover pool and may consist of cash and short-term investments such as bank deposits, domestic Pfandbrief bonds and AAA government debt.

In order to ensure that the overcollateralisation (OC) level is compatible with the triple-A rating objective, the programmes include a dynamic Asset Coverage Test (ACT) that requires the balance of the mortgages in the collateral pool to significantly exceed the balance of the outstanding covered bonds. The level of OC will depend on the credit quality of the mortgages in the cover pool as well as other risks as assessed by the rating agencies.

IV. VALUATION AND LTV CRITERIA

For Credit Suisse, the LTV limit is set at 70% while for UBS at 80%. When calculating the appropriate loan balance within the asset coverage test (ACT), Credit Suisse allows higher LTV loans to be included in the pool, but loan amounts exceeding the cap are disregarded. For Credit Suisse, the LTV ratio of the mortgage loans cannot be more than 100%. UBS does not allow loans with LTV above 80% to be included in the Cover Pool, and if this LTV cap is breached after inclusion the loan amounts exceeding the cap will be credited with a reduced multiplication factor. In addition, the ACT gives reduced value to loans more than 90 days in arrears.

For both programmes LTV is calculated using market values.

For all properties that comply with its standard valuation boundaries (e.g. value below CHF3mn or property less than 15 years old) Credit Suisse utilises a hedonic automatic valuation model provided by IAZI, one of the two main providers of such automated appraisals in Switzerland. Should the purchase price lie above 15% off the IAZI valuation, Credit Suisse performs an onsite valuation of the property (this also applies for properties that fall outside the valuation boundaries).

UBS uses a hedonic automated valuation model from Wüst&Partner (the second main provider) for all loan applications. W&P and IAZI together value about two-thirds of all residential property transactions in the country. Input factors for the W&P model are property characteristics such as year of construction, volume of property and net living space. Additionally, the property's positioning within the local area and macro-level information (e.g. accessibility, tax level and price level of the municipality) are taken into account. If UBS deems on-site valuation as appropriate these will by specialist UBS staff (e.g. engineers or architects).

V. ASSET-LIABILITY MANAGEMEMT

Both covered bond programmes benefit from a number of safeguards:

> Exposure to market risk (i.e. interest rate and currency risks) needs to be neutralised by use of derivatives. Subject to certain rating triggers, swaps with suitable counterparties have to be entered into to ensure that exposure to market risk is properly hedged;

> Liquidity risk is mitigated by the requirement to establish a reserve fund as well as by other contractual arrangements. All of the bonds issued to date have a pre-maturity test to ensure repayment of the bonds on a hard bullet basis (although other structural enhancements, such as extensions, are available to the issuers if in future investors or rating agencies prefer it);

> Cash flow adequacy is secured through the asset-coverage and interest-coverage tests and the contractual obligation to neutralise any exposure to interest rate and currency risk;

> Commingling risk is mitigated by the hedging strategy as well as the requirement of all collections arising from the cover assets to be swept into the Hypotheken accounts after loss of F1/P-1 short-term ratings of the issuers;

- Minimum rating requirements are in place for the various third parties that support the transaction, including the swap counterparties and account banks. There are also independent audits of the calculations undertaken on a regular basis;

As a default of the issuer does not accelerate the covered bonds, an amortisation test has been created to ensure that no time subordination exists between the covered bonds series. The amortisation test will fail if the aggregate loan amount falls below the outstanding balance of all the covered bonds.

VI. TRANSPARENCY

Both issuers have committed to publishing monthly investor reports on a timely basis.

These reports provide various information relevant to investors including,

- the monthly calculations of the Asset Coverage Test and the Interest Coverage Test,
- details of outstanding covered bonds and list of parties involved in the transaction,
- balance of programme accounts,
- a mortgage portfolio summery outlining total contract balance, average loan balance, number of properties, WA remaining terms (in years) and WA LTV (in %),
- tables showing number of contracts or properties and mortgage amounts per remaining terms, current loan to value, total balance by property, interest rate type, distribution by W&P property region, property type, and arrears.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Although there is no mandatory reporting requirement, both of the issuers have committed to provide detailed and regular disclosure. The issuers are regulated Swiss financial institutions, which are subject to regulation, supervision and examination by the Swiss banking regulator (FINMA). The issuers are responsible for the monthly pool monitoring and Asset Coverage, Interest Coverage and Amortisation Test calculations. The results are checked and verified by an independent asset monitor who immediately advises the trustee upon their breach. The cover pools themselves are audited by independent professional auditors at regular intervals.

In addition, rating agencies are involved in the programme and re-affirm the ratings of the program upon a pre-defined issuance volume. They also monitor the amount of over-collateralisation required to maintain the triple-A ratings.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Upon transfer for security purposes of the mortgage loans and the related mortgage certificates, each of the guarantors (Credit Suisse Hypotheken AG and UBS Hypotheken AG) becomes the legal holder of the mortgage loans as well as the legal owner of the mortgage certificates.

In an insolvency scenario over the issuers Credit Suisse or UBS, the mortgage notes and the related mortgage certificates would not form part of Credit Suisse or UBS's estate. Accordingly, the asset cover pool may be managed and enforced by the guarantors independently from the corporate insolvency proceedings of Credit Suisse or UBS AG.

There are a number of trigger events for default, the first being an issuer event of default. This can occur in a number of situations including the following:

- Failure to pay any interest or principal amount when due;
- Bankruptcy proceedings being ordered by a court or authority against the issuer;
- Failure to rectify any breach of the asset coverage or interest coverage test;

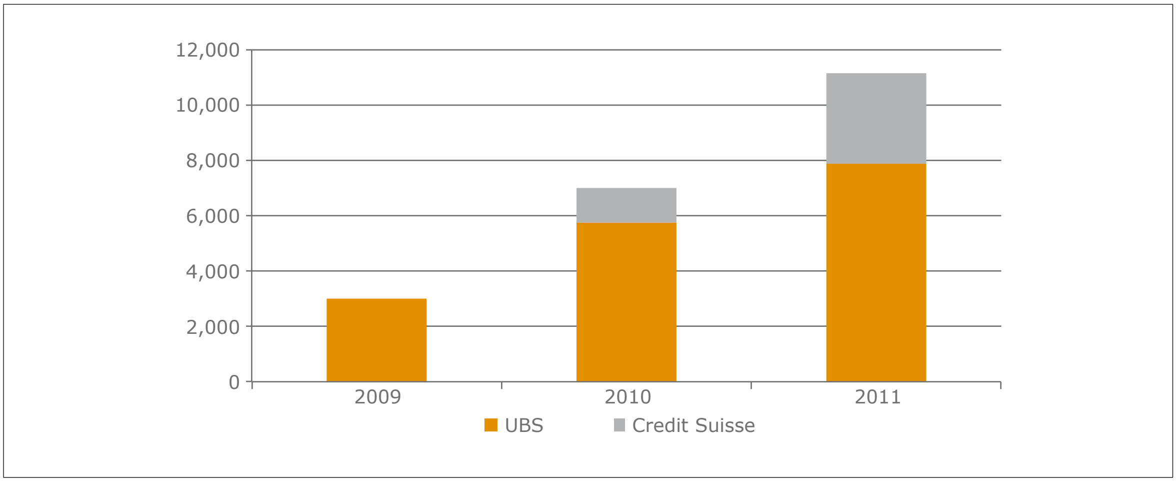
An issuer event of default would not accelerate payments to covered bondholders, but would allow the trustee to start proceedings against the issuer or the guarantor.

The second event of default is the guarantor event of default. This would arise after an issuer event of default if the guarantor failed to make any payments when due, an amortisation test failed or the guarantor was declared bankrupt. A guarantor event of default would cause the acceleration of payments to covered bondholders and their early redemption at the amount relevant to that particular covered bonds series.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

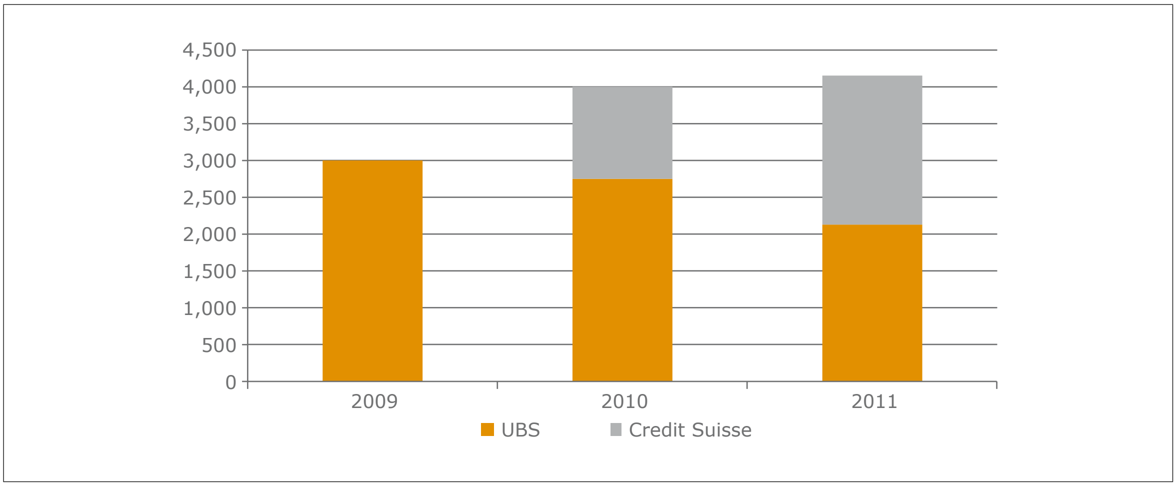
Swiss general-law based covered bonds have a 20% risk-weighting under the CRD Standard Approach. They fall under Liquidity Category III (structured covered bonds) of the ECB eligible assets criteria.

> Figure 1: Covered Bonds Outstanding 2009-2011, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2009-2011, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/92/Credit_Suisse_CB and http://www.ecbc.eu/framework/78/UBS_CB

3.30 TURKEY

By Fritz Engelhard, Barclays Capital, Batuhan Tufan, Garanti Bank
and Ozlem Gokceimam, Garanti Bank

I. FRAMEWORK

In Turkey, the legal basis for Turkish Covered Bonds is the by-law published by the Capital Markets Board (CMB) on 4 August 2007 (Serial: III, No: 33, Mortgage Covered Bonds).

Turkish Covered Bonds are defined as "*İpotek Teminatlı Menkul Kıymetler (İTMK)*" or "Turkish mortgage covered bonds" and are trademarked by the legislation.

The İTMK by-law is part of a series of legislations, which follow the enactment of "The Housing Finance Law (No: 5582)" by the Parliament, which includes basic definitions and amendments to certain laws, aimed at establishing a healthy and functioning housing finance system on 6 March 2007.

II. STRUCTURE OF THE ISSUER

Banks defined in Article 3 of the Banking Law (No: 5411 dated 19/10/2005), as well as mortgage finance companies, are allowed to issue İTMK. The authorisation to issue İTMK is subject to the issuance of a licence by the Capital Markets Board, which can only be achievable following the fulfilment of certain conditions. Banks and mortgage finance companies who wish to issue İTMK must provide "the office, technical facilities and organisational structure" in addition to "a risk management system that will monitor the risk that may rise due to the issuance of İTMK".

Further, if the issuer is a bank issuer, the consent of the Banking Regulatory and Supervision Agency (BRSA) is also a pre-requisite.

Provided the above conditions are met together with supporting evidence, a licence to issue İTMK may be granted.

İTMK bonds are debt securities, which are general obligations of the issuer and secured by cover assets. The cover assets are held on the balance sheet of the issuer and a subsequent transfer of assets to another legal entity does not take place.

The issuer must apply to the CMB for registration of the İTMK before any issuance, public or private placement, can take place. Before such application, a cover monitor must have been appointed by the issuer.

III. COVER ASSETS

Eligible assets are residential and commercial mortgage loans. Assets originated or purchased by the issuers can be registered in the cover register if they meet the below criteria:

> Granted after the Housing Finance Law (No: 5582). If originated before, should meet the criteria defined by Article 11 of the Housing Finance Law. (Assets acquired from Housing Development Administration of Turkey are excluded from this criteria)

> All interest and principal payments have been secured by a mortgage and all obligations have been met on time.

> The property must be located in Turkey and must possess a certificate of occupancy.

> For the entire life of the loan, the real estate has to be fully insured against earthquakes, fire and any kind of natural hazard.

- The value of the property must be appraised by an officially listed real estate appraisal company and be in accordance with the by-law (Serial: VIII, No: 35, Principles Regarding Appraisal Companies)

Loans that meet the above criteria may be recorded in the cover pool up to 75% of their appraised value for residential mortgage loans and up to 50% of their appraised value for commercial mortgages.

Up to 15% of the net present value of the cover pool may comprise of substitute collateral which are cash, short term debt instruments issued by the Central Bank of Turkey, public debt instruments (domestic and foreign), securities issued under treasury reimbursement guarantee (as defined in Law No: 4749 dated 28 March 2002), securities issued or guaranteed by governments or central banks of OECD countries, or any other assets that may be approved by CMB.

Derivative instruments that are publicly traded or transacted with a bank, an insurance company or central clearing agency which are rated at least investment grade by rating agencies, can be included in the cover pool up to 15% of its net present value.

IV. ASSET - LIABILITY MANAGEMENT

The issuer is expected to perform a risk management system that will measure, analyse and devise risk policies against risks such as credit risk, interest rate risk, exchange rate risk, liquidity risk, market risk as well as operational risk and counterparty risk. Further, it has to involve certain written guidelines to reduce the before mentioned risks and adapt to changing market dynamics. It should be revisited at least once a year.

In addition to the risk management system, the cover pool must also comply with certain cover matching principles. The matching principles involve:

- Nominal Value Matching: The total volume of the İTMK must be covered at all times by assets of at least the same amount. Derivative instruments are excluded from this calculation and debt instruments are included with their face value.
- Interest Revenue Matching: The interest revenue of the cover assets for one year following the calculation date must not be less than the interest expenditures of the İTMK.
- Net Present Value Matching: The net present value of the cover assets must at all times be at least 2% more than the net present value of all obligations of the İTMK.
- The issuer has to monitor the matching of the above criteria daily and has to carry out weekly stress tests that include the parallel shifting of yield curves of matching maturity and foreign currency values. The interest rate shifts for YTL denominated bonds is determined as 300 bps, whereas the same value is 150 bps for foreign currency denominated bonds. Further, to measure the effect of exchange rate risks on cash flows a 30% parallel shift is performed on the purchase rate of the relevant currency published by Central Bank of Turkey.

V. TRANSPARENCY

According to the "Capital Market Law - Special Cases of Public Disclosure Article 16/A" – For the protection of small shareholders and the enlightenment of the public, the Board shall adopt regulations with respect to:

- The collection of share certificates;
- Requirements for proxy voting in general assemblies;

- Share certificate transfers;
- Capital increases, mergers and transfers resulting in significant changes in the share distribution of the company; and
- Notice to shareholders at times of significant events and developments affecting the value of securities and the furtherance of control of the capital and management of publicly held Joint Stock Companies.

Members of board of directors, general managers and their deputies, and shareholders holding 10% or more of the capital of publicly held joint stock corporations shall provide the Board and relevant exchanges and other organised markets such information relating to their shares in those corporations as the Board may require for the purpose of disclosure.

The Public Disclosure Platform (PDP) is an electronic system through which electronically signed notifications required by the capital markets and ISE regulations are publicly disclosed. In addition to ISE companies and ETFs, ISE member intermediary institutions may submit notifications to PDP. Independent audit companies, on the other hand, send the electronically signed financial statements for which independent audit is required, to the relevant company electronically in order to be announced to the public. Please see http://www.kap.gov.tr/yay/English/ek/KapHakkinda.aspx for further information.

VI. COVER MONITOR AND BANKING SUPERVISION

A cover monitor supervises the cover pool. The cover monitor is appointed by the issuer and must possess the expertise and experience necessary to fulfil all duties. A qualification as a certified auditor by the CMB suggests that the necessary expertise is provided.

The monitor has to ensure that the prescribed cover for the İTMK exists at all times and that the cover assets are recorded correctly in the cover register. Without the cover monitor’s approval no assets may be added to or removed from the cover pool. The monitor also ensures that the cover matching principles are met once every 15 days and submits a summary report to the issuer.

The cover monitor is required to report any inconsistencies in the cover register or failures in matching principles directly to the CMB.

She/he is also authorised to conduct a discretionary review of the cover assets, including substitute assets as well as the derivative instruments in place. Further, the cover monitor can also check the land registries of the mortgages and request any other information that may be necessary for the cover monitor’s review.

VII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

A cover register held by the issuer permits the identification and segregation of the cover assets. The collateral backing the İTMK is to be registered in book and/or in electronic form.

In case the issuer fails to meet the standards to be an issuer, the CMB simultaneously appoints another authorised bank or mortgage finance corporation, cover monitor or another audit firm as the manager to pursue the best interests of the İTMK holders. Following the loss of the issuer status, the right to actively manage the cover assets, including selling and buying of assets, is transferred to the manager automatically.

Until the İTMK are completely redeemed, cover assets cannot be sequestered, including collection of public receivables, cannot be subject to injunctive decisions of courts and cannot be included in the bankruptcy estate of the issuer.

The manager may transfer all or a part of the assets recorded in the cover register to another issuer that meets the İTMK issuer criteria. Following such transfer, the ownership of the cover assets is also passed on to the new issuer who can merge the newly acquired assets with its existing cover assets. The new issuer also automatically becomes the beneficiary of any excess cash flows from the cover assets.

If the cover assets cannot be transferred to another issuer or if the cash flows from the cover assets do not suffice, the manager can allocate the residual cash to İTMK holders according to their respective shares and further request from the CMB that the İTMK be early redeemed. Should the collateral not suffice to cover all outstanding İTMK plus interest, the İTMK holders rank pari-passu with unsecured debtors of the issuer.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

İTMK comply with the requirements of Art. 52 par. 4 UCITS Directive as well as with those of the Capital Requirements Directive (CRD), Annex VI, Part 1, Paragraph 68 a) to f). Therefore, they may qualify for a beneficial treatment under the CRD.

The EU opened accession negotiations with Turkey on 3 October 2005. As a candidate for EU membership, Turkey will be obliged to be compliant with EU Directives in case of full membership. Thus, in recent years Turkish authorities were strongly aligning banking regulations to EU standards. The revised Accession Partnership of the EU with the Republic of Turkey from 18 February 2008 foresees that Turkey adapts its regulations to the CRD. The EU progress report on Turkey, published in November 2008, states that "further efforts are needed to continue alignment with the new capital requirements for credit institutions and investment firms".

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/50/Turkey

3.31 UKRAINE

By Anton Sergeev, Arsen Nizelsky and Konstantin Kuczerenko,
Ukrainian National Mortgage Association

I. FRAMEWORK

In Ukraine the legal basis for Covered Bond issuance is the Law on Mortgage Bonds, adopted on December 22nd, 2005. It supersedes certain provisions of general bankruptcy legislation (Art. 8 par. 4, art. 15 par. 1 no. 8 and other provisions of the Law on Mortgage Bonds).

In 2006 the legal basis for covered bonds has been complemented by several supervisory regulations of the State Securities and Capital Markets Commission. The most important is the Regulation No. 774 "On the mortgage coverage of common mortgage bonds, administration of the mortgage coverage register and the management of mortgage coverage of covered bonds" (the Mortgage Coverage Regulation) which was passed on 1st September 2006.

II. STRUCTURE OF THE ISSUER

The issuer may be any bank or a non-bank financial institution which is entitled to grant loans secured by mortgages or to which mortgage loan claims were transferred from another entity. Non-bank financial institutions under Ukrainian law are: credit unions, pawnshops, leasing companies, trust companies, insurance companies, pension funds, and investment funds. The issuer does not need to be a specialized bank or financial institution.

Banks and non-bank financial institutions issuing covered bonds may pursue all business activities which are permitted for their respective types of financial institutions. Insurers, pension funds and investment funds are restricted to granting loans (secured by mortgage), although they might acquire loans from other entities.

The only specific legal rule in relation to bank employees is set out in general banking licensing guidelines (art. 19 par. 3 Law on Banks and Banking Activities). Indirectly, the National Bank Directive (from 29.01.2004 "Methodical Directives Concerning Organization and Functioning of a Risk Management System at the Banks of Ukraine") sets stricter rules concerning bank officials who are responsible for risk management functions. Ukrainian law does not prescribe any specific limitations for outsourcing.

The issuer holds cover assets on its balance sheet. Cover assets are not transferred to a different legal entity acting as a guarantor of covered bonds.

III. COVER ASSETS

Cover assets are ex lege pledged to secure performance of the issuer's obligations to the Covered Bondholders. Other creditors of the issuer are not allowed to extend claims against covered assets, to impose seizures or otherwise encumber covered assets, unless the claims of mortgage bond holders have been satisfied in full. The issuer may not alienate cover assets as long as there are no legal grounds for replacement of cover assets (such grounds are: revealed nonconformity of individual assets with the quality requirements of the law; initiation of the foreclosure on mortgage property or early termination of the mortgage; more than a three-month payment delay by the debtor; and bankruptcy of the debtor). In case of insolvency of the issuer the cover pool is excluded from the general insolvency estate of the issuer and continues to serve as a pledge for the performance of the issuer's obligations to the bond holders.

For every issue of covered bonds a separate cover pool must be formed.

In accordance with the Law on Mortgage Bonds, mortgage assets may be included in the mortgage coverage under the following conditions:

1) Mortgage assets are owned by the issuer and can be alienated in case of non-performance of obligations under mortgage bonds;
2) Debtor obligations secured by mortgages are subject to performance in monetary form;
3) Data that the issuer is a mortgagee under a corresponding mortgage agreement and is duly registered in respective state register in the manner prescribed by legislation;
4) Mortgage assets are not pledged or encumbered in any other manner to secure issuer's obligations other than its obligations under mortgage bonds;
5) There was no decision of foreclosure or bankruptcy procedure regarding the debtor of the respective mortgage or credit agreement;
6) Respective mortgage agreement does not provide for possibility to replace or alienate mortgaged property by a mortgagor without consent of a mortgagee;
7) Mortgaged property is located on the territory of Ukraine and is insured for its overall value against risks of accidental destruction, accidental damage or spoiling;
8) Mortgage assets are not included in the composition of mortgage coverage of another issue of mortgage securities, unless otherwise provided by this Law;
9) The ratio of the initial principal obligation secured by mortgage does not exceed 75 percent of the appraised value of the subject of mortgage;
10) The debtor obligation is not secured by a subsequent mortgage,;
11) Mortgage assets comply with the other requirements provided by the Law.

Derivatives may not be included into the cover pool. However the Law on Mortgage Bonds provides for use of the agreements on preservation of real value (now derivative contracts) – agreements intended to reduce credit, currency and interest rate risks associated with the bonds, or to management of the flow of receivables of the mortgage coverage, including without limitation *swaps, options, future and forward contracts and equivalent financial instruments*. Use of derivative contracts is a complex issue which may be further regulated by the National Bank and Securities Commission to assure the safety of the bonds.

The issuer forms a separate cover pool for each issue. Only in certain cases new mortgage assets may be added to the cover. In accordance with the article 13 of the Mortgage Bonds Act, if during the period of maturity of common mortgage bonds the mortgage coverage correlation exceeds figures prescribed herein, the issuer shall be obliged to include new mortgage assets in composition of mortgage coverage in order to comply with mortgage coverage correlation provided by law.

Due to article 14 of the mentioned Act, individual mortgage assets shall be excluded from the composition of mortgage coverage of common mortgage bonds only in connection with their replacement. Replacement of individual or inclusion of new mortgage assets in the composition of mortgage coverage shall be carried out in the following cases:

1) nonconformity of individual mortgage assets in the composition of mortgage coverage to requirements set by the law or in prospectus;
2) initiation of foreclosure on mortgaged property or early termination of mortgage for any other reasons;
3) more than a three-month delay of payments by a debtor under an obligation secured by mortgage;
4) bankruptcy proceedings are taken against a debtor under a mortgage asset;
5) exceeding of mortgage coverage correlation prescribed by Article 13 herein;
6) addition of mortgage assets to the mortgage coverage in connection with issuance of new bonds secured by a common mortgage coverage or as required to observe the balance principles.

The explicit transparency requirements regarding cover assets are provided by article 28 of the Law on Mortgage Bonds "Publication and Disclosure of Mortgage Bond Information". Issuers, who have placed mortgage bonds, shall be obliged to publish and disclose complete information on the financial and economic position and results of their activity; any legal facts (deeds and/or events) that may affect performance of obligations under mortgage bonds; correspondence of the state of mortgage coverage to requirements of the Law. Time limits, manner and form of such disclosure is prescribed by the Regulation of the State Securities and Capital Markets Commission No. 1591 "On disclosure of information by the issuers of securities" adopted on 19th December 2006. This Regulation provides for the duty of Covered Bond issuers to disclose the ad-hoc information (e. g. changes in the cover pool, replacement of the cover pool manager, acceleration of the covered bonds) as well as regular information on the cover pool on the quarter-year basis.

IV. VALUATION AND LTV CRITERIA

Property valuation shall be conducted by the certified natural persons or legal entities under the Property Evaluation Act. The National standards of valuation of immovable property approved by the Cabinet of Ministers provides for a valuation of immovable property based on market value.

In the meantime no regular property value monitoring is provided by the legislation of Ukraine.

In accordance with the Article 8 of the Mortgage Bonds Act the ratio of the nominal principal amount of the mortgage asset to the appraised market value of the mortgaged property, determined by the certified valuer is 75%, while article 13 of the said Act establish this ratio in amount of 60% for non-residential property.

V. ASSET - LIABILITY MANAGEMENT

Art. 13 par. 3 no. 2 Law on Common Bonds stipulates, that the average weighted interest of the covered bonds must exceed the average weighted interest of the mortgage assets. No. 3 of this paragraph prescribes, that the size of the periodical payments against interest receivables from the cover assets must be identical to the size of the issuer's payments against interest receivables on covered bonds. The Mortgage Coverage Regulation on the cover pool of covered bonds specifies these rules as follows:

> The average weighted interest rate of the cover assets must exceed the average weighted interest rate of the covered bonds. This criterion may, however, be disregarded, if the market situation after

the issue of covered bonds does not allow to comply with it, always provided that the interest yield of the cover assets exceeds the interest yield of the covered bonds;

> The interest yield of the cover assets must exceed the interest yield of the covered bonds.

Additionally, the Law provides for a duration test: the average weighted duration of the cover assets must exceed the duration of the covered bonds. According to the Mortgage Coverage Regulation, only the contractual (and not the factual) duration of the assets must be taken into account.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

During the period of maturity of mortgage bonds, the issuer shall be obliged to ensure audits of the mortgage coverage at his own cost.

The external audits shall be conducted annually. Unscheduled audits may be conducted on demand of the manager or the Securities and Stock Market State Commission.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

In accordance with the Article 10 of Law on Mortgage bonds the cover assets are identified by the cover register. A register of mortgage coverage is defined as information on each mortgage asset in mortgage coverage. The register of mortgage coverage must contain information on the initial and current value of mortgage coverage, its composition, as well as the following data on each mortgage asset:

1) details of the mortgage and credit agreement and name of the borrower;
2) original principal amount and interest rate on the debt;
3) outstanding principal amount;
4) maturity;
5) description of mortgaged property sufficient for identification of the latter, information on state registration of mortgage (date and number);
6) appraised value of mortgaged property under the mortgage agreement;
7) LTV as of the date of mortgage agreement conclusion;
8) other data according to prospectus.

The register of mortgage coverage shall include a description of substitute assets, included in the mortgage cover and the derivative contracts.

According to art. 8 of the Law on Mortgage Bonds, mortgage coverage of mortgage bonds shall be deemed to be pledged to secure performance of obligations of an issuer/pledger to holders of mortgage bonds/pledge. Pledge of mortgage and other assets entered into the register of mortgage coverage arises according to the Law from the moment of inclusion of mortgage assets into the register.

Each issue of a covered bonds has to be registered with the Securities and Stock Market State Commission. In order to register an issue of mortgage bonds, a mortgage coverage register shall be submitted. Extracts from the register of mortgage coverage shall be submitted to the Securities and Stock Market State Commission within the time limit and according to the form prescribed by the Securities and Stock Market State Commission. Thus without the register, an issue would not be valid.

Asset segregation

Segregation of the assets is accomplished by separate accounting for the mortgage coverage. For issuers-banks, mortgage coverage and transactions with it shall be recorded by the issuer separately in the manner prescribed by the National Bank of Ukraine, and for issuers that are non-banks – by a specially authorized executive body in the area of regulation of financial services markets.

Mortgage coverage shall not be included in insolvency's estate of the issuer. The issuer shall not be entitled to alienate, pledge, or otherwise encumber mortgage and other assets included in the composition mortgage coverage unless a decision on replacement of respective mortgage assets is taken pursuing to this Law. The issuer shall not be entitled to dispose of mortgage coverage otherwise than to perform obligations under respective issue of mortgage bonds.

Impact of insolvency proceedings on covered bonds and derivatives

According to the provisions of the Law and the Mortgage Coverage Regulation there are two possible scenarios in case of insolvency of the issuer:

1) the mortgage coverage manager assumes the servicing of the mortgage coverage or transfers it to another servicer of its choice. In this case the bondholders continue to receive payments according to the terms of the covered bonds;

2) the mortgage coverage manager alienates the mortgage coverage and prepays the covered bonds. This leads to an acceleration of the covered bonds.

Further details may be regulated in the prospectus (terms of the covered bonds). It may be stipulated in the terms of the covered bonds that the general assembly of the bondholders shall decide which of the scenarios is to be chosen.

Preferential treatment of Covered Bond holders

The Covered Bond holders have the right to demand early repayment of the covered bonds in case of the insolvency of the issuer (art. 17 par. 1 no. 2, par. 2 Law on covered bonds). They may exercise this right only through the monitor, who is also competent to decide whether to sell the cover pool or to leave it on the balance sheet of the issuer.

Cover assets are legally separated from the insolvency estate of the issuer. First of all, Covered Bond holders shall be fully satisfied out of the cover assets. Only the remaining assets may be returned to the issuer (art. 11 par. 3 Law on covered bonds).

The Covered Bond holders may seek satisfaction not only from the cover assets, but also from the other assets of the issuer, if the cover assets are not sufficient to satisfy them (art. 17 par. 2 no. 4 Law on covered bonds).

Access to liquidity in case of insolvency

There are no specific regulations in the Law concerning access to liquidity in case of insolvency. Generally, a certain level of liquidity is guaranteed by the relatively high mandatory over-collateralization (10%) which may be held in liquid assets (cash, state securities).

Sale and transfer of mortgage assets to other issuers

Art. 11 Law on covered bonds stipulates that the execution into the cover pool may be levied through *selling* of the cover pool or in another way not prohibited by the law. The monitor gains the right to sell the cover assets in case of insolvency or an essential violation of the duties of the issuer; then, the monitor has to satisfy the cover bond holders out of the proceeds. It is important to note, that the selling of the cover assets to another bank or financial institution does not transfer the issuer's liabilities out of the covered bonds. The selling of the cover pool is effected in accordance with the general civil law rules (cession or transfer of collateral note).

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The National Bank of Ukraine ruling on risk-weighting does not contain any specific provisions concerning covered bonds so far. According to a general provision debt securities of other credit institutions are 100%-risk-weighted.

The Ukrainian covered bonds fulfill the criteria of Paragraph 68 (d) and (e) of the Annex VI, Part 1, of the Capital Requirements Directive (CRD). The criteria of UCITS 52(4) are fulfilled with the exception of the creation by the Ukrainian Banks of their registered office in a Member State of the European Union.

3.32 UNITED KINGDOM

By Jussi Harju, Barclays Capital
and John Millward, HSBC

The UK covered bond market was established in 2003, becoming well established using English law structured finance techniques prior to the introduction of a dedicated covered bond regulatory framework. In March 2008, HM Treasury implemented a specific UK covered bond statutory instrument, with the FSA also publishing its accompanying Sourcebook covering its implementation of the framework as the "special public supervisor". The Regulated Covered Bonds Regulations 2008 (the "Regulations") overlaid the existing general law and contractual structures, providing the necessary underpinning for UCITS Article 52(4) compliance and thereby providing benefits including higher prudential investment limits, higher investment thresholds for insurance companies and lower risk weights under the BCD. HMT and the FSA introduced a set of revisions to the UK legislation (the "Amendment Regulations") and Sourcebook in November and December 2011 respectively, with the intention of further raising "transparency in the UK regulated covered bond market" and making "the UK regime more readily comparable with [other] European ... jurisdictions by creating a more prescriptive regulatory framework"[1]. The amendments will become effective for regulated programmes from 1 January 2013, and are discussed in more detail below.

As the special public supervisor for regulated covered bond issuers under the Regulations, the FSA's stated aims are to ensure a robust regulated covered bond market in the UK, and to ensure that quality is maintained to preserve investor confidence in the UK regulated covered bond market's reputation. The FSA has a wide range of enforcement powers under the Regulations, including the power to issue directions, de-register issuers or fine persons for any breaches of the requirements under regulated covered bond programmes.

As of July 2012, 12 covered bond programmes have been registered, which are required to undergo a rigorous, independent and comprehensive risk review by the FSA in order to achieve regulated status and are subject to detailed ongoing supervision and monitoring. The UK market also comprises various covered bond programmes which are not regulated, however this summary is confined to the principal features of regulated covered bonds as we expect that the public market will be dominated by regulated programmes going forward.

UK REGULATED COVERED BONDS

I. FRAMEWORK

The UK Regulations came into force on 6 March 2008, and were amended in November 2011 with the new changes coming into force from 1 January 2013. Under the Regulations, in order to attain "regulated status" there are two broad sets of requirements the issuers need to comply with – those relating to issuers and those relating to the covered bonds. Issuers are permitted (but are not required) to submit their covered bond programmes to the UK Financial Services Authority (the FSA) for recognition. The application process is comprehensive, as described in Section VII below. Those issuers and covered bonds that meet all of the criteria set out in the Regulations are added to the register of Regulated Covered Bonds maintained by the FSA.[2] The Regulations only apply to those covered bonds which have been

[1] Source: "Review of the UK's regulatory framework for covered bonds", November 2011

[2] The register may be found at http://www.fsa.gov.uk/Pages/Register/rcb_register/index.shtml

admitted to the register. As at July 2012, these issuers are: Abbey National Treasury Services plc, Bank of Scotland plc (residential mortgage programme), Barclays Bank plc, Clydesdale Bank plc, Co-operative Bank p.l.c., Coventry Building Society, HSBC Bank plc, Leeds Building Society, Lloyds TSB Bank Plc, Nationwide Building Society, Royal Bank of Scotland plc and Yorkshire Building Society.

Regulated covered bonds are subject to special public supervision by the FSA. The FSA is required to have regard to "the need to preserve investor confidence in, and the desirability of maintaining the good reputation of, the Regulated covered bond sector in the United Kingdom …" in the exercise of its functions under the Regulations. Regulated covered bonds comply with the requirements of Article 52(4) of the EU Directive on Undertakings for Collective Investment in Transferable Securities (the UCITS Directive). At time of writing, all Regulated covered bonds also comply with the definition of covered bonds set out in Directive 2006/48/EC of the European Parliament, hereafter referred to as the Banking Consolidation Directive, or BCD).

Most elements of the Regulated covered bond structure are governed by contract, with the Regulations providing overarching legislative and supervisory framework but without prescribing the complete design and contractual arrangements for the product, and creating the necessary underpinning for UCITS compliance. For example, the cover assets are ring-fenced by means of a "true sale" to a special purpose entity and detailed cover pool collateral sufficiency tests are set out in the programme documents. The Regulations do, however, prescribe certain key structural principles and requirements, outlined in more detail below, for example it is required that assets must always remain capable of covering claims attaching to covered bonds at all times, and priority of claims against the cover pool in a winding up scenario (i.e. no counterparty may have any claim against the cover pool in priority to bondholders for regulated programmes). The FSA also has a veto over material amendments to the contracts, broad powers to enforce its provisions and conducts its own rigorous ongoing review of regulated programmes.

II. STRUCTURE OF THE ISSUER

The Regulations require the issuer to be a credit institution authorised in the UK to carry out regulated activities, such as deposit-taking. It must also have a registered office in the UK and meet certain additional requirements set out by the FSA. The Regulations do not place any additional restrictions on the business activities of the issuer beyond those set out in existing financial institution regulations.

Regulated covered bonds are direct, unconditional obligations of the issuer; however, investors also have a priority claim over a pool of cover assets in the event of the insolvency or default by the issuer. The Regulations require all cover assets (including any substitution assets) to be segregated from the insolvency estate of the issuer by being sold to a special purpose entity (referred to in the Regulations as the "owner"), which guarantees the issuer's obligations under the bonds. All transactions to date have used a limited liability partnership (LLP) for this purpose. The purchase price paid by the LLP for the cover assets is either cash (funded by an inter-company loan from the issuer) or a partnership interest in the LLP. The transfer of mortgages to the LLP is by way of equitable assignment; however, the mortgage borrowers must be notified of the assignment (which perfects legal title in favour of the LLP) following the occurrence of certain trigger events, such as the downgrade of the issuer below investment grade (if the issuer is a bank) or an issuer insolvency event (if the issuer is a building society).

The LLP guarantees the issuer's obligations in respect of the covered bonds and provides security over the cover assets to a security trustee on behalf of the investors. If the guarantee is activated (see Section VIII below), the LLP will use the cash flows from the cover pool (e.g. payments of interest and principal from the mortgage borrowers, after taking account of any swap payments) to service the covered bonds. If these cash flows are insufficient, the LLP is permitted to sell cover assets, subject to meeting certain tests to ensure equality of treatment of bondholders.

III. COVER ASSETS

The Regulations broadly allow those assets which are listed in paragraph 68 of Annex VI of the banking consolidation directive to be permitted in the cover pool, subject to the following restrictions:

> Exposures to credit institutions with ratings below Credit Quality Step 1 (AA-) as set out in the BCD are not permitted; and

> The Regulations historically allowed securitisations to be included in the cover pool if: (i) the underlying mortgages were originated or acquired by the issuer or one of its affiliates; (ii) they are rated AAA; and (iii) in the case of mortgages originated by an affiliate, the affiliate is a credit institution with a registered office in the UK. This has now been amended as discussed further below.

The Regulations also allow certain assets which are not permitted under the BCD - namely loans to registered social landlords and loans to public-private partnerships (subject in each case to certain restrictions).

The Amendment Regulations passed in November 2011 have amended the eligibility requirements in three important respects, which will become mandatory as of 1 January 2013 for regulated programmes:

> **Segregation of asset types:** Issuers will be required to designate programmes as either “single asset type” or “mixed asset type”, with such designations being fixed. Mixed asset type programmes would be allowed to include any of the assets set out in the existing regulations, whereas single asset type programmes would be required to select one of the following classes (each as defined in the BCD) as well as liquid assets: residential mortgages, commercial mortgages or public sector loans (including social housing and PPP loans, which are not BCD eligible). Note that all existing regulated programmes only allow residential mortgage loans and substitution assets already (this is governed in the underlying documentation). Once a type is designated this designation can not be changed, thus providing investors more certainty regarding the cover pool asset composition

> **Securitisations and non-property assets:** Securitisations will no longer be allowed as eligible property. In practice, no UK regulated programmes currently utilise this flexibility and therefore this amendment is unlikely to impact any of the existing structures significantly.

> **Definition of liquid assets:** The Amendment Regulations also give a narrow definition of liquid assets, which are defined that are defined as UK government bonds (or other government bonds which comply with the requirements set out in paragraph 68(c) of Annex VI to the banking consolidation directive) or deposits in GBP or another specified currency held with the issuer or with a credit institution which comply with the requirements set out in paragraph 68(c) of Annex VI to the banking consolidation directive.

The Regulations require cover assets to be of high quality, and the FSA is permitted to reject any application for regulated status if it believes that the quality of the proposed assets will be detrimental to the interests of investors in Regulated covered bonds or the good reputation of the Regulated covered bonds sector in the United Kingdom.

Cover assets must be situated in EEA states, Switzerland, the US, Japan, Canada, Australia, New Zealand, the Channel Islands or the Isle of Man. If an issuer includes non-UK assets in its cover pool, it must get confirmation that the laws of the relevant jurisdiction would not adversely affect the rights of the LLP or the security trustee.

In all of the programmes that have been registered to date, the cover pools consist of assets with narrower eligibility criteria than those allowed required under the Regulations, and comprise only UK residential mortgages and the substitution assets described below.

Substitution assets can be included in the cover pool, subject to a prescribed limit (which for most programmes is 10% of cover assets), although HSBC has explicitly linked its substitution asset limit to that set out in the Regulations. In existing programmes, substitution assets are limited to short-term investments in sterling, namely bank deposits and debt securities with a minimum rating of (typically) double-A minus or P-1/A-1+/F1+, triple-A rated RMBS and government debt, in each case subject to the restrictions described above. From 1 January 2013 securitisations will no longer constitute eligible property under the Regulations, and the types of liquid assets eligible as substitution assets will be restricted to UK or specified government securities, or deposits in sterling or another specified currency, in each case complying with the relevant sub-paragraphs of paragraph 68 of Annex VI to the BCD.

IV. VALUATION AND LTV CRITERIA

The properties securing the mortgage loans are valued using UK mortgage market accepted practice. A surveyor is often used, although other methods (such as automated valuation models) are also accepted depending on the issuer's underwriting criteria. Residential property values are indexed to either the Halifax or Nationwide real estate price index, each of which reports quarterly on a region-by-region basis. Price decreases are fully reflected in the revaluation, while in the case of price increases a haircut (15% in all programmes) is applied.

The LTV limit for mortgages varies across the different programmes (see Figure 1), but in all existing programmes it is below the 80% level for residential mortgages required under the BCD and the Regulations. It is important to note that loans above the LTV limit may be included in the pool, but the amount of the loan which exceeds the LTV limit is excluded from the Asset Coverage Test (see Section V below). Loans which are in arrears are either repurchased by the issuer or subject to specific haircuts (see Figure 1).

V. ASSET - LIABILITY MANAGEMENT

For UK regulated programmes, over-collateralisation (OC) levels are determined according to the higher of: (i) contractual minimum amounts specified in the legal agreements, (ii) requirements imposed by the FSA as the special public supervisor, and (iii) amounts required to pass the programme's asset coverage tests (in particular as required to support the given rating level from the relevant rating agencies). Prior to December 2011, the regulations did not specify a fixed minimum OC requirement; however the Amendment Regulations introduced an OC requirement of 8% on nominal basis (as with all of the amendments, effective 1 January 2013) with the intention of promoting consistency and comparability between different covered bond regimes. It should be noted that for many programmes, the contractual minimum amounts specified in the transaction documentation are already well in excess of the new regulatory minimum requirement, and in any case the amounts required to pass the rating agency and/or FSA stresses are significantly in excess of this.

A key principle of the Regulations is that they require the cover pool to be capable of covering all claims attaching to the bonds at all times. In addition to the amounts required either under the regulatory minimum or under the contractual mechanics (as described further below), the minimum OC level for any programme is also considered by the FSA on a case-by-case basis, taking into account the quality of the cover assets, risk-mitigation measures, such as swaps and downgrade triggers, asset-liability mismatches, and so on. The FSA has the power to order the issuer to transfer additional assets to its cover pool if it believes the collateral in the pool is insufficient.

The principal contractual requirement under UK structures is the presence of a dynamic Asset Coverage Test (ACT) which must be carried out on a monthly basis to ensure that minimum OC requirements are satisfied. The ACT requires the principal balance of the mortgages in the cover pool (after applying the haircuts listed below) to equal or exceed the principal amount of covered bonds then outstanding. The following haircuts are applied:

> The issuer only gets credit for mortgages up to the indexed LTV limit specified in the programme documents (see Section IV above) or the asset percentage of the mortgages, whichever is lower.[3] The LTV limit for performing mortgages is between 60-75%; for non-performing mortgages (i.e. greater than three months in arrears) it is between 0% and 40%, depending on the programme. The asset percentage is determined from time to time by the rating agencies, subject to a maximum asset percentage set out in the programme documents (and which corresponds to the minimum contractual requirement referred to above). Figure 1 below sets out the LTV limits, maximum asset percentage and current asset percentage (and the minimum levels of OC that these imply) for each Regulated covered bond programme.

> Additional haircuts are applied to mitigate set-off risk, redraw risk on flexible mortgages, and potential negative carry.

The issuer is required to rectify any breach of the ACT within a specified timeframe by transferring additional cover assets to the LLP. If the breach is not rectified within the allowed remedy period, the trustee will serve a notice to pay on the LLP. This will require the LLP to pay interest and principal on the covered bonds as originally scheduled under the guarantee, as described further in Section VIII below.

An amortisation test is run on each calculation date after the delivery of a notice to pay (see Section VIII below), which is designed to ensure that the cover pool will be sufficient to enable the LLP to make payments under the covered bonds on their originally scheduled payment dates as required under the guarantee. The amortisation test is similar to the ACT, but requires a lower level of OC to reflect the fact that the cover pool is being wound down. If the test is failed, the covered bonds will accelerate against the LLP, as described further in Section VIII below. The LLP typically enters into swaps with suitably-rated counterparties at the time each covered bond is issued to fully hedge any mismatches between the currencies and interest rates of the bonds and the cover assets. In addition, downgrade triggers for swap counterparties and bank account providers, the ACT, maturity extension rules, the pre-maturity test (if applicable) and the amortisation test all ensure cash flow adequacy. The issuer may also become liable to enforcement action by the FSA.

[3] For example: Let us assume a cover pool which contains two loans. Each loan has a principal balance of £80 and is secured by a property worth £100. If the ACT applies an LTV cap of 75% and an asset percentage of 90%, the issuer will get credit for £144 of loans: applying the LTV cap would allow £150 (maximum 75% LTV for each loan); but the asset percentage allows a lower amount (£160 x 90% = £144) and therefore takes precedence.

Most UK covered bond transactions currently in the market have a soft-bullet maturity. Following the service of a notice to pay, the legal final maturity may be extended, typically by 12 months, in order to allow the realisation of the cover assets.[4] It is important to note that the issuer does not have the option to extend the bond's maturity; failure by the issuer to repay the bond in full on the originally-scheduled maturity date would result in an event of default, whereby the covered bonds would become immediately due and payable as against the issuer.

Certain programmes include a hard bullet option, whereby a "pre-maturity test" is designed to ensure that the LLP has sufficient cash available to repay the bonds, in full, on the original maturity date in the event of the issuer's insolvency. If, in a specified period before a maturity date (6-12 months, depending on the issuer and the rating agency), the issuer's ratings fall below certain specified triggers (typically A-1+ / P-1 / F1+), the pre-maturity test requires the LLP to cash-collateralise its potential obligations under the guarantee. The LLP can raise this cash through contributions from the issuer or by selling randomly-selected loans.

All Regulated covered bond programmes include a number of other safeguards. In particular, there are minimum rating requirements for the various third parties that support the transaction, including the swap counterparties and bank account providers, and an independent asset monitor is required to undertake an audit of the cash manager's calculations on a regular basis (see below).

If the issuer's short-term ratings are downgraded below A-1+ (S&P), P-1 (Moody's) or F1+ (Fitch), the LLP is required to establish and maintain, from the income it receives from the cover assets, a reserve fund in an amount sufficient to meet the higher of (i) the next three months interest payments on a rolling basis, and (ii) the next following interest payment, together with the relevant amount of senior costs and £600k (as required under the UK's Enterprise Act). This amount is retained in a GIC account. If a notice to pay is delivered, the LLP can use the reserve fund to meet its obligations under the guarantee.

VI. TRANSPARENCY

UK regulated covered bond programmes benefit from the provision of some of the most detailed investor reporting conventions of any covered bond jurisdiction. This is in part due to regulated issuers being required to produce detailed reporting to the FSA as special public supervisor, although historically the UK market has conformed since inception to a relatively high standard of investor reporting (originally evolving from early issuers' reporting conventions in the residential mortgage backed securities market). Notwithstanding this, following its market notice in November 2010[5] the Bank of England introduced detailed eligibility criteria for the inclusion of covered bonds in its market operations including (amongst other requirements) the provision of loan level data, publication of transaction documentation, homogenised transaction summaries and standardised investor reporting. These requirements are not mandatory but are required for eligibility in the various Bank of England schemes.

As part of the Amendment Regulations referred to in various respects above, and in keeping with the FSAs regard for "the need to preserve investor confidence in, and the desirability of maintaining the good

[4] Some programmes also allow the issue of bonds which become pass-through (i.e. principal repayments by mortgage borrowers are passed along to the covered bondholders) if the issuer fails to repay the bond on its scheduled maturity date; however, no bonds in this format have been publicly issued.

[5] Please see http://www.bankofengland.co.uk/markets/marketnotice101130abs.pdf for further details the Bank of England Transparency Initiatives.

reputation of, the regulated covered bonds sector in the United Kingdom", HMT introduced various additional reporting and transparency requirements in relation to regulated covered bonds. The requirements are closely aligned with the existing Bank of England eligibility requirements (including loan level data for cover pool assets), and UK regulated programmes will be required to publish the relevant information from the effective date of 1 January 2013.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

An applicant under the Regulations must be a credit institution authorised in the UK to carry out regulated activities, such as deposit-taking. Issuers must satisfy the FSA that their programmes comply with the criteria set out in the Regulations and provide, among other things:

> details on the quality of cover assets and the ability of the assets on the issuers balance sheet to satisfy substitution requirements;

> details concerning the programme structure, such as the cover pool eligibility criteria, the formulae used to calculate compliance with minimum OC requirements, ability to meet payments on a timely basis and ratings triggers;

> details concerning asset and liability management, audit and controls, risk management and governance framework;

> details on the proficiency of cash management and servicing functions;

> detailed analysis on the ability of the assets and the mitigants within the programme structure to address inherent interest rate, currency, asset and liability mismatch and market value risks;

> arrangements for the replacement of key counterparties; and

> independent legal and audit opinions on the compliance of the issuer and programme with the Regulations.

The issuer is responsible for monthly cover pool monitoring. The FSA must be notified by the issuer of any breaches of the ACT, and may also require the issuer to provide such additional information about the cover pool as it considers fit. All existing programmes have at least two internationally recognised rating agencies who will also undertake detailed reviews both on a condition precedent to each issuance, and thereafter on at least a quarterly basis as part of ongoing transaction surveillance. The rating agencies may revise the asset percentage as part of these review processes, either due to variations in asset quality or embedded transaction risk factors, or due to periodic rating criteria change.

All programmes already involve an independent third party asset monitor within the existing contractual arrangements (in all cases, this role is fulfilled by an independent audit firm), who would perform various functions within the transaction including an annual review of the ACT calculation. All programmes (and the FSA) also require periodic audit procedures to be undertaken with respect to the asset pool, which in most (but not all) programmes is performed by the same audit firm. The Amendment Regulations, effective 1 January 2013, have introduced a specific requirement for regulated programmes to be subject to scrutiny from an independent "Asset Pool Monitor" which is intended to formalise the process and bring the UK framework in line with other jurisdictions. The Asset Pool Monitor is required under the regulations to act as independent auditor, will conveyed with certain powers to inspect books and records associated with the relevant programme, must conduct a biannual inspection of the issuer's compliance with the Regulations and must report to the FSA on an annual basis (or sooner if the issuer is found to be failing to comply with its duties).

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

The Regulations require all cover assets (including any substitution assets) to be segregated from the insolvency estate of the issuer by being transferred to a special purpose entity (referred to as the "owner" in the Regulations), which guarantees the issuer's obligations under the bonds. All transactions to date have used an LLP for this purpose. All cover pool hedges are entered into directly by the LLP.

The Regulations require that the cover assets be recorded on a register maintained by or on behalf of the issuer and the LLP. The register must be available for inspection by the FSA. The issuer is responsible for ensuring that all cover assets meet the relevant eligibility criteria set out in the Regulations and, if applicable, any additional criteria set out in the programme documents.

The LLP becomes obligated to pay the covered bondholders under the guarantee upon delivery by the bond trustee of a notice to pay following the occurrence of an issuer event of default or other trigger event. The events which can trigger a notice to pay typically include:

> Failure by the issuer or any group guarantors to pay any interest or principal on the covered bonds when due;

> Bankruptcy or similar proceedings involving the issuer or any group guarantors;

> Failure to rectify any breach of the asset coverage test; and

> Failure to rectify any breach of the pre-maturity test (if applicable).

The delivery of a notice to pay does not accelerate payments by the LLP. To the extent that an issuer event of default has occurred, the bond trustee may commence proceedings against the issuer and any group guarantors on an unsecured basis on behalf of the covered bondholders. Nevertheless, provided that an LLP acceleration event (as described below) has not occurred, the LLP will continue to make the originally scheduled payments of interest and principal on the covered bonds.

LLP acceleration events typically include:

> The LLP fails to pay any interest or principal when due under the guarantee;

> Bankruptcy or similar proceedings are commenced involving the LLP; and

> After delivery of a notice to pay, the LLP breaches the "amortisation test".

The occurrence of an LLP acceleration event causes the acceleration of payments by the LLP to covered bondholders and the redemption of the bonds at the relevant early redemption amount.

The LLP is reliant on the proceeds derived from the cover assets to make payments under the guarantee. Under the Regulations, in a winding up scenario, no claims against the cover assets can rank ahead of the claims of the Regulated covered bondholders. If the proceeds from the cover pool are insufficient to meet the obligations to bondholders in full, investors will continue to have an unsecured claim against the issuer and any group guarantors for the shortfall.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The list of eligible assets under the Regulations is in some respects narrower than that set out in the CRD (particularly for single asset type programmes following the implementation of the Amendment Regulations). Residential mortgage backed securities, for example, are severely restricted in the original Regulations and will no longer be allowed from 1 January 2013. However, certain assets which are excluded from the BCD – such as loans to UK housing associations – are technically permitted in the cover pool under the Regulations. Therefore, it is possible that some regulated covered bonds could not qualify for preferential risk weightings in the hands of regulated investors. To date, however, all existing Regulated covered bonds are contractually restricted to containing only residential mortgage assets (as well as substitution assets up to the prescribed limit), meaning they are BCD compliant and therefore benefit from the same preferential treatment as covered bonds from other EU jurisdictions.

> Figure 1: Overview – Regulated UK covered bond programmes

At the time of writing there are 12 regulated covered bond issuers in the United Kingdom: Abbey National (ABBEY); Barclays Bank Plc (BACR); Bank of Scotland Plc (HBOS); HSBC Bank (HSBC), Leeds Building Society (LEEDS), Lloyds TSB Bank (LLOYDS), Nationwide Building Society (NWIDE); Royal Bank of Scotland (RBS); Coventry Building Society (COVBS); Yorkshire Building Society (YBS) and Co-operative Bank (COOPWH).

	ABBEY	BACR	HBOS	HSBC	LEEDS	LLOYDS	NWIDE	RBS	YBS	COVBS	COOPWH
Programme volume (bn)	€ 35	€ 35	€ 60	€ 25	€ 7	€ 30	€ 45	€ 15	€ 8	€ 7	£3
LTV cap	75%	75%	60%	75%	75%	75%	75%	75%	75%	75%	75%
House price index	Halifax	Halifax	Halifax	Halifax	Halifax	Halifax	Nationwide	Halifax	Avg. of Halifax & Nationwide	Nationwide	Halifax
Maximum asset percentage	91.0%	94.0%	92.5%	92.5%	93.5%	93.0%	93.0%	90.0%	92.5%	90.0%	93.5%
Minimum OC *	109.9%	106.4%	108.1%	108.1%	107.0%	107.5%	107.5%	111.1%	108.1%	111.1%	107.0%
Current asset percentage	76.7%	72.8%	71.0%	78.2%	66.3%	79.9%	75.2%	75.2%	77.5%	78.7%	77.5%
Current nominal OC	138.2%	166.7%	152.0%	1032.8%	182.0%	153.0%	173.2%	153.4%	258.5%	142.4%	343.6%
Credit for loans in arrears (>3 months)	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	No credit	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	<3M: 75%, >3M: 40%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%
Can issue hard bullets? **	Yes	Yes	Yes	Yes	No; soft-bullets	Yes	Yes	Yes	No; soft-bullets	No; soft-bullets	Yes
Asset monitor	Deloitte	PWC	KPMG	KPMG	Deloitte	PWC	PWC	Deloitte	KPMG	E&Y	PWC

Source: Barclays Research, transaction documents.

* OC = Over-collateralisation, minimum OC calculated as 1/maximum asset percentage.
** Hard-bullets possible only if pre-maturity test is in place and passed / soft-bullets issued with 12-months extension.

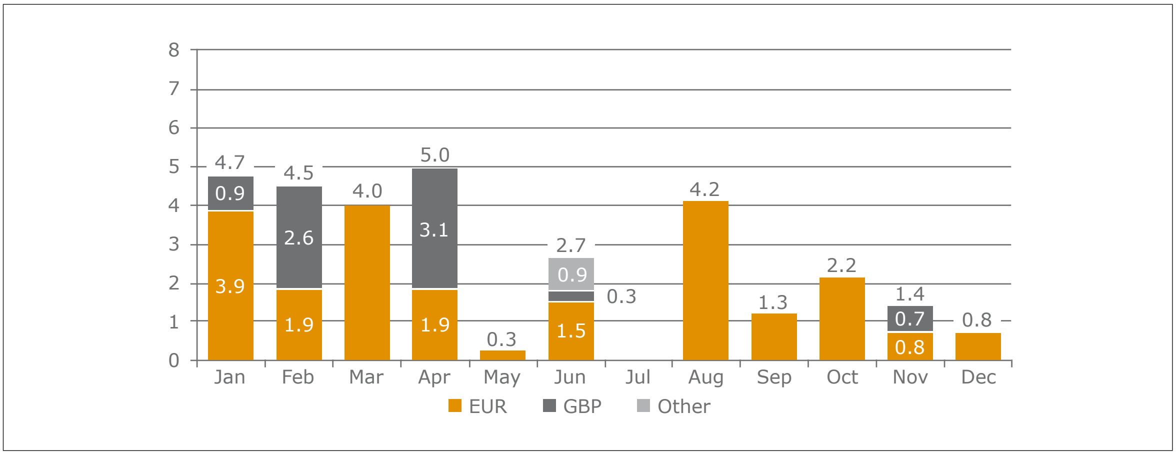
X. ADDITIONAL INFORMATION

Development of the market

The current outstanding volume of regulated publicly placed fixed-rate benchmark covered bonds and respective taps amounts to EUR 111.0 bn (equivalent). Supply in 2010 was EUR 18.9 bn, versus redemptions of EUR 7.6 bn, increasing the total outstanding to €79bn at the end of 2010. In 2011 the gross supply totalled EUR 30.9 bn while redemptions were relatively modest at EUR 8.3 bn. The net supply for the year was EUR 22.6 bn and at YE 11 the total outstanding volume stood at EUR 101 bn, up from EUR 78.6 bn at YE 2010. At the time of writing the year-to-date gross supply stood at EUR 11.8 bn and net supply stood at EUR 9.8 bn on the back of EUR 2 bn redemptions. With only EUR 2.5 bn remaining redemptions due in 2012 the net supply this year is likely to remain relatively high.

In 2011 the UK covered bond market opened up for benchmark GBP denominated covered bonds. Earlier in 2004, 2006 and end of 2010 there were some smaller GBP-denominated issuances but 2011 finally saw a start for GBP-issuance in meaningful sizes. A total of GBP 6.6 bn of GBP-denominated covered bonds was issued, representing 25% of 2011 total issuance volume, with majority of the issuance taking place in the first four months of the year (see figure 2). This positive trend has continued strong in 2012 and the year-to-date supply at the time of writing already stands at GBP 5.25 bn. This increased issuance activity has increased the share of GBP-denominated covered bonds of the total outstanding to 14% of year-to-date issuance from 3% at YE 10. This development has been mainly at the expense of EUR-denominated issuances, which at 79% (88% as at YE10) still represent the vast majority of all outstanding UK covered bonds.

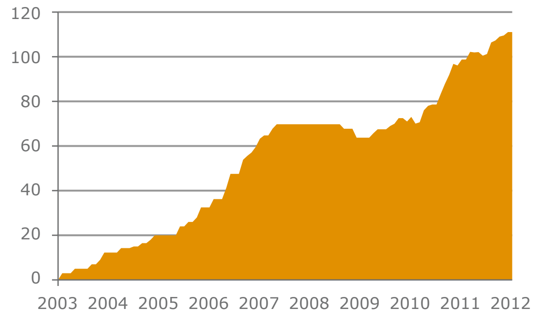
> Figure 2: Monthly supply of fixed-rate benchmark UK covered bonds in 2011, EUR bn



Source: Barclays Research

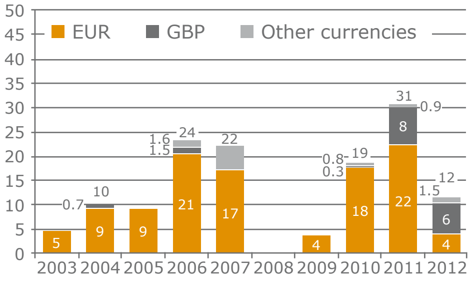
Figure 3 and 4 show the development of total outstanding of regulated fixed-rate benchmark UK covered bonds and annual supply of UK covered bonds per currency. Figures 5 and 6 show the market share (as measured by covered bonds outstanding) per issuer and the currency distribution for outstanding issuances.

> FIGURE 3: DEVELOPMENT OF OUTSTANDING VOLUME, EUR BN



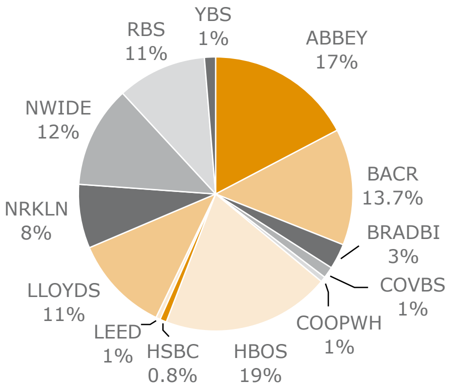
Source: Barclays Research

> FIGURE 4: ANNUAL SUPPLY BY CURRENCY, EUR BN



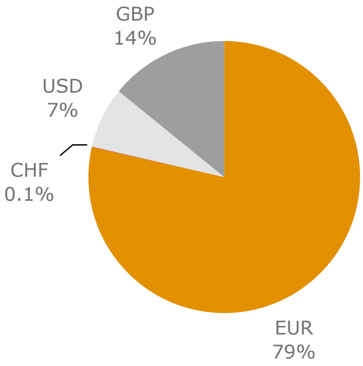
Source: Barclays Research

> FIGURE 5: MARKET SHARE OF OUTSTANDING (€111BN), MAY 2012



Source: Barclays Research

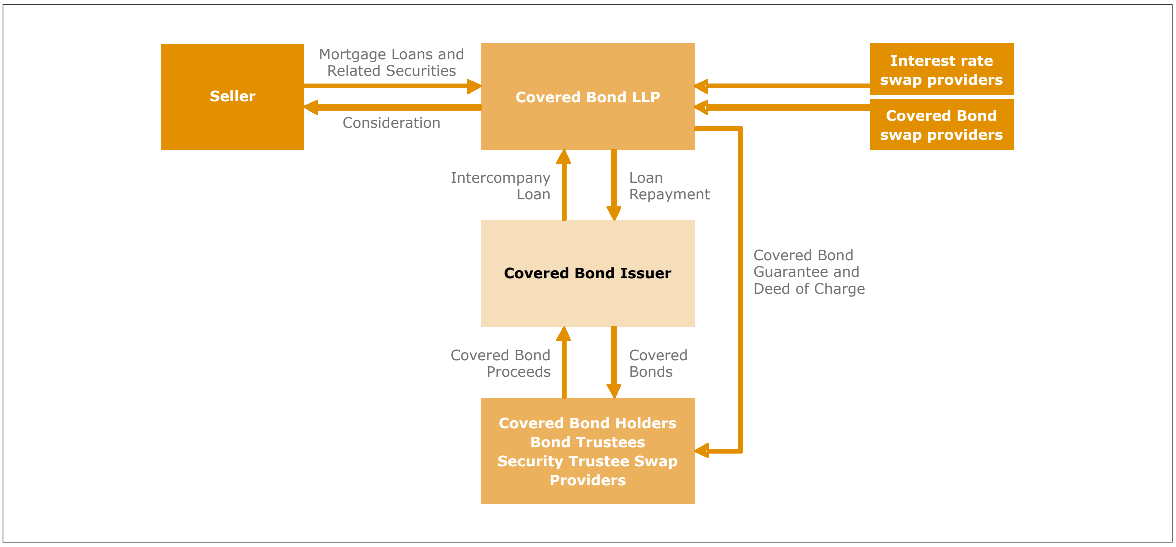
> FIGURE 6: CURRENCY DISTRIBUTION OF OUTSTANDING (EUR BN), MAY 2012



Source: Barclays Research

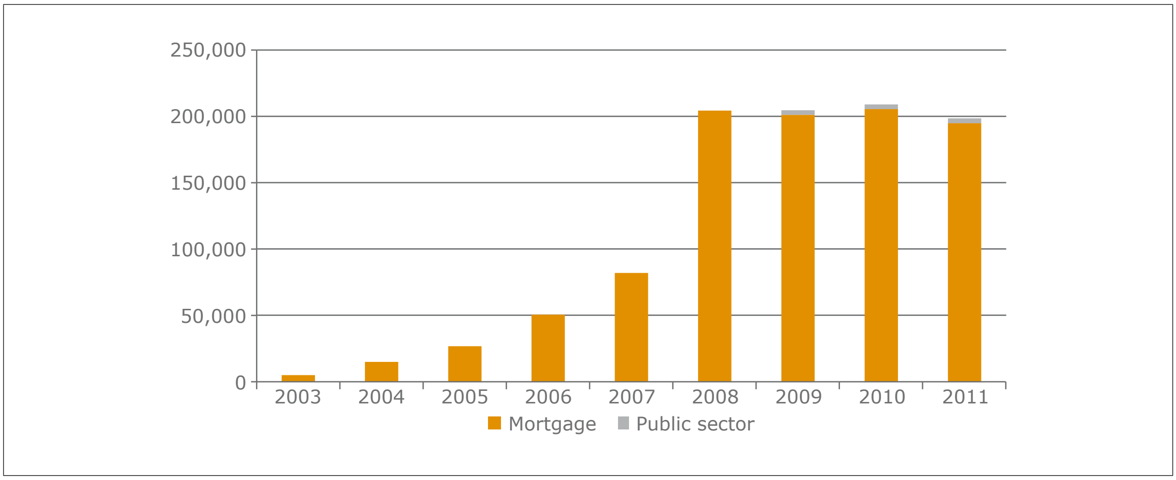
Another interesting recent development in the UK covered bond market was the emergence of publicly placed floating rate GBP-denominated covered bonds. This year, at the time of writing, a total of GBP4.1bn of publicly placed floating rate covered bonds has been issued by UK banks and building societies. The floating rate coupon, short maturities and the relatively attractive pricing have made these bonds attractive to traditional credit investors. In addition, the coupon offered by the covered bonds compared well with the coupon offered by publicly placed senior RMBS notes sponsored by the same institutions, thus making them an attractive proposition to RMBS investors.

> Figure 7: Generic UK covered bond programme structure


Seller
Mortgage Loans and Related Securities
Consideration
Covered Bond LLP
Interest rate swap providers
Covered Bond swap providers
Intercompany Loan
Loan Repayment
Covered Bond Issuer
Covered Bond Guarantee and Deed of Charge
Covered Bond Proceeds
Covered Bonds
Covered Bond Holders
Bond Trustees
Security Trustee Swap Providers

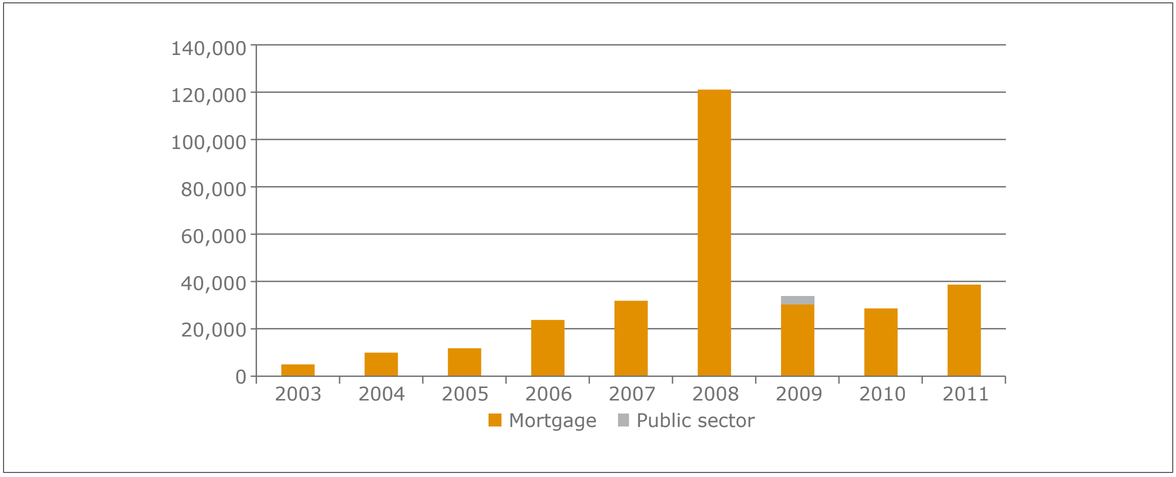
Source: Barclays Research

> Figure 8: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC. Please note that this data includes private placements, floating rate covered bonds and self-retained issuances that may have been used to access central bank liquidity.

> Figure 9: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC. Please note that this data includes private placements, floating rate covered bonds and self-retained issuances that may have been used to access central bank liquidity.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/52/Regulated_Covered_Bonds_

3.33 UNITED STATES

By Sabine Winkler, Credit Suisse Securities (Europe) Limited

I. FRAMEWORK[1]

US covered bond legislation: review & outlook

Past attempts to create a US covered bond market

The US does not yet have covered bond legislation. The first US covered bond was issued by Washington Mutual Bank in September 2006 and between then and June 2007, Bank of America and Washington Mutual Bank priced a total of seven covered bonds – three are not yet matured. Since June 2007, we have not seen a new covered bond issue of a US lender. In September 2008, after Washington Mutual Bank's closure, JPMorgan Chase acquired the assets and most of the liabilities, including covered bonds and secured debt, of Washington Mutual Bank from the Federal Deposit Insurance Corporation (FDIC) as receiver for Washington Mutual Bank. Claims by equity holders, subordinated creditors, and senior unsecured debt holders were not acquired.

In the absence of covered bond legislation, Bank of America and Washington Mutual Bank developed structures under general law. Both structures operate a two-tier approach: the covered bonds are issued by special purpose vehicles, rather than by US lenders. They are secured by a related mortgage bond series launched by a lender. The mortgage bond series is backed by collateral that remains on the lender's balance sheet. This structure, by its nature, is more cumbersome, complex and costly than direct issuance (i.e., where the covered bonds are launched by a lender and the covered bond collateral remains on its balance sheet) and as the crisis intensified, became disfavoured by investors.

In 2008, the US Treasury and the FDIC worked together and released the Best Practices for Residential Covered Bonds (Best Practices Guide) and the Final Covered Bond Policy Statement, respectively. The hope was that these statements would provide clarity and allay investor concerns about the treatment of covered bonds in the event of lender insolvency and support growth of a standardised US covered bond market. Since their release, it has however become apparent that regulatory (non-legislative) guidance alone is insufficient to promote the development of a robust US covered bond market populated by domestic and foreign investors.

Market take-off and resolution of broader issues

After several years of investigation, covered bonds are increasingly being touted in the US as another source of liquidity for lenders. This is due not only to a growing recognition of the benefits that could be reaped from a vibrant domestic covered bond market, but also to the resurgence of a USD-denominated (benchmark) covered bond market that to date has mainly advantaged non-US lenders. A robust US covered bond market is likely to bring additional private capital into the national lending market and contribute to a less volatile asset finance and origination system in the US.

There is a political dimension to the development of a special-law-based US covered bond market. We think that the take-off of such a market depends on the resolution of broader issues associated with

[1] The description of the US framework is merely a summary of aspects of the (proposed) legislation. As a summary, it is not complete. For details refer to the respective (draft) legislation, regulations, statements and base prospectuses. This summary does not constitute legal advice by the author.

the securitisation and housing finance reform, including the fate of Fannie Mae (FNMA) and Freddie Mac (FHLMC), and the future role of the Federal Home Loan Banks (FHLBs). Covered bonds are a viable alternative to funding assets off-balance sheet, but on-balance sheet funding instruments cannot fully replace the multi-trillion-dollar securitisation market in the US. US covered bonds are thus being considered for the most part as a source of complementary liquidity.

There is still an active effort under way to enact legislation in the US. In June 2011, H.R. 940 was reported out of the House Committee on Financial Services. Tax provisions of the bill have been referred to the House Committee on Ways & Means for review and approval, and once that is done, H.R. 940 is expected to be reported to the full House of Representatives for a final vote. Meanwhile, in November 2011, S. 1835 was introduced into the Senate and referred to the Senate Committee on Banking, Housing, and Urban Affairs for consideration.

Identical legislative text needs to be approved by both the House of Representatives and the Senate, and the act has to be signed by the President in order to become law. Both H.R. 940 and S. 1835 have been designed to establish the fundamental elements of US covered bonds, including special public supervision designed to protect the bondholders, and the treatment of the product in the event of issuer insolvency. Once legislation is introduced, the Secretary, in consultation with the covered bond regulators, could begin establishing a covered bond regulatory oversight programme. With primary and secondary legislation in place, lenders could start developing programmes tailored to their needs.

Divergent interests and workable compromises

Although H.R. 940 and S. 1835 may be revised further and the oversight programme remains to be developed, the proposed legislation would currently establish the features regarded essential for covered bonds. It may be that some features of US covered bonds end up being tailored to address domestic concerns and be viewed as somewhat unique. To the extent that these variations foster the development of a deeper domestic investor base, they are likely to be welcome. We think that the question is not whether, but how, a US covered bond market will take shape. Market stakeholders approach this question with deliberate care. Because of their divergent interests, a workable compromise is the likely outcome.

The compromise is likely to be a balance between investor protection and issuer flexibility, between innovation and standardisation, between the rights of regulatory authorities and those of investors, and between the lenders' need for viable funding instruments and the financial system's need for stability. Although there is bi-partisan support for H.R. 940 and S. 1835, some disagreement has been generated by the FDIC and some Federal Home Loan Banks. For example, there was close voting at the House Committee on Financial Services' mark-up hearing in June 2011 on changes offered by Barney Frank (D-MA) on behalf of the FDIC dealing with the resolution mechanism and oversight programme.

> Disagreements about the proposed rights, powers and responsibilities of the regulatory authorities, and about who creates and oversees the oversight programme. The FDIC has sought either control or an effective veto over the oversight programme and the approval of covered bond programmes.

> Disagreements about the proposed resolution scheme, in particular the FDIC's rights and powers in a conservatorship or receivership of a lender. As a receiver or conservator for a lender, the FDIC has sought to retain its discretionary power to repudiate covered bonds and recover the cover pool in exchange for the payment of actual direct compensatory damages.

These disagreements are to some extent driven by the FDIC's concerns that the proposed legislation would increase the risk of loss to the Deposit Insurance Fund if a lender using covered bonds would become insolvent. To the extent that these concerns are warranted, the FDIC has little choice but to object to covered bond legislation in light of its mandate to protect insured depositors. Other stakeholders have a different opinion and regard the FDIC's concerns as overstated.

> From their perspective, covered bond legislation is meant to expand the funding alternatives for US lenders offering them an opportunity to lengthen the duration of their liabilities and diversify their investor base, and thus contributes to financial stability.

> From their perspective, the rights granted to covered bond holders under the proposed legislation would be less generous than those currently enjoyed by other creditors of US lenders, i.e., the FHLBs and qualified financial contract (QFC) counterparties.

> From their perspective, several changes to the proposed covered bond legislation have already been made to address the FDIC's concerns about asset encumbrance for the benefit of covered bond holders and its ability to recover potential depositor losses.

> From their perspective, the development of a US covered bond market is at risk if a workable compromise cannot be found. The current rights of the FDIC in the resolution of a US lender pose risk to and create uncertainty for covered bond holders, and add to the costs of the product for US lenders.

Confidence remains high that where there is a will, there is likely to be a way forward on legislation. For example, to address lingering concerns about structural subordination of unsecured creditors of lenders, consideration may be given to lower over-collateralisation (OC) offset by improved liquidity facilities in the event of a lender's insolvency. However, such an approach would likely need to be effected as part of a more holistic way to managing asset-backed funding instruments rather than by singling out covered bonds for disparate treatment.

Due to the tight congressional calendar and the impending US presidential election, there is uncertainty as to when covered bond legislation will be passed by the Senate and the House of Representatives in the 112th Congress[2]. If passage of legislation does not occur in 2012, probabilities rise that it could become caught up in housing finance market reform debates. Legislation is a necessary but not sufficient condition for the development of a US covered bond market. Covered bond issuance by US lenders may take even longer as it also depends on the establishment of issuance programmes.

Proposed United States Covered Bond Act

In June 2011, the House Committee on Financial Services approved H.R. 940, the United States Covered Bond Act of 2011. H.R. 940 was introduced by Scott Garrett (R-NJ) and Carolyn Maloney (D-NY) in March 2011. H.R. 940 is similar to H.R. 290 introduced in 2011, and H.R. 5823 and H.R. 4884 introduced by Scott Garrett (R-NJ), Paul E. Kanjorski (D-PA) and Spencer Bachus (R-AL) in 2010, and Scott Garrett's (R-NJ) proposed changes to H.R. 4173[3], the Wall Street Reform and Consumer Protection Act of 2009, that were introduced in 2009, but that were later withdrawn at the request of Barney Frank (D-MA).

[2] The 112th Congress convened on 3 January 2011 and will end on 3 January 2013.

[3] H.R. 4173 eventually became Public Law 111-203, Dodd-Frank Wall Street Reform and Consumer Protection Act.

H.R. 940 is more comprehensive than H.R. 2896, the Equal Treatment of Covered Bonds Act of 2009, and H.R. 6659, the Equal Treatment of Covered Bonds Act of 2008.

In November 2011, S. 1835, the United States Covered Bond Act has been introduced into the Senate by Kay Hagan (D-NC) and Bob Corker (R-TN). It is co-sponsored by Michael Crapo (R-ID) and Chuck Schumer (D-NY). The language of S. 1835 is close to H.R. 940. Notable differences from H.R. 940 currently are: an expansion of the definition of eligible issuers; for issuers that are not subject to the jurisdiction of a federal banking agency, the covered bond regulator would be the Board of Governors of the Federal Reserve System rather than the Secretary of the Treasury: a right afforded to the respective covered bond regulator and a majority of covered bond holders to replace the independent asset monitor; and the omission of tax provisions.

The content of H.R. 940 and S. 1835 may be further amended as the legislative process unfolds. For now, both H.R. 940 and S. 1835 address some of the uncertainties currently restricting the acceptance of general-law-based US covered bonds, and cover the following points:

> **Issuers:** In accordance with H.R. 940, eligible issuers would be IDIs, savings and loan holding companies, bank holding companies, non-bank financial companies and their subsidiaries. In accordance with S. 1835, eligible issuers would further be brokers, dealers, insurance companies and their subsidiaries. Pooled covered bond issuance by entities sponsored by eligible issuers would be permitted. This would provide an opportunity for smaller-sized lenders to use the product. A regulator could approve existing programmes. Eligible issuers would be allowed to have more than one covered bond programme.

> **Collateral:** In accordance with H.R. 940 and S. 1835, a cover pool would be defined as a dynamic asset pool and would consist of eligible assets from a single eligible asset class, substitute assets[4] and ancillary assets[5]. Eligible asset classes would initially be residential mortgages, commercial mortgages, public-sector debt, auto loans or leases, student loans, credit or charge card loans and small business loans. Issuers would have to clearly mark collateral in their books and records. A loan would not qualify as an eligible asset if delinquent for more than 60 consecutive days. An asset in a cover pool that would not qualify as an eligible asset could not be taken into account in the Asset Coverage Test (ACT).

> **Supervision:** The covered bond regulator for an issuer would be the appropriate federal banking agency[6] or, for an issuer that is not subject to the jurisdiction of such agency, the Secretary (H.R. 940) or the Board of Governors of the Federal Reserve System (S. 1835). The Secretary, in consultation with the covered bond regulators, would have to set up an oversight programme within 180 days after the enactment of the act. Covered bond programmes would require approval by the respective covered bond regulator. The Secretary would maintain a publicly available registry of approved programmes and the covered bonds drawn under them. The respective covered bond

[4] In accordance with H.R. 940 and S. 1835, substitute assets would be cash, obligations of the US government, and triple-A rated obligations of a US government corporation or government-sponsored enterprise. In accordance with H.R. 940, any overnight investments in federal funds would also quality as substitute assets.

[5] In accordance with H.R. 940 and S. 1835, ancillary assets would include currency swaps, interest rate swaps, credit enhancements, and liquidity arrangements associated with the assets in a cover pool.

[6] Under the Federal Deposit Insurance Act, the term appropriate federal banking agency means the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation or the Board of Governors of the Federal Reserve System.

regulator could direct an issuer to cease issuing covered bonds if an approved programme is not maintained in line with the law and the oversight programme.

> **Coverage:** The Secretary, in consultation with the covered bond regulators, would define minimum OC levels for covered bonds backed by each of the eligible asset classes based on their credit, collection and interest rate risks, but not liquidity risk. To verify compliance with the OC requirement, issuers would have to perform an ACT. Each month, an issuer would have to submit the ACT outcome to the Secretary, the respective covered bond regulator, indenture trustee, asset monitor and bondholders. Bonds issued under an approved covered bond programme would remain special-law-based even if the OC requirement were not met. An uncured failure of the OC requirement within a set time would constitute a default on covered bonds. This regulatory minimum OC requirement would not preclude a higher one from being established by issuers under their covered bond programmes.

> **Limit:** Based on safety and soundness considerations and the financial condition of an issuer, the respective covered bond regulator would set a covered bond issuance limit as a percentage of total assets. A covered bond regulator could review this limit as often as quarterly, and if safety and soundness considerations or an issuer’s financial condition have changed, increase or decrease the limit. A cut of the limit would not affect an issuer’s outstanding covered bonds.

> **Monitoring:** Each issuer would have to appoint an independent asset monitor that verifies and reports at least annually to the Secretary, the respective covered bond regulator, indenture trustee and bondholders whether a pool meets the regulatory minimum OC requirement. At least monthly, issuers would have to deliver a list of the eligible and substitute assets in the pool to the independent asset monitor and indenture trustee.

> **Reporting:** In accordance with existing securities regulations, each covered bond regulator would adopt a separate scheme of registration, disclosure and reporting obligations and exemptions for offers or sales of covered bonds. Once a year, the covered bond regulators would have to submit a joint report to the Congress describing the state of the covered bond market in the US and testify on the state of this market before the House of Representatives and the Senate.

> **Insolvency:** There are two scenarios: default on covered bonds either before or after an issuer enters conservatorship, receivership, liquidation or bankruptcy (issuer insolvency). Issuer insolvency would not necessarily cause an acceleration of the outstanding covered bonds.

a) **Default on covered bonds before issuer insolvency:** The cover pool and the related covered bonds would be automatically transferred to a newly created separate estate.

b) **Default on covered bonds after issuer insolvency without FDIC involvement:** The cover pool and the related covered bonds would be automatically transferred to a newly created separate estate.

c) **Default on covered bonds after issuer insolvency with FDIC involvement:** The FDIC would have the right to transfer the cover pool and the related covered bonds to another eligible issuer within a one-year period. Until a transfer is made or the FDIC elects to cease further performance, the FDIC would be required to meet the issuer’s obligations under the covered bonds. If the FDIC does not complete the transfer within one year, elects to cease further performance or fails to meet an issuer’s obligations under the covered bonds, the cover pool and the related covered bonds would be automatically transferred to a newly created separate estate.

The transferee, whether another eligible issuer or a newly created separate estate, would become liable for the covered bonds and related obligations of the issuer secured by the cover pool. The cover pool would be held by the transferee free and clear of any right, title, interest or claim of the issuer or any conservator, receiver, liquidating agent or bankruptcy trustee.

If a separate estate were created, investors would retain a claim against the issuer for any deficiency with respect to the covered bonds. The issuer or its conservator, receiver, liquidating agent or bankruptcy trustee, would retain a residual interest in the estate. The issuer, or its conservator, receiver, liquidating agent or bankruptcy trustee, would be required to transfer to the estate all property of the estate that is in the possession or under the control of the issuer, and may have to continue servicing the cover pool for 120 days.

The respective covered bond regulator would give the Secretary, the indenture trustee, the residual interest owner and the bondholders written notice of the creation of the separate estate. It would appoint a trustee for the separate estate and servicers or administrators for the cover pool. The servicers or administrators would actively manage the cover pool and would have to maximise its proceeds and value.

They would be allowed to dispose of assets in the cover pool, and, in order to manage timing mismatches among the assets and liabilities of the estate, to raise funds. The respective covered bond regulator would supervise the trustee and any servicer or administrator. The respective regulator would be permitted to remove or replace the trustee or any administrator or servicer and require reports from a servicer or administrator. The trustee would close the estate after it has been fully administered.

> **Borrowings:** The Comptroller General of the United States would have to conduct a study whether a separate estate should have access to loans from the Federal Reserve Banks. The Comptroller General of the United States would have to submit a report to the Senate and the House of Representatives on the results of this study not later than six months after the enactment of the US covered bond law.

> **Actions:** No court would be able to take any action to restrain or affect the resolution of a separate estate, except at the request of the respective covered bond regulator. In addition, no person, including bondholders, could bring a judicial or administrative action against the estate, except to compel the release of funds that are required to be distributed.

Covered Bond Policy Statement & Best Practices Guide

On 9 July 2008, the FDIC approved its Final Covered Bond Policy Statement, clarifying its position on the treatment of qualifying covered bonds in a receivership or conservatorship. On 29 July 2008, the US Treasury released its Best Practices Guide with the support of the FDIC, the Office of Thrift Supervision, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Securities and Exchange Commission. The Best Practices Guide introduces guidelines to promote the development of a standardised market for US covered bonds backed by residential mortgages.

The Final Covered Bond Policy Statement and the Best Practices Guide represented a step forward in 2008. However, it has become apparent that a US covered bond market is unlikely to be built solely on their foundation. In fact, the Best Practices Guide serves as a template for market participants, and the Final Covered Bond Policy Statement is designed to provide for a relief from the temporary automatic stay of execution rule incorporated into the Federal Deposit Insurance Act (FDIA) in 2006. It is unlikely, yet not impossible, that US lenders will develop general-law-based covered bond programmes.

FDIC: Final Covered Bond Policy Statement

The policy statement provides guidance on the availability of expedited access to collateral in the cover pool in a receivership or conservatorship, after the FDIC decides whether to continue or to terminate the transaction. Its focus is to seek a way around the temporary automatic stay of execution rule imposed under the FDIA. Under the FDIA, the FDIC can request a stay of up to 45 days (as conservator) or 90 days (as receiver). For covered bonds structured in accordance with the final Covered Bond Policy Statement, the stay can be shortened to ten days. The policy statement applies to bonds meeting the following criteria.

> **Features:** The policy statement applies to bonds that are non-deposit, recourse debt obligations of IDIs with a term greater than one year, and no more than 30 years, that are secured, directly or indirectly, by perfected security interests under applicable state and federal law on collateral held and owned by the IDI.

> **Limit:** The policy statement applies to covered bonds issued with the consent of an IDI's primary federal regulator. It is limited to covered bonds that comprise no more than 4% of an IDI's total liabilities after issuance.

> **Collateral:** Performing mortgages compliant with the existing supervisory guidance on the underwriting of residential mortgages, on one-to-four family residential properties, underwritten with documented income and at the fully indexed rate are eligible. MBS collateralised by eligible mortgages must not exceed 10% of the collateral. Substitution collateral may be cash, US Treasury and agency securities. The loan-to-value (LTV) for the mortgages in the cover pool needs to be disclosed.

The policy statement must not be construed as waiving, limiting or otherwise affecting the rights or powers of the FDIC. Neither does it impose new responsibilities on the FDIC as conservator or receiver. The FDIC may consider changes to the policy statement as the US covered bond market develops. It can repeal the policy statement after 30 days' notice in the Federal Register. In this event, securities launched before repeal, but in compliance with the policy statement, will be grandfathered.

US Treasury: Best Practices Guide

The Best Practices Guide is a complement to the FDIC's policy statement and presents a standardised model for covered bonds issued by US lenders in the absence of dedicated legislation. It outlines two structures: SPV Issuance and Direct Issuance. To be consistent with the Best Practices Guide, a programme has to meet the following criteria.

> **Issuer:** Issuers may be depository institutions and their subsidiaries, and bankruptcy-remote SPVs. Pooled issuance is possible, i.e., multiple depository institutions could use a joint SPV to pool assets. The collateral has to be owned by the depository institution. Only well-capitalised entities should issue covered bonds.

> **Features:** The maturity for covered bonds has to be greater than one year, but no more than 30 years. Covered bonds may be issued in any currency and may be registered or non-registered with the SEC. They may either be fixed or floating rate instruments.

> **Limit:** An issuer requires approval by its respective primary regulator to launch covered bonds. Covered bonds may account for no more than 4% of an issuer's total liabilities after issuance.

> **Security:** Issuers need to grant a first priority perfected security interest in the collateral for the benefit of the bondholders. Issuers have to clearly mark the collateral, liabilities and the security pledge in their books and records. Multiple series can be backed by a common cover pool.

> **Coverage:** At all times, issuers must maintain an OC of at least 5% of the outstanding principal balance of the covered bonds. When calculating OC, for each loan, up to 80% of the property's value can be taken into account. If more than 10% or 20% of the collateral is substituted in any month or quarter, respectively, issuers must disclose updated collateral information to investors.

> **Test:** Issuers need to conduct a monthly ACT. The results of the ACT and of any reviews by the asset monitor must be made available to investors. If an ACT is failed, issuers may not launch a new series while such a breach exists. If an ACT is failed, and the breach is not remedied within one month, the trustee may terminate the covered bond programme and principal and accrued interest must be paid to investors.

> **Collateral:** Performing first-lien mortgages on one-to-four family residential properties, meeting the existing supervisory guidance on the underwriting of residential mortgages, underwritten with documented income and at the fully indexed rate are eligible. Ineligible are negative amortisation mortgages. Mortgages over 60 days in arrears must be replaced. At the time of inclusion in the cover pool, mortgages need to have a maximum LTV of 80%. The LTV needs to be updated quarterly using a nationally recognised, regional housing price index or other comparable measurement. A single Metro Statistical Area cannot make up over 20% of the cover pool. Substitution collateral may be cash, US Treasury and agency securities.

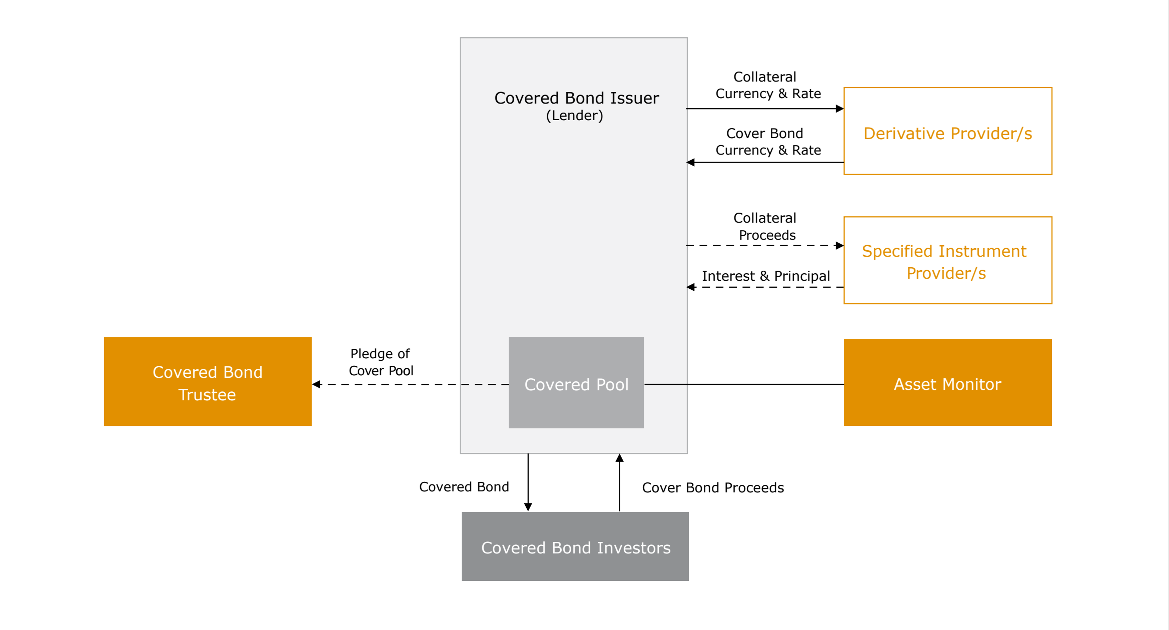
> **Derivatives:** At issuance of a series, issuers may enter into derivative agreements for the series to hedge risks arising from any timing and currency discrepancies. Derivative agreements need to be with financially sound counterparties and the identity of those counterparties has to be disclosed to investors.

> **Investment:** At issuance of a series, issuers need to enter into a specified investment agreement for the series with financially sound counterparties. Upon issuer insolvency or repudiation by the FDIC as conservator or receiver, proceeds from the collateral must flow into the specified investment. Scheduled payments are paid out of this investment as long as the investment provider receives proceeds in an amount at least equal to the amount falling due. If the proceeds are insufficient to meet a payment, the series would become immediately due and payable (payment acceleration).

> **Disclosure:** At the time an investment decision is made, and monthly after issuance, descriptive information on the collateral must be disclosed to investors no later than 30 days after the end of each month. The depository institutions and SPV need to disclose information relating to their financial profile and other material information.

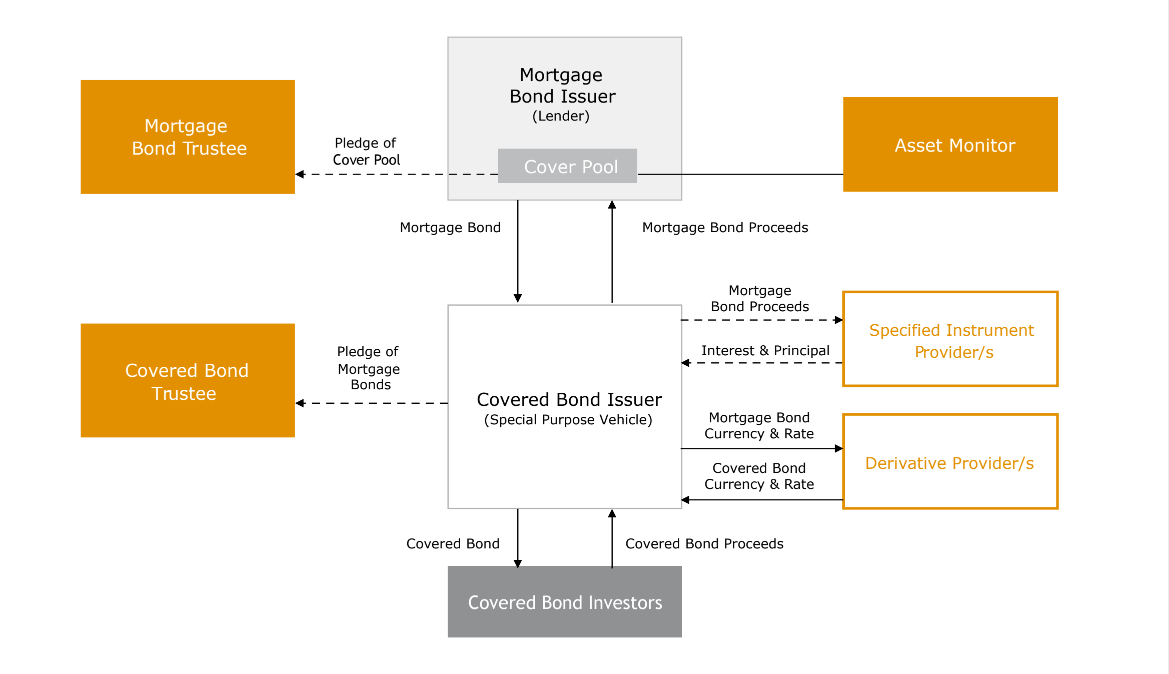
> **Monitoring:** The primary regulators monitor an issuer's controls and risk management processes. Issuers must designate an independent asset monitor and an independent trustee. An asset monitor has to determine compliance with the ACT. A trustee needs to represent bondholder interests and enforce their rights in the collateral in the event of issuer insolvency.

> Figure 1: Simplified Direct Issuance


Covered Bond Issuer
(Lender)
Collateral
Currency & Rate
Cover Bond
Currency & Rate
Derivative Provider/s
Collateral
Proceeds
Interest & Principal
Specified Instrument
Provider/s
Covered Bond
Trustee
Pledge of
Cover Pool
Covered Pool
Asset Monitor
Covered Bond
Cover Bond Proceeds
Covered Bond Investors

Source: Best Practices Guide, Credit Suisse

> Figure 2: Simplified SPV Issuance


Mortgage
Bond Trustee
Pledge of
Cover Pool
Mortgage
Bond Issuer
(Lender)
Cover Pool
Asset Monitor
Mortgage Bond
Mortgage Bond Proceeds
Mortgage
Bond Proceeds
Interest & Principal
Specified Instrument
Provider/s
Covered Bond
Trustee
Pledge of
Mortgage
Bonds
Covered Bond Issuer
(Special Purpose Vehicle)
Mortgage Bond
Currency & Rate
Covered Bond
Currency & Rate
Derivative Provider/s
Covered Bond
Covered Bond Proceeds
Covered Bond Investors

Source: Best Practices Guide, Credit Suisse

> **Insolvency:** As receiver or conservator for an IDI, the FDIC has three options in responding to a covered bond: the FDIC affirms the bond and meets the obligations of the IDI under the bond, it pays off the bond in cash up to the collateral value, or it allows liquidation of the collateral to pay off the bond. The second and third options are triggered if the FDIC repudiates the bond or if default occurs. In each case, an amount equal to actual direct compensatory damages is paid in full up to the collateral value. If the collateral value exceeds the actual direct compensatory damages, the excess amount is returned to the FDIC as conservator or receiver for the IDI. If investor claims are not met (i.e., the actual direct compensatory damages exceed the collateral value), any unsatisfied claims are unsecured claims in the receivership or conservatorship. Any losses must be allocated pro rata across series backed by a common cover pool, irrespective of the maturity of the individual series.

US lenders: SPV Issuance currently in practice

Importance of first priority perfected security interests

In the absence of covered bond legislation, US lenders were compelled to make use of SPV Issuance. The existing programmes of Bank of America and JPMorgan Chase Bank are governed by, and construed in accordance with, the laws of the State of New York and the State of Delaware, including the Uniform Commercial Code as adopted in each of those states. Applicable to these programmes are also federal legislations, including federal securities and tax laws and the FDIA. The Uniform Commercial Code adopted by each state in largely (but not exactly) the same form governs the creation, perfection and priority of security interests in the relevant collateral.

> **Sponsor:** A sponsor issues USD-denominated floating-rate mortgage bonds in series. Each series is a direct, unconditional and senior secured obligation of a sponsor ranking pari passu, pro rata, and without priority among themselves. A mortgage bond is backed by a cover pool that remains on a sponsor's balance sheet. The cover pool is revolving. A sponsor grants to a Mortgage Bond Indenture Trustee (MBIT) a first priority perfected security interest in the cover pool for the benefit of the mortgage bond holders.

> **SPV:** The sole purpose of a bankruptcy-remote SPV is to launch a covered bond series and to use the proceeds to purchase a related mortgage bond series. The SPV grants a first priority perfected security interest in the related mortgage bond series and other covered bond collateral to a Covered Bond Indenture Trustee (CBIT) for the benefit of the secured creditors, including covered bond holders.

> **Bonds:** The existing covered bonds are limited recourse obligations of the SPV ranking pro rata and without priority among themselves. Investors have no further claim against the SPV or the sponsor if the proceeds from the enforcement of the first priority perfected security interest in the covered bond collateral are insufficient to meet their claims. The two statutory trusts organised under the laws of the State of Delaware with outstanding covered bonds are BA Covered Bond Issuer and WM Covered Bond Program.

> **Monitoring:** Bank of America and JPMorgan Chase Bank are supervised by the Office of the Comptroller of the Currency. The Bank of New York Mellon was appointed independent asset monitor to verify the arithmetic accuracy of the ACT calculations of both lenders yearly. If the sponsor were downgraded to or below a minimum level, the asset monitor would have to verify the ACT calculation monthly until the necessary credit ratings have been reinstated.

Criteria to ensure sustained collateral quality

The existing programmes provide the sponsors with considerable flexibility with regard to the composition of the cover pool. The eligibility criteria can be altered subject to approval of the credit rating agency then rating the outstanding covered bonds. Eligible as collateral are currently first-lien or second-lien residential mortgages and home equity lines of credit originated or acquired by the sponsor. In the case of BA Covered Bond Issuer, loans in arrears for over 60 days must be excluded from the ACT calculation. For each loan, up to 75% of the property's value can be considered in the ACT calculation. A property's value is the value given to the property by the sponsor adjusted for changes by the Federal Housing Finance Agency (formerly the Office of Federal Housing Enterprise Oversight) House Price Index. Index declines are fully reflected in the reassessment of the mortgaged property's value, but only 85% of an index increase can be considered. Substitution collateral may be cash, debt issued or guaranteed by 0% risk-weighted public sector entities, exposures to 10% or 20% risk-weighted entities, and triple-A rated, USD-denominated RMBS. RMBS must not account for more than 10% of the total principal amount of the outstanding covered bonds. Substitution collateral is limited to up to 10% of the cover pool.

Monthly tests to ensure adequate collateralisation

A mismatch between a mortgage bond's coupon and the yield on the collateral in a cover pool is unhedged. The principal and core terms of a covered bond series match those of the related mortgage bond series. An SPV enters into derivative agreements with eligible counterparties to address risks arising from interest, currency and timing discrepancies between the mortgage bond and covered bond series. Derivative counterparties need to make payments to the SPV if and to the extent they receive payments. If the SPV fails to meet a scheduled payment, for example, if the FDIC as receiver or conservator does not authorise an interest payment on a sponsor's mortgage bond, the derivative counterparty needs to cover limited amounts of interest. Depending on the final terms of a series, the series is repaid in full on its maturity date or, if the SPV fails to repay the series in full on this date, repayment can be deferred. In accordance with the programme terms, a deferral can be up to 60 days. Payment deferral does not constitute an event of SPV insolvency. The individual programme terms provide for an ACT and a Proceeds Compliance Test (PCT).

> **ACT:** The sponsor performs this monthly test and ensures that the adjusted total loan amount is at least equal to the total unpaid principal amount of all outstanding mortgage bonds. The adjusted total loan amount is multiplied by an asset percentage, which is at least 96% for BA Covered Bond Issuer and 93% for WM Covered Bond Program, and refers to a minimum OC of 4.2% and 7.5%, respectively. An ACT is also carried out if collateral is removed from the cover pool or prior to the issuance of a new covered bond series. If the test is failed, the sponsor has to top up the cover pool to ensure that the ACT is passed again at the next calculation date. Consecutive failure of this test results in an event of sponsor insolvency.

> **PCT:** Upon an event of sponsor insolvency and declaration of acceleration of the mortgage bonds by the MBIT but before an event of SPV insolvency, the CBIT performs this monthly test. The CBIT assesses whether the sum of the total amounts deposited in, or credited to, the specified instrument for each covered bond series less any accrued interest, and the total unpaid principal amounts of each mortgage bond series is at least equal to the total principal amount of all outstanding covered bonds. A failure of the PCT constitutes an event of SPV insolvency.

Procedures upon an event of sponsor and/or SPV insolvency

For example, if a sponsor becomes insolvent or is in an unsound condition, the FDIC may be appointed as conservator or receiver for the sponsor. In the event of sponsor insolvency, the cover pool turns static and the MBIT may declare the principal of all mortgage bonds and any accrued and unpaid interest thereon through the acceleration date to be due and payable (Mortgage Bond Acceleration). The cover pool and mortgage bonds would not be segregated from the estate of the sponsor. The FDIC, as receiver or conservator for a sponsor, currently has the following options in responding to covered bonds: (1) continue to perform the sponsor's obligations under the mortgage bonds and most likely seek to transfer the programme to another lender; (2) repudiate the mortgage bonds and pay an amount equal to the lesser of actual direct compensatory damages and the cover pool's fair market value; or (3) allow the cover pool to be liquidated by the MBIT and the proceeds to be used to pay an amount equal to the lesser of actual direct compensatory damages and the cover pool's fair market value. If the collateral were insufficient to fully back any recognised claim of the MBIT under the mortgage bonds, the MBIT would be an unsecured creditor of the sponsor as regards the portion of the claim that is unsecured.

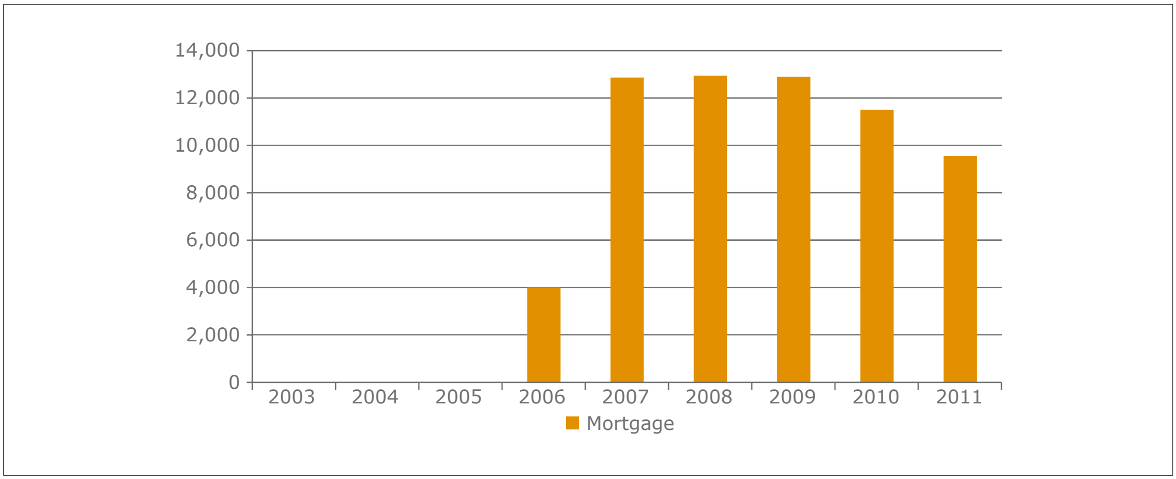
Upon an event of sponsor insolvency, the MBIT on behalf of the SPV has to deposit the cash from the liquidation of or the proceeds from the collateral in the cover pool into a specified instrument for each covered bond series. Reserves on each specified instrument have to be swapped to provide the funds needed to meet scheduled payments under the covered bonds. Funds standing to the credit of each specified instrument must not be commingled with a sponsor's other funds and assets. As long as the reserves on a specified instrument are sufficient to meet scheduled payments under the respective covered bond series, the covered bonds do not accelerate.

Following an event of SPV insolvency, the CBIT can declare all outstanding covered bonds to be due and payable against the SPV at their early redemption amount plus accrued interest (Covered Bond Acceleration). The CBIT may enforce its security interest over the covered bond collateral, liquidate it and exchange the proceeds with the derivative providers to prepay the covered bonds. No covered bond investor can proceed directly against an SPV unless the CBIT fails to take such action. If the proceeds from the enforcement of the security interest in the covered bond collateral are insufficient to meet the claims of the covered bond holders in full, no other collateral will be available for the payment of the deficiency.

II. RISK WEIGHTING & ECB ELIGIBILITY

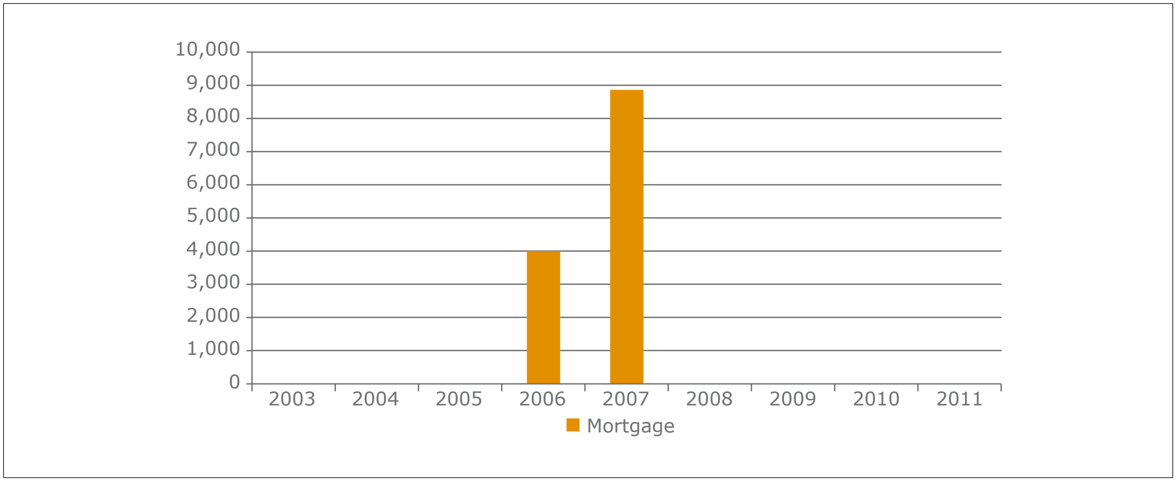
The outstanding general-law-based US covered bonds are not compliant with UCITS 52(4) and do not benefit from the higher investment limits as none of the current issuers is a credit institution with its registered office in a EU member state and subject by legislation to special public supervision designed to protect the bondholders. These bonds cannot be European CRD compliant without being in line with UCITS 52(4). Thus, the securities cannot benefit from special treatment in terms of risk weight. The Eurosystem accepts eligible assets as collateral for its credit operations. The outstanding EUR-denominated general-law-based US covered bonds are currently part of Liquidity Category IV.

> Figure 1: Covered Bonds Outstanding, 2003-2011, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2011, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/57/US_Covered_Bond

CHAPTER 4 - RATING AGENCIES & METHODOLOGY

4.1 COVERED BOND RATINGS: MORE OF THE SAME AS SOVEREIGN DOWNGRADES CONTINUE TO DRIVE RATING CHANGES

By Boudewijn Dierick, BNP Paribas
and ECBC Rating Agency Approaches Working Group Chairman

In a similar vein to last year, the covered bond market continued to be affected in the last 12 months by downgrades of sovereign ratings in Europe. In various countries, the downgrades of the sovereigns have not only resulted in downgrades of banks but also led to lower rating caps for covered bonds which have driven the ratings of covered bonds down even further in certain markets.

There have been various changes (certain only announced) in rating agency methodologies for covered bonds and counterparty criteria and, in some cases, the application of the criteria have been slightly altered. As a result, the market context and, hence, this introduction are very similar to the introduction of the fact book from 2011.

The general trend observed is that covered bond ratings become more linked to country ratings despite intrinsic strengths of laws and programmes and the quality and amount of the underlying collateral. Developments in refinancing margins and asset performance have driven overcollateralisation-levels higher but continued to have a limited impact on covered bond ratings thanks to strong issuer support.

Various issuers and other market participants feel that the changes in covered bond ratings are too extreme. The strengths of covered bonds are being overridden by ongoing downgrades of sovereigns which have dragged covered bond ratings down despite the resilience the asset class has shown compared to other markets during the crisis and the double recourse from which investors benefit.

As covered bonds are at the intersection of a number of rating methodologies (structured finance, financial institutions, public sector, sovereign), reviews or updates of rating methodologies often also have an impact on covered bonds issued by the bank or in a country. Rating methodologies are updated more frequently these days as the rating agencies are trying to conform to new regulation requesting that their methodologies are public, annually updated and transparent. However, these ongoing changes in methodologies may contradict with the expectation of issuers and investors looking for rating stability.

The rating agencies have made progress to make their criteria more transparent and make ratings more comparable and predictable by publishing monitoring reports and adding outlooks to ratings. This remains a challenge as it requires to take into account all the subtle differences between jurisdictions, laws, structures, housing markets and capture this in one rating.

The rating agencies have taken note of the complaint that new criteria should be announced well in advance. All rating agencies now follow similar procedures with changes in criteria being announced in so-called "Request for Comments" following which market participants are invited to send their comments. All proposed new criteria and methodology changes affecting the Covered Bond market have also been presented to and discussed with the ECBC Rating Agency Approaches (RAA) Working Group which has met more often than intended as a result. Most rating agencies now publish regular overview reports comparing the different programmes and ratings (Moody's European Covered Bonds monitoring overview, S&P's Global Covered Bond characteristics and rating summaries).

All rating agencies have published or proposed new or modified counterparty criteria for structured finance which in most cases also affect covered bonds but only Fitch announced changes in its covered bond criteria. All rating agencies are focusing more on the "level of commitment" from issuers to maintain a certain minimum level of overcollateralisation independent of the ratings of the covered bonds. In most cases, this level is well above the minimum required in the various covered bond laws.

On 30 May 2012, Fitch published an *Exposure Draft For Global Covered Bonds Rating Criteria*. The period for comments ended in July and the final criteria are expected to be published by the time of publication of the 2012 fact book. These changes in criteria are expected to have an impact on lower rated issuers (BBB+ category especially) and issuers in countries where sovereign rating is well below AAA. Fitch intends to link covered bond ratings more directly with issuer and country ratings, especially for public sector covered bonds, which could result in some rating downgrades. Fitch has also updated its spread assumptions for public sector assets which led to higher OC-requirements and has increased its D-factors for various programmes. It intends to revise the spread assumptions for residential mortgage assets by the end of 2012.

Fitch has published various reports about covered bonds and related topics, like impact of CRD, Basel and sovereign downgrades, rating transitions study, use for bank funding as well as many country-specific reports like comments on new proposed legislations such as New Zealand, Canada, Singapore.

At the time of writing, Moody's is reviewing the comments it received from the market on their proposed swap counterparty criteria changes for structured finance. Those for covered bonds are not affected for the moment. Moody's has lowered the Timely Payment Indicators (TPI) for many countries where the sovereign was downgraded. This, together with the wave of bank downgrades in Q2 2012 and the significant lowering of the country rating ceilings in countries like Italy and Spain, has led to various multi-notch downgrades of covered bonds in those countries. It means that despite the strength of specific covered bond legal frameworks and the availability of high levels of overcollateralisation the rating of the covered bonds will be restrained by the country ceiling.

On 31 May 2012, Standard & Poor's published the *Covered Bonds Counterparty And Supporting Obligations Criteria* report which took into account the feedback it received from market participants and was considered as an improvement even though collateral requirements in case of downgrades of swap counterparties remain high. Similar to Fitch, Standard & Poor's favours programmes with external counterparties. Issuers had to submit an action plan in July 2012 outlining their intentions and need to make the required modifications in their programmes by January 2013. Following the receipt of the plans, the ratings of only 7 programmes were negatively affected.

Standard & Poor's revised the asset spread assumptions impacting the ALMM risk in covered bond programmes. Besides specific reports for Canada and Denmark, it also published some general reports about the sensitivity of covered bonds to issuer downgrades, the impact of credit risk in mortgage covered bonds and about differences between covered bond programmes.

DBRS published its covered bond methodology for European covered bonds in August 2011 and is becoming more active in certain markets. DBRS presented their methodology to the ECBC RAA Working Group and also provided an article for the rating agency section of this year's fact book which outlines their methodology and its main building blocks (the issuer rating and the assessments of legal and structuring framework as well as the Cover Pool Credit).

COVERED BOND RATINGS CAPPED BY COUNTRY RATINGS

Moody's has reduced the country ceiling for covered bonds and RMBS transactions significantly. In the past they allowed 6 notches but they seem to have reduced this to 3 notches as all Italian covered bonds were downgraded to A2 when Italy was downgraded to Baa2 in July 2012.

Fitch and S&P allow for some more leeway for covered bond ratings backed by residential mortgage assets. Fitch is reviewing this as part of their covered bond criteria review but in practice they already increased the linkage and now seem to allow only 4 notches difference. S&P used to have the strongest link but this is not the case anymore as they allow up to 6 notches for euro-zone countries (5 for non-investment grade countries).

For public sector covered bonds programmes, Fitch applies the most direct link-approach of all rating agencies. For public sector programmes with a majority of exposures from one country there is a direct link which means that a downgrade of the sovereign would lead automatically to a downgrade of the covered bonds. S&P allows for one notch for very concentrated portfolios while Moody's allows for more leeway depending on the pool composition.

CRA 3 REGULATION

The European Union's pending reform of Credit Rating Agency (CRA) regulation, known as CRA 3 will probably have less impact on the covered bond market than initially feared.

One of the key items in the reform potentially affecting the covered bond market was the mandatory rotation of rating agencies. The initial text suggested rotation for all rated issuers and products (except for sovereigns) but the scope of application has been narrowed significantly. Besides an increase in costs, the proposed rotation would have caused significant practical implementation issues. Issuers would have had to change rating agencies for their covered bond programmes, and at the same time, change rating agencies for them as senior unsecured issuers as well as for all their external counterparties.The current tri-party discussions in Brussels (Trialogue process) concern the application of rating rotation to all or only certain structured finance products like re-securitisations.

The ECBC RAA Working Group has met with representatives of the European Securities and Markets Authority (ESMA) and the European Commission to discuss the CRA 3 proposal and voiced its concerns especially about the proposed mandatory regulation which has more negative than positive effects and is not expected to improve long-term rating quality and stability.

Other items of the envisaged regulation have raised fewer comments and are aimed to reduce the reliance of ratings, improve competition in the rating industry, harmonise civil liability of CRAs, reduce conflicts of interest and improve CRAs' methodologies and processes.

To reduce the over-reliance on ratings, the focus is on reducing the references to ratings in EU-laws and regulations as much as possible.

The quality of ratings can increase with more disclosure by issuers and rating agencies like transparent and regularly updated rating methodologies.

Making rating agencies subject to civil liability for mistakes in methodology or other infringements may entail the counter-effect that rating approaches will become even more conservative out of fear for mistakes. These measures, due to be finalized this year, could have significant implications for Europe's credit markets in general.

4.2 DBRS' RATING METHODOLOGY

By Keith Gorman and Claire Mezzanotte, DBRS

INTRODUCTION

As described in the rating methodology "Rating European Covered Bonds", DBRS covered bond (CB) ratings are composed of the following three building blocks:

1. Issuer Rating (IR)
2. Assessment of each CB programme's Legal and Structuring Framework (LSF)
3. Cover Pool Credit Assessment

The concepts behind the three building blocks are to assign a rating to a CB issuance using a step by step process. The first step is to determine the Maximum Achievable Rating (MAR) for a CB programme based on the IR and LSF. Once the MAR is determined, a rating can be assigned to the CB issuance based on a Cover Pool Credit Assessment and evaluation of the sufficiency of programme over-collateralisation (OC) levels.

THE THREE BUILDING BLOCKS

1. Issuer Rating (IR)

The CB issuer is the primary source of the timely payment and repayment of both the interest and principal of a CB. As CBs have a dual repayment mechanism, CB holders have recourse to the issuer if the CBs are not fully repaid from proceeds of the cover pool (residual claim over "unsecured assets", pari passu with unsecured creditors). As a result, the IR is the anchor rating of a CB programme. The IR is assigned and monitored by the DBRS Financial Institutions Group (FIG) following the analytical process described in the relevant FIG rating methodologies. Each issuer rating has two components: Intrinsic Assessment (IA) and Support Assessment (SA). The Intrinsic Assessment is DBRS opinion about the issuer's intrinsic fundamentals whereas, the Support Assessment reflects DBRS opinion about the likelihood and predictability of timely external support for a bank, in case of need. Accordingly, the CB rating incorporates the support element that may exist in the IR. Because of the importance of the issuer in CB transactions, DBRS rates CBs only in cases where the issuer has a DBRS public or private rating.

2. Legal and Structuring Framework (LSF)

The LSF assessment is the largest of the three building blocks, as once the LSF assessment is assigned, DBRS can determine the MAR or Maximum Achievable Rating for a CB programme. Additionally, the LSF assessment implicitly limits the number of notches a CB can be rated above the IR.

Assessing the strength of the LSF primarily entails an in-depth review of the dedicated CB legislation and the legal environment of the relevant jurisdiction. This analysis is supported by external legal opinions when necessary. The second element of the LSF assessment is an in-depth review of the structuring features supplemental to the dedicated legislation. When such dedicated legislation does not exist or when an issuer chooses to issue outside of the legislation, the LSF assigned solely reflects the contractual arrangements between transaction parties. Most importantly, the true sale agreements are reviewed to ensure bankruptcy remoteness of the CP in case of an issuer default.

The LSF grade is assigned by the DBRS Covered Bond team by jurisdiction for each CB transaction. DBRS analyses the specific terms of each CB programme to assess if the issuer manages the CP in a more conservative manner than required by jurisdictional laws. A more conservative approach by the issuer may benefit the CB. For example, in jurisdictions where CBs are issued directly from the issuer's balance sheet where repayment of mortgage credits is considered part of the segregated covered pool, the establishment of a bank account to hold collections in a segregated account may give more comfort in the continuity of cash flows in case of issuer insolvency and assigned a higher LSF grade, all else equal.

The LSF assignment is one of four grades: Very Strong, Strong, Adequate, and Moderate. In addition to analysing the CB legislation to ensure segregation of the CP from the issuer's bankruptcy estate, DBRS assesses the current market environment and analyses structural qualitative features which may have an effect on the continuity of cash flows to the CB, in the case of issuer insolvency. This includes factors such as the existence and role of a regulatory supervisor in the normal course of business and issuer insolvency as well as contingency plans in case of issuer default.

Within the LSF assignment, DBRS incorporates sovereign risk by assessing the willingness and ability of regulators and central banks to support a CB programme. For example, although legislation within a jurisdiction ensures the cover pool assets are ring-fenced from the bankruptcy estate of an issuer and warrant an LSF of Very-Strong or Strong, a lower assessment may be assigned due to the risk related to a lower rated sovereign.

3. Cover Pool Credit Assessment and Cash Flow Analysis

The Cover Pool Credit Assessment begins with the structured finance rating approach used to analyse similar types of assets in asset-back transactions (e.g., RMBS, CMBS, etc.). Rating specific Probability of Default (PD) and Loss Given Default (LGD) assumptions are estimated for the cover pool after applying the appropriate methodology. Following the cover pool assets analysis, a multi-scenario cash flow analysis is conducted to incorporate the expected cash flows from the issuer and/or cover pool (including expected proceeds from the sale of all or part of the CP in case of issuer default), and liquidity provisions, as well as the interest rate stresses and currency stresses to ensure the all CBs within a programme receive timely interest and full principal by the stated maturity date.

The cash flow analysis assumes that if an issuer is solvent, all payments to the CB are made by the issuer. Post issuer insolvency, it is assumed that the cover pool (including any hedging contracts) will be the sole source of payment to the CBs. In addition to any proceeds received from the CP under normal repayment schedules, DBRS assumes that the cover pool will need to be liquidated at the appropriate time to repay CB interest and/or principal. The collateral liquidation value is estimated assuming a 0% conditional prepayment rate (CPR) on the cover pool with the cash flows discounted by a market value stress to calculate the Net Present Value (NPV) at liquidation. Three tiers of market value stresses were estimated by DBRS based on market value spreads for senior RMBS securities in multiple European jurisdictions.

SOVEREIGN STRESS

DBRS incorporates the probability of sovereign default into its asset level analysis by applying a sovereign related stress component to its stress scenarios. In addition, DBRS incorporates the ability of a sovereign to provide support to an insolvent CB issuer when assigning the LSF.

DBRS LSF MATRICES

The probability of default of a CB is function of the joint probability of default of the Issuer and the Cover Pool Credit Assessment, and a non-zero probability that the CB will receive the full benefit of the cash flows from the CP. This benefit is determined by the assignment of the LSF grade. The four categories are assigned so as this probability of not receiving this full benefit (increased possibility of disruption of cash flows) decreases as the LSF weakens. The four LSF matrices are generated based on the Weighted Average Life (WAL) of the outstanding CB programme debt, one for each of the LSF grades (see example in Appendix).

The ratings of the issuer and CP become a more constraining factor when determining the rating (within and up to the MAR) under Strong, Adequate, and Modest LSFs, as the impact of rating deterioration is magnified by the strengths and weaknesses of the relevant Legal Framework and supplementary structural features. Legal uncertainties and corresponding potential legal challenges, as well as lack or inadequacy of replacement mechanisms might increase delays and lengthen the time needed to transfer the CP to another bank or a special administrator in charge of maintaining timely payments to CB holders. These considerations lead to a reduced uplift for the CB rating vis-à-vis the IR in weaker LSFs, notably in "Adequate" and "Modest".

Once the matrices are generated and the LSF is determined, the MAR for a CB can be determined based on the IR and the "AAA" Cover Pool Credit Assessment. Ratings are assigned when programme OC level exceeds the target OC level for a given Cover Pool Credit Assessment in the LSF matrix.

COUNTERPARTY RISK

In CB programmes where there is an interest rate or currency swap, DBRS analyses the counterparty risk as detailed in the "Swap Criteria for European Structured Finance Transactions" methodology.

CB SURVEILLANCE

DBRS monitors outstanding CB ratings in accordance with the Master European Structured Finance rating methodology. As part of the surveillance of the CP Credit Assessment, DBRS monitors changes to the assets of the CP due to reinvestments and substitutions on a quarterly basis at a minimum. To the extent the quality of the Cover Pool degrades over time, the DBRS analysis may find that the OC level is insufficient to maintain the outstanding rating of the CB.

Related research:

> "Rating European Covered Bonds", October 2011. http://www.dbrs.com/research/242989/rating-european-covered-bonds.pdf

> "Swap Criteria for European Structured Finance Transactions", June 2011. http://www.dbrs.com/research/245168/swap-criteria-for-european-structured-finance-transactions.pdf

> "Legal Criteria for European Structured Finance Transactions". April 2012. http://www.dbrs.com/research/247074/legal-criteria-for-european-structured-finance-transactions.pdf

> Commentary: "The Effect of Sovereign Risk on Securitisations in the Euro Area". May 2012. http://www.dbrs.com/research/239786/the-effect-of-sovereign-risk-on-securitisations-in-the-euro-area.pdf

APPENDIX: EXAMPLE LSF MATRIX

Adequate LSF – 5 Year Weighted Average Life

		COVER POOL											
		AAA	**AA (high)**	**AA**	**AA (low)**	**A (high)**	**A**	**A (low)**	**BBB (high)**	**BBB**	**BBB (low)**	**BB (high)**	**BB**
ISSUER RATING	**AAA**	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
	AA (high)	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AA (high)	AA (high)	AA (high)	AA (high)	AA (high)
	AA	AAA	AAA	AAA	AAA	AAA	AAA	AA (high)	AA	AA	AA	AA	AA
	AA (low)	AAA	AAA	AAA	AAA	AA (high)	AA (high)	AA	AA	AA (low)	AA (low)	AA (low)	AA (low)
	A (high)	AAA	AA (high)	AA (high)	AA (high)	AA	AA	AA	AA (low)	AA (low)	A (high)	A (high)	A (high)
	A	AA (high)	AA (high)	AA (high)	AA	AA	AA	AA (low)	AA (low)	AA (low)	A (high)	A	A
	A (low)	AA	AA	AA	AA (low)	AA (low)	AA (low)	A (high)	A (high)	A (high)	A	A (low)	A (low)
	BBB (high)	AA (low)	AA (low)	A (high)	A (high)	A (high)	A (high)	A	A	A (low)	A (low)	A (low)	BBB (high)
	BBB	AA (low)	A (high)	A (high)	A (high)	A	A	A	A (low)	A (low)	A (low)	BBB (high)	BBB (high)
	BBB (low)	A (high)	A (high)	A	A	A	A	A (low)	A (low	A (low)	A (low)	BBB (high)	BBB (high)
	BB (high)	A (low)	A (low)	A (low)	A (low)	A (low)	BBB (high)	BBB (high)	BBB (high)	BBB	BBB	BBB (low)	BBB (low)
	BB	A (low)	A (low)	A (low)	BBB (high)	BBB (high)	BBB (high)	BBB (high)	BBB	BBB	BBB (low)	BBB (low)	BBB (low)
	BB (low)	BBB (high)	BBB (high)	BBB (high)	BBB (high)	BBB (high)	BBB	BBB	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BB (high)
	B (high)	BBB	BBB	BBB	BBB	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BB (high)	BB (high)
	B	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BB (high)	BB (high)	BB (high)	BB (high)
	B (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BB (high)	BB (high)	BB (high)	BB (high)	BB	BB
	CCC (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB	BB	BB (low)	BB (low)
	CCC	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB	BB	BB	BB (low)	BB (low)
	CCC (low)	BB	BB	BB	BB	BB	BB (low)	BB (low)	BB (low)	BB (low)	BB (low)	B (high)	B (high)

4.3 FITCH RATINGS COVERED BONDS RATING METHODOLOGY

By Suzanne Albers, Hélène M. Heberlein
and Beatrice Mezza, Fitch Ratings

INTRODUCTION

Fitch covered bond ratings mainly address their probability of default, but also incorporate an element of loss given default. Fitch's covered bonds rating methodology involves the following steps:

1. **Analysis of the payment discontinuity risk**, to determine how far the covered bonds probability of default can differ from that of the financial institution acting as main debtor of recourse (which is, in general, the covered bond issuer itself). The relationship is expressed through the Fitch Discontinuity Factor while the institution's probability of default is evidenced through its Issuer Default Rating (IDR).
2. **Analysis of the cover assets and projected cash-flows**, to check whether, post issuer default and considering over-collateralisation between the cover pool and all outstanding covered bonds, asset cash-flows enable payments on the liabilities under Fitch' stress scenarios corresponding to the covered bonds' maximum achievable rating on a probability-of-default basis.
3. **Recovery given default analysis:** the assigned covered bond rating can be lifted above its rating on a probability-of-default basis by a maximum of two or three notches depending on whether the rating on probability-of-default basis is in the investment or non investment grade range, provided that over-collateralisation taken into consideration produces outstanding stressed recoveries on covered bonds assumed to be in default.

On 30 May 2012, Fitch published an exposure draft detailing proposed amendments to its criteria. A six-week consultation period followed. Fitch plans to publish its updated criteria in August 2012. As submission for the ECBC Fact Book is required before August, Fitch has summarised its current criteria below, noting where highlights from the exposure draft would be expected to impact criteria. Please go to www.fitchratings.com for the current criteria report.

1. DISCONTINUITY RISK

Fitch Discontinuity Factors express the risk of an interruption of payments caused by the transition from the issuer to its cover pool as the source of payment on the covered bonds. The Discontinuity Factor takes into account systemic, cover pool and issuer-specific aspects.

Proposed Change: To replace Discontinuity Factors with Discontinuity Caps to simplify the approach and enhance transparency. Discontinuity Caps correspond to the maximum rating notch uplift from the IDR to the covered bond rating on a probability-of-default basis. The proposed Discontinuity Caps, together with the associated discontinuity risk description, are as follows: 8 (for pass-through programmes with sufficient liquidity protection), 6 (Very Low), 5 (Low), 4 (Moderate), 3 (Moderate High), 2 (High), 1 (Very High) and 0 (Full Discontinuity).

The fact that covered bond holders have full recourse against a financial institution justifies using the IDR of this institution as a rating floor from a probability-of-default perspective.

Fitch Discontinuity Factors represent a weighted average of the assessment for each of the four subsections as follows, and are further adjusted to take into account the nature of privileged hedging arrangements, if any:

> **Asset Segregation (45%):** Fitch investigates the strength of the asset segregation mechanism, notably whether it also places over-collateralisation beyond the reach of other creditors until all covered bonds have been repaid in full. Identified risks relate, for example, to the potential claw back of assets set aside for covered bonds investors, commingling with the issuer's other cash flows, borrowers' set-off rights or the bankruptcy remoteness of any foreign assets included in the cover pool.

> **Liquidity Gap (35%):** in most cases, incoming cash flows from the cover pool do not exactly match payments on the privileged liabilities in a given period. The liquidity gap component of Fitch Discontinuity Factors compares the time needed to monetise regular cover assets in a stress situation to the length of time granted by the programme's protection mechanism. The agency classifies the cover assets in different categories depending on their tradability. Apart from pass-through programmes, where there is no need for asset liquidation post issuer default, temporary liquidity gaps arising in the aftermath of an issuer default can be mitigated by extendible maturities of the covered bonds, pre-maturity tests and mandatory liquidity requirements or the voluntary posting of liquid assets. Programmes lacking a specific protection mechanism, or which do not mitigate short term shocks, such as to ensure interest payments if principal is extendible, or *pari-passu* ranking termination payments in the event of a counterparty default, are viewed particularly negatively.

Proposed Change: To incorporate sovereign ratings and other systemic indicators within the liquidity gap component of the discontinuity analysis. The component would be renamed "Liquidity Gap and Systemic Risk". For non-pass-through programmes mostly exposed to domestic assets, sovereign ratings below 'AA−' would be likely to lead to lower D-Caps. A cap of up to six notches for covered bond ratings relative to sovereign ratings and tighter relationships for affected public sector programmes will also apply.

> **Alternative Management (15%):** the agency studies the legal or contractual provisions for replacing an insolvent institution in its capacity as manager of the covered bonds and servicer of the cover assets. It is crucial that upon insolvency of the issuing bank, a substitute manager of the cover pool is appointed as soon as possible and that he has all powers and means to take the necessary actions, such as liquidation of the pool, if necessary, to repay the covered bond holders. In addition, Fitch analysts carry out operational reviews to identify the obstacles any such alternative manager might face when taking over the cover pool and the covered bond administration, which, ultimately, could also prevent timely payments to covered bond holders.

Proposed Change: The alternative management component would be divided into two distinct parts: framework-based and cover pool-specific. The framework-based assessment would consider points such as whether an administrator is appointed sufficiently ahead of insolvency and whether it would take exclusive care of the interest of covered bondholders. The cover pool-specific assessment would depend on factors such as the perceived quality of the issuer's systems for cover pool and covered bond management, the expected ease of data transfer to potential buyers of cover pool assets and the automation level and quality of data provision to Fitch.

> **Covered Bonds Oversight (5%):** The attitude of the domestic banking authorities towards the instrument plays a role in Fitch's Discontinuity Factors. Indeed, the agency recognises that regulators may exercise a positive influence on covered bonds if they monitor their risk profile through specific guidelines, especially if the covered bond market accounts for a substantial part of domestic banks' funding. This particular section addresses the preventive action of supervisory authorities rather than the likelihood of support of a given institution, which Fitch financial institutions analysts already factor in as part of the IDR assignment. Covered bond programmes based solely on contracts get no benefit from oversight.

Proposed Change: Oversight would no longer be a separate component, but together with potential support for regulated covered bonds would be considered within the other components of the D-Caps.

> **Adjustment for Privileged Derivatives:** Fitch tightens the relationship between the IDR and the covered bonds rating through an increased Discontinuity Factor for programmes relying on privileged derivatives. The tightening is more severe in the absence of clear counterparty replacement provisions post issuer insolvency, and affects arrangements with intra-group counterparties more than with counterparties external to the issuer banking group. Also, the materiality of the exposure and the replacement prospects are taken into consideration.

Proposed Change: D-Caps would be driven by the highest discontinuity risk component rather than a weighted view. Fitch proposes to publish the assessment for each component. Where systemic risk is assessed as low, Fitch would expect D-Caps of 4, 5 and 6 for most public sector programmes and 3 and 4 for most mortgage programmes.

The combination of the likelihood of default associated with the relevant IDR and the Discontinuity Factor for a given programme indicates the maximum rating that can be assigned to the covered bonds on the basis of their probability-of-default, provided over-collateralisation between the cover assets and the covered bonds is sufficient to withstand Fitch stresses commensurate with this targeted rating. The table below show these achievable ratings for a few Discontinuity Factors.

Maximum Achievable Covered Bonds Rating on a Probability of Default Basis

	Discontinuity Factors										
Issuer Default Rating	**100%**	**70%**	**60%**	**50%**	**40%**	**30%**	**20%**	**15%**	**10%**	**5%**	**0%**
AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
AA+	AA+	AA+	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
AA	AA	AA+	AA+	AA+	AA+	AAA	AAA	AAA	AAA	AAA	AAA
AA-	AA-	AA	AA	AA+	AA+	AA+	AAA	AAA	AAA	AAA	AAA
A+	A+	AA-	AA-	AA-	AA	AA	AA+	AA+	AAA	AAA	AAA
A	A	A+	AA-	AA-	AA	AA	AA+	AA+	AAA	AAA	AAA
A-	A-	A	A+	A+	AA-	AA-	AA	AA+	AA+	AAA	AAA
BBB+	BBB+	A-	A	A+	A+	AA-	AA	AA	AA+	AAA	AAA
BBB	BBB	BBB+	BBB+	A-	A	A+	AA-	AA-	AA	AA+	AAA
BBB-	BBB-	BBB	BBB	BBB	BBB	BBB+	A	A+	AA-	AA	AAA
BB+	BB+	BBB-	BBB-	BBB-	BBB	BBB	BBB+	A-	A	AA-	AAA
BB	BB	BB+	BB+	BBB-	BBB-	BBB	BBB	BBB+	A-	AA-	AAA
BB-	BB-	BB	BB	BB+	BB+	BBB-	BBB	BBB	BBB+	A	AAA
B+	B+	BB-	BB	BB	BB+	BB+	BBB-	BBB	BBB	A-	AAA
B	B	B+	BB-	BB-	BB	BB+	BBB-	BBB-	BBB	BBB+	AAA
B-	B-	B	B+	BB-	BB-	BB	BB+	BBB-	BBB-	BBB+	AAA
CCC+/ CCC	CCC+/ CCC	B-	B	B+	BB-	BB-	BB	BB+	BBB-	BBB	AAA

Source: Fitch

Proposed Change: Discontinuity Caps directly convey the maximum rating notch uplift from the IDR to the covered bond rating on a probability-of-default basis, so the table above would no longer be used.

2. STATIC ASSET ANALYSIS AND CASH-FLOW MODELLING

In order to reach a conclusion about the covered bonds' probability of default, Fitch simulates a wind-down scenario under the management of a third party. Fitch tests whether over-collateralisation accounted for by the agency is sufficient to withstand the stress scenario corresponding to the rating on a probability-of-default basis, such that cash flows generated by the cover pool are sufficient to meet payments to privileged creditors on their due date. The stress scenario includes assumptions about the behaviour of the cover assets in terms of delinquencies, defaults, losses and prepayments. It also factors in the cost of bridging maturity mismatches, and incorporates Fitch's standard interest and currency stresses to the extent there are open positions between the cover pool and the related covered bonds, after taking into account privileged swaps. Finally, the assumed costs of a third-party manager are deducted from the stressed asset cash flows.

Unless the covered bonds are redeemable on a pass-through basis, the natural amortisation of the cover pool compared to the scheduled payments under the covered bonds may result, at times, in an excess of cash, and at times, in a shortfall of cash. Fitch's cash flows model simulates the re-investment of any excess cash at below Euribor rates. Conversely, shortfalls of cash can be compensated by monetising the cover assets at a given sale price or cost of borrowing.

Fitch's stressed refinancing cost assumptions are derived from observable sale prices where available. For mortgage assets, Fitch generally assumes that the most likely buyers will be other covered bond issuers, who will take into account their own cost of funding when placing an offer. In this instance, Fitch uses average residential mortgage-backed securities and covered bonds secondary market spreads as a starting point to calculate the corresponding refinancing costs. Fitch also applies price caps on the first sale after the default of the issuer. This is because the market will be aware of the pressure to refinance/sell assets that the administrator of the pool is facing and therefore potential buyers will try to take advantage from this situation.

Fitch will not always give full credit to over-collateralisation available at the last reporting date: in the absence of any contractual commitment or public statement, the agency considers the lowest over-collateralisation observed in the preceding 12 months if the issuer is rated 'F2' or above. Below this rating threshold, it considers only the legal minimum over-collateralisation.

Proposed Changes:

> To expand the expectation for contractual or public statements to wind-down programmes, ie from issuers that no longer focus on cover pool eligible assets as part of their normal business activity or that are not expected to issue covered bonds in the short or medium term.

> For issuers in solvent wind-down or with IDRs below 'F3' or 'BBB−', Fitch proposes to also analyse other factors before giving credit to a public statement on over-collateralisation. For example, Fitch will consider the strength of the wording of the statement, any consequences of a breach, the performance of similar statements, the level of unencumbered assets and whether the programme is actively used for covered bond issuance.

> For Spanish cédulas hipotecarias (CH), Fitch proposes to apply tiered haircuts to the lowest level of over-collateralisation recorded over the last 12 months, with the haircuts increasing as IDRs decrease. This treatment reflects the fact that those bonds are secured by the entire mortgage book on the balance sheet of the issuer, rather than only a selected portion. Therefore, unless this book is growing, even issuers rated 'F2' and higher will have limited capacity to maintain current over-collateralisation levels, if they continue to issue CH. For issuers rated below 'F2' and without a public statement on over-collateralisation, Fitch proposes criteria to rely on a higher level of over-collateralisation than the legal minimum. This is because the mandatory minimum level of 25% is calculated based on the "eligible" loan book only, while the bonds are secured by additional non-eligible assets as well. This higher over-collatereralisation credit for programmes without a relevant public statement and with issuers rated below 'F2' has recently been applied by the agency, as described in Fitch's rating communication for these programmes.

If the over-collateralisation taken into account does not withstand credit risk, maturity, interest rate and currency mismatches, the cash flow model will fail, indicating that the tested rating scenario is too severe, and hence a less stressful scenario will be tested until the model passes. Through a reiterative process, the covered bonds rating on a probability-of-default basis is set at the level corresponding to the highest rating scenario that, if applied to the cash flows, can be compensated through over-collateralisation without leading to a covered bond default.

3. RECOVERIES GIVEN DEFAULT

Fitch's covered bond ratings do not fully reflect expected loss: indeed, the benefit given to recoveries from the cover pool in the event of a default under the covered bonds is limited to a two-notch uplift from the rating corresponding to the covered bonds rating on a probability of default basis (if it is in the investment-grade range), and to three notches (if it is in the speculative grade). In its recovery analysis, Fitch disregards any potential recourse to the bankruptcy estate of the issuer. Covered bond investors often have an additional unsecured claim, ranking pari passu with the senior unsecured creditors of a bankrupt institution, to the extent that the proceeds from the cover pool liquidation are insufficient to repay their debt in full. However, it may be impracticable for them to enforce their right if the two bankruptcy procedures do not start at the same time; moreover, the outcome is subject to several uncertain parameters, such as the quality of the non-cover-pool assets, and the capital structure prevailing at the time of the issuing institution's bankruptcy.

When giving credit to recoveries from the cover pool in a stress scenario, Fitch expressly incorporates payments owed to privileged swap counterparties. To the extent they rank equally with covered bond investors, they would share any recovery proceeds should the incoming cash flows from the cover pool and from privileged swaps be insufficient to meet the secured liabilities in timely fashion. Therefore, Fitch obtains the recovery percentage by dividing the net present value of stressed future cash flows, including payments expected from swap counterparties, by the net present value of the residual liabilities, including payments owed to swap counterparties. This recovery percentage then translates into a given number of notches as per the table below.

Recovery Ratings	Recovery Prospects	Recovery Range (%)	Maximum Notching	
			Investment Grade	Speculative Grade
RR1	Outstanding	91 - 100	2	3
RR2	Superior	71 - 90	1	2
RR3	Good	51 - 70	1	1
RR4	Average	31 - 50	–	–
RR5	Below Average	10 - 30	-1	-1
RR6	Poor	0 - 10	-1/-2	-2/-3

Source: Fitch Ratings

In some jurisdictions, however, notching up for recovery may only be justifiable if stressed recoveries on covered bonds assumed to be in default reach 100%. This is because there might be some form of time subordination among outstanding issues of covered bonds such as in the absence of cross-default between different covered bonds and therefore an administrator may liquidate most of the assets in the pool in order to repay earlier maturing issues at the detriment of later maturing ones.

Proposed Change: No change for recoveries given default.

CONCLUSION

The IDR, discontinuity assessment and over-collateralisation compared to the cover pool's credit risk as well as maturity, interest rate and currency mismatches between the cover pool and the covered bonds are driving the covered bond ratings assigned by Fitch. Whereas the IDR sets the floor for the covered bonds rating on a probability-of-default basis, the discontinuity assessment indicates how far the covered bonds rating on a probability of default basis can differ from the IDR. Finally, over-collateralisation protects against credit risks in the cover pool and mismatches between the cover pool and the covered bonds. It furthermore drives the level of recoveries on covered bonds assumed to be in default.

Among the 127 covered bonds programmes publicly rated by the agency at 25 June 2012, 84 were rated 'AAA', the majority of which correspond to a 'AA+' or 'AA' rating on a probability-of-default basis, and incorporate one or two notches for recovery given default.

The average Discontinuity Factor for the 103 mortgage covered bonds was 36.5%, meaning that, all else being equal, the covered bonds could be rated 'AAA' (assuming a two notch uplift for recovery given default) as long as the IDR is 'A' or above. The average Discontinuity Factor for the 23 public sector covered bonds was 21.3%, meaning that, all else being equal, the covered bonds could be rated 'AAA' (assuming a two notch uplift for recovery given default) as long as the IDR is 'BBB+' or above. Fitch also rates one covered bond programme secured by assets which are neither mortgages nor public sector debt.

For 'AAA' rated programmes, the median over-collateralisation supporting the rating was 22% for mortgage programmes as of 19 June 2012, and 14% for public sector programmes.

Covered Bonds Surveillance

Fitch covered bonds surveillance platform constitutes a single, comprehensive source of periodic information on key covered bond credit characteristics. It gives an overview of the IDR, the Discontinuity Factors and the covered bonds ratings for all programmes publicly rated by the agency. It shows the amount of outstanding covered bonds and corresponding cover pools, highlighting available nominal over-collateralisation as of each reporting date, as well as the percentage of over-collateralisation (or asset percentage) supporting the assigned rating.

The surveillance pages contain graphs comparing the redemption profile of the cover assets to the covered bonds. It also displays indicators of maturity, interest rate and currency mismatches between the cover pool and the covered bonds. Furthermore, it enables users to follow the composition of cover pools, such as geographical distribution for public sector assets or loan-to-value ratios for mortgage loans.

This is a subscription service accessible from www.fitchratings.com.

Proposed Change: That covered bond rating Outlooks be assigned to give an early indication of the potential future direction of a covered bond rating. Outlooks indicate the likely direction of a rating over a one- to two-year period. Fitch proposes that the main drivers of covered bond rating Outlooks will be the relevant sovereign rating Outlook, the Long-Term IDR Outlook, the economic and/or sector outlook associated with the assets comprising the cover pool and the outlook for the maintenance of OC within a programme.

4.4 MOODY'S COVERED BOND RATING METHOD

By Jane Soldera, Nicholas Lindstrom,
and Juan Pablo Soriano, Moody's

SUMMARY

Our rating for a covered bond is determined after applying a two-step process:

> Moody's Expected Loss (EL) Model: This model determines a rating based on a largely quantitative calculation of expected loss, taking into account both the issuer's credit strength and the value of the cover pool following issuer default.

> Timely Payment Indicator (TPI): This indicator applies a ceiling to the rating arrived at using Moody's EL Model. The TPI framework determines the maximum covered bond rating based on the issuer's senior unsecured rating and the TPI assigned to the programme. The TPI assigned will reflect the probability of timely payments continuing on the covered bonds following the default of the issuer (or a rated entity on which the issuer relies for support, in each case referred to as *issuer default*).

MOODY'S EXPECTED LOSS (EL) MODEL – OVERVIEW

Our covered bond ratings are primarily determined by the expected loss under Moody's EL Model. The model assumes there is recourse, first, to the issuer and, second, to the cover pool. The model accordingly calculates the expected loss as a function of (a) the probability of issuer default; and (b) the subsequent losses (if any) on the cover pool. Following issuer default, the level of losses will be determined assuming a stressed environment. The key factors affecting the loss assumptions include:

> The credit quality of the assets in the cover pool;

> Refinancing risk, which arises when funds need to be raised to refinance the cover pool following issuer default; and

> Any interest-rate and currency risks to which the cover pool is exposed (both up to and at the time of refinancing the cover pool).

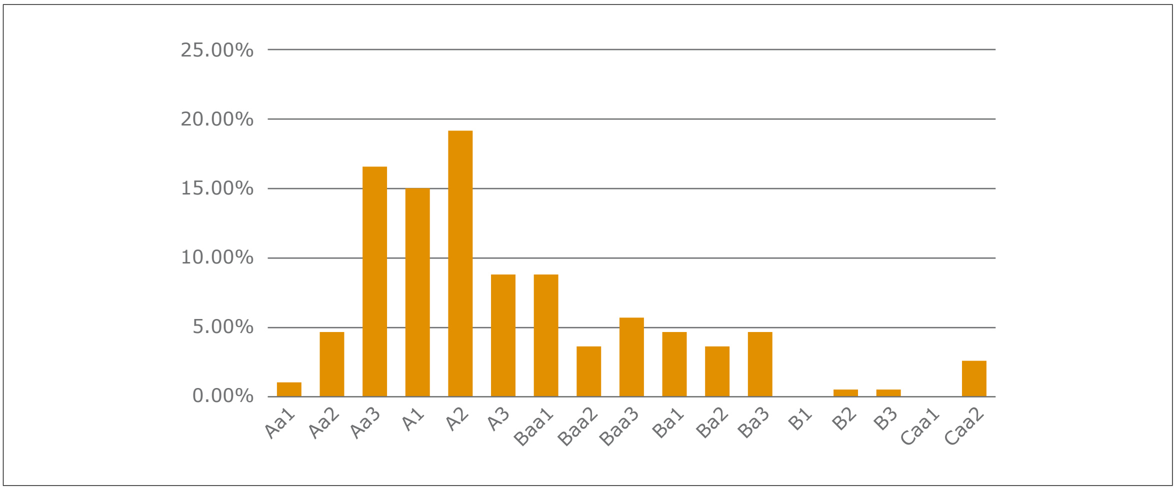
Moody's EL Model calculates expected loss on a month-by-month basis, from the point of issuance to the final maturity of a covered bond. For each period it calculates the probability of issuer default, on the basis of the issuer's rating, and the estimated loss on the collateral (if any) assuming the issuer has defaulted. The results are then summed and discounted back to a net present value to give the overall expected loss on the covered bond.

MOODY'S EL MODEL - ROLE OF THE ISSUER

The issuer's role is crucial to the performance of a covered bond programme. Before issuer default, we assume the issuer is performing its obligations and there should be no loss to covered bondholders. To assess the risk of issuer default, we look to the issuer's senior unsecured rating or, if the issuer is unrated, we may use the rating of another group entity provided it has a sufficiently robust obligation to provide financial support to the issuer. Moody's EL Model also takes into account various issuer and issuer group-related benefits in addition to the issuer's senior unsecured rating. For instance, the issuer will normally actively manage the cover pool to the benefit of the covered bondholders: this may include replacing defaulted assets with performing assets, or replacing high loan-to-value (LTV) loans with lower

LTV loans, particularly if this is required by law. This kind of support from the issuer explains why the issuer's role is more important than that of a simple guarantor.

> Figure 1: Distribution of issuer ratings, Q4 2011*



*as of date of publication of Moody's Performance Overview
Source: Moody's calculation

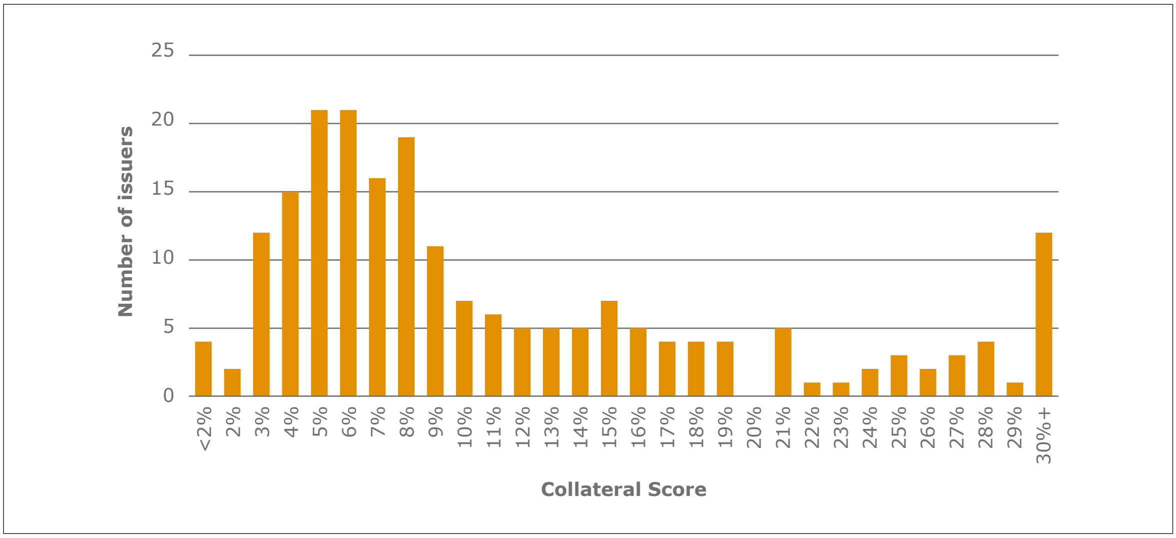
MOODY'S EL MODEL - VALUE OF THE COVER POOL AFTER ISSUER DEFAULT

To avoid losses on covered bonds following issuer default, the realisable value of the cover pool, including any over-collateralisation, will need to be sufficient to cover the principal and interest payable on the covered bonds. In our analysis, there are three key factors affecting the value of the cover pool: (a) the credit quality of the collateral; (b) refinancing risk; and (c) interest-rate and currency risks. Taken together, refinancing risk and interest rate and currency risks are referred to as *market risks*.

(I) Credit quality of the collateral in the cover pool

We determine the credit quality of the cover pool by estimating the level of borrower loan losses that will accrue after issuer default in a highly stressed environment. The collateral score measures the level of loss, whereby the lower the collateral score the stronger the credit quality of the cover pool. Factors that affect the collateral score vary, but for mortgage loans they will normally include (i) the performance of the relevant property market(s); (ii) the range and distribution of loan-to-value ratios; (iii) the quality of the loan underwriting (in particular, the calculation of whether the borrower can afford the loan); (iv) the seasoning of the pool; and (v) the type of loan product, for example, amortising or interest-only. Factors most relevant for public-sector loans will include the credit strength of the public-sector borrowers and concentration levels of those loans. The credit quality of the cover pool may vary over time, as issuers typically have discretion to add and remove assets, but we monitor this by re-calculating the collateral score for most programmes on a quarterly basis.

> FIGURE 2: COLLATERAL SCORES Q4 2011



Source: Moody's calculation

(II) Refinancing risk in the cover pool

The expected maturity of the assets in the cover pool is generally longer than that of the covered bonds. This mismatch means that, following issuer default, funds may need to be raised against the cover pool to enable timely payment of principal on the covered bonds. Moody's EL Model assumes that when funds must be raised against the cover pool this will be done at a discount to the notional value of the cover pool. The refinancing environment for the assets at this time is likely to be stressed and this is taken into account in the level of discount we build into our credit enhancement assumptions for a given rating level.

The credit enhancement necessary to address refinancing risk is based on three factors:

(a) The level of discount required to sell or refinance the assets (referred to as *refinancing margin*);

(b) The portion of the cover pool exposed to refinancing risk; and

(c) The average life of the refinancing risk, i.e., the average duration of the refinancing risk for assets in the cover pool at the time of issuer default.

We typically assume that at the time of issuer default, for (b), the portion of the cover pool exposed to refinancing risk is a minimum of 50% and, for (c), the average duration of the refinancing risk is a minimum of five years.

For (a), the refinancing margins are set by reference to each jurisdiction and then adjusted for individual programmes. Factors that influence the refinancing margins in our analysis include (i) on a jurisdiction level, the margins observed for covered bonds in a given market; (ii) on programme and/or jurisdiction level, the mitigants to refinancing risk; and (iii) on a programme level, the collateral quality.

(III) Interest-rate and currency risks in the cover pool

Following an issuer default, investors in covered bonds may be exposed to interest-rate and currency mismatches. These mismatches result from different interest rates, the duration of these rates, and different currency denominations of cover pool assets compared with the covered bonds. Under Moody's EL Model, the potential mismatches are estimated by taking into account:

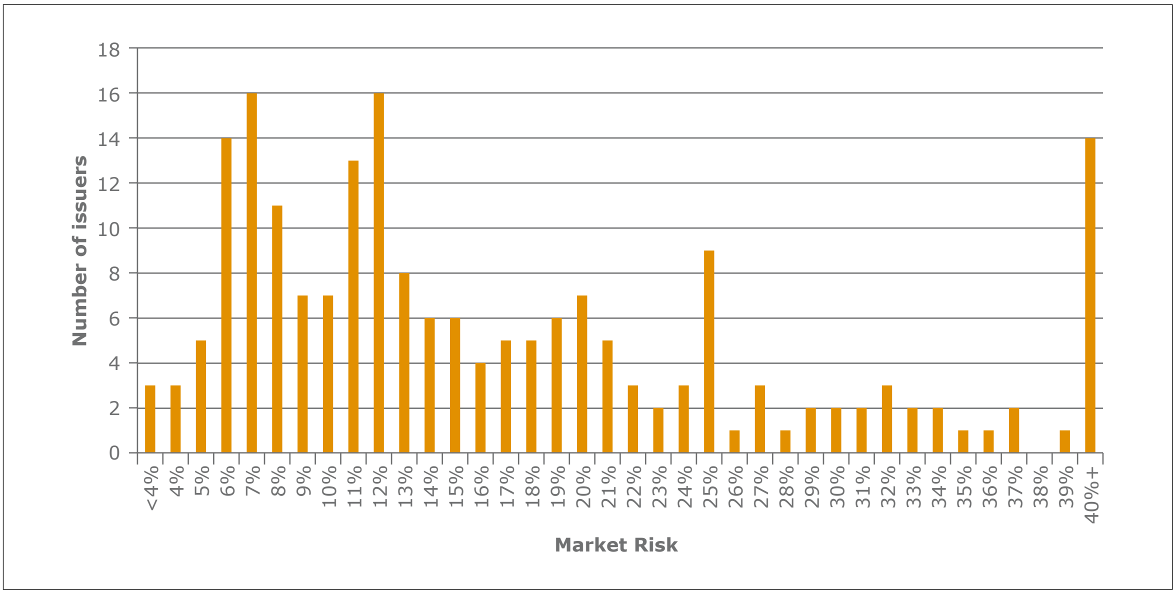
(a) The size of the possible interest-rate (or currency) movement over the relevant period, for example looking at the impact of increasing and decreasing interest rates and taking the path that leads to the harshest expected loss on the covered bonds;

(b) The portion of the assets with interest-rate (or currency) mismatches; and

(c) In the case of interest-rate risk, the average duration of the mismatch based on how quickly the rates or margins on the assets in the cover pool may be adjusted.

Moody's EL Model takes into account whether there is hedging in place at the point of issuer default and the probability of the hedging terminating at issuer default, or subsequently. Generally, the lower the probability of a hedge terminating, the lower the risk of an interest-rate or currency mismatch arising; however, in no case do we currently assume that swaps used to hedge interest-rate and currency risk completely and permanently remove these risks from a covered bond.

> Figure 3: Market risk Q4 2011



Source: Moody's calculation

MOODY'S TIMELY PAYMENT INDICATORS ("TPIs")

Risks to timely payment limit covered bond ratings

Following issuer default, the issuer can no longer be relied on to make timely payments on the bonds and bondholders must therefore rely on external support, liquidity and the legal/ contractual framework of the bonds to provide for timely payment. A "timely payment indicator" or "TPI" is Moody's assessment of the likelihood that timely payment would continue to be made to covered bondholders following issuer default and TPIs range from "Very High" to "Very Improbable". The purpose of TPIs is to indicate a ceiling for the rating of a covered bond that limits the rating to a certain number of notches above the issuer's rating.

Determining TPIs

We determine TPIs on a jurisdiction-by-jurisdiction basis as many of the factors we analyse are common within jurisdictions. TPIs may then be adjusted at the programme level to reflect particular features of a programme. We publish a TPI Table setting out the expected maximum covered bond ratings for different issuer rating/TPI combinations (see Moody's rating methodology report referred to at the end of this chapter). We will normally determine the rating ceiling based on the TPI table; however, for some programmes the actual rating ceiling may be higher or lower, particularly if the issuer has a low investment-grade rating, or is rated below investment grade.

We consider a range of qualitative factors to determine TPIs. The most important of these – and the biggest risk to timely payment for most covered bonds – is the existence of refinancing risk. This risk is highly volatile, which is why our highest ratings cannot be maintained on covered bonds that are subject to material refinancing risk, unless they are also backed by a highly-rated issuer.

One important way in which we assess the effects of refinancing risk for each jurisdiction is to consider covered bonds' systemic importance in that jurisdiction. We consider whether, following an issuer default, covered bonds would be likely to receive support from the government or market participants. Other factors that we consider relevant to TPI levels include (i) continuity of servicing and cash management; (ii) the risk that any relevant swaps might be terminated; (iii) the risk of acceleration of the covered bonds; (iv) enhancement levels; and (v) the issuer's ability to change the programme (in particular to add new assets and enter into new hedging arrangements).

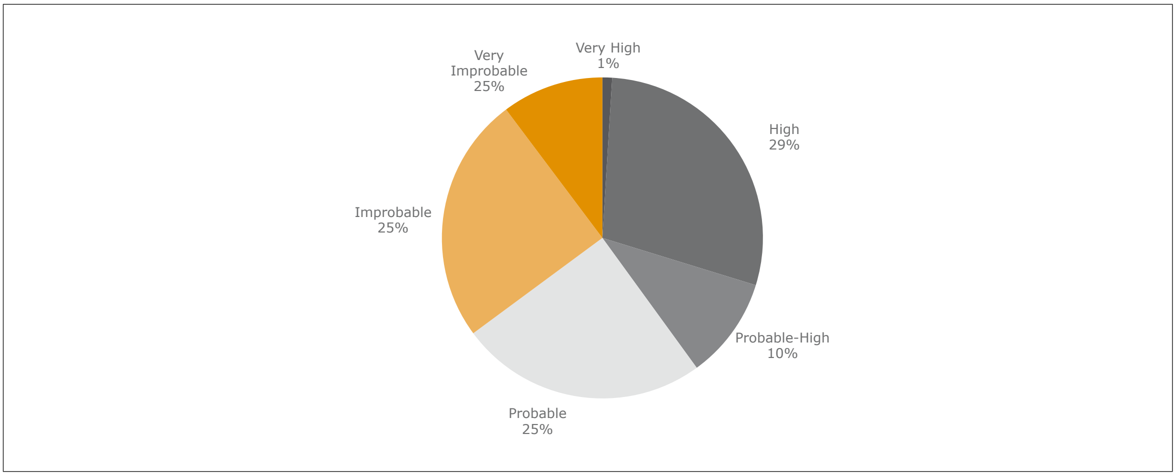
Sovereign risk driving lower TPIs

Following the downgrades of euro area countries over the last few years, sovereign risk has been the main driver for reductions in TPI levels in the affected countries. In countries with weaker creditworthiness, the stresses on the government and financial system may mean the government and market participants are less willing and/or able to provide funds to support refinancing of covered bonds following issuer default. For more details on the impact of sovereign downgrades on covered bond ratings see our report *European Covered Bonds: Sovereign Downgrades Key to Bond Rating Migration* (listed below).

Other TPI changes

For those countries that have not experienced a downgrade over the financial crisis TPIs have generally increased. For instance, TPIs for mortgage-backed programmes were recently raised from Probable-High to High in Germany and from Probable to Probable-High for certain law-based programmes in France. One exception has been Denmark where TPIs were lowered as the market shift toward adjustable rate mortgages introduced additional refinancing risk to programmes.

> Figure 4: TPIs, Q4 2011



Source: Moody’s calculation

References:

> Moody’s EMEA Covered Bond Monitoring Overview: Q4 2011 (updated quarterly)

> Moody’s Approach to Rating Covered Bonds; 4 March 2010

> European Covered Bonds: Sovereign Downgrades Key to Bond Rating Migration; 5 March 2012

> EMEA Covered Bonds 2012 Outlook; 12 December 2011

> Assessing Swaps as Hedges in the Covered Bond Market; 17 September 2008

> European Covered Bond Legal Frameworks: Moody’s Legal Checklist; 9 December 2005

4.5 STANDARD & POOR'S

By Roberto Paciotti, Karlo Fuchs, Sabrina Miehs
and Nicolas Malaterre, Standard & Poor's

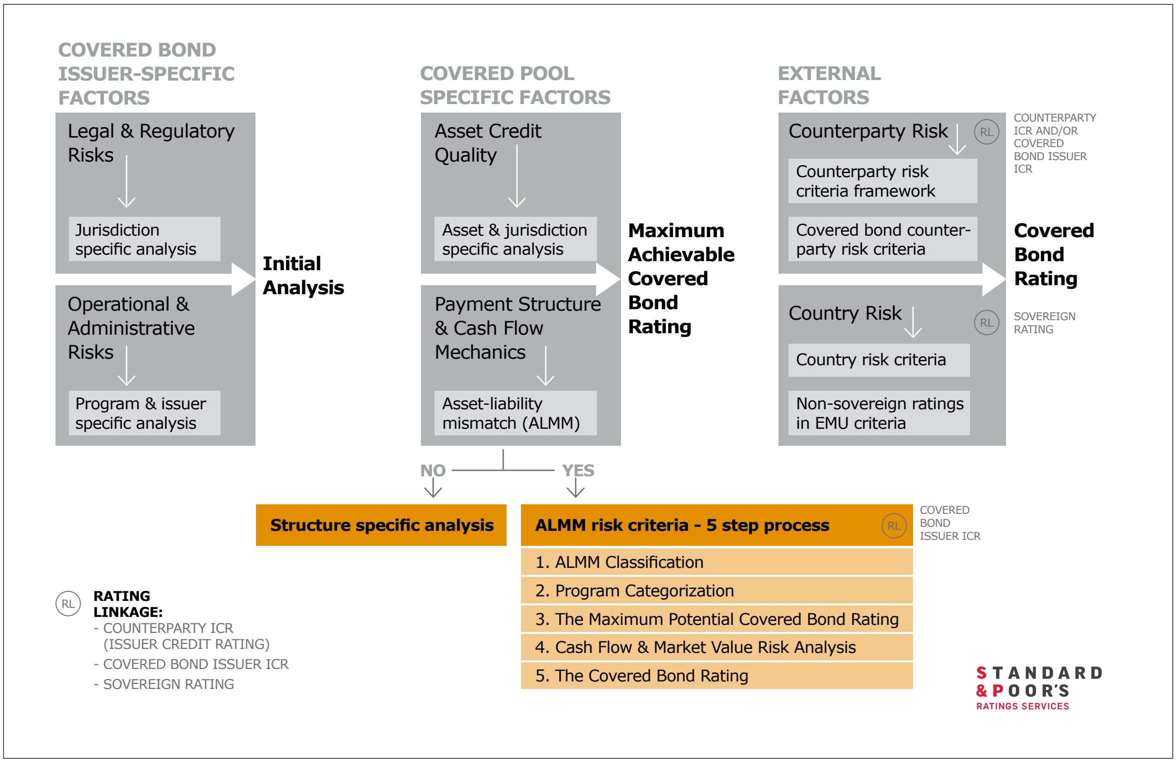
Standard & Poor's Ratings Services rates covered bonds issued globally based on its criteria published in late 2009 ("Revised Methodology And Assumptions For Assessing Asset-Liability Mismatch Risk In Covered Bonds" published on Dec. 16, 2009 and available on Ratings Direct and www.standardandpoors.com/coveredbonds).

S&P's criteria reflects its belief that covered bonds that exhibit mismatches between the underlying assets and the covered bond liabilities should be linked to the issuer credit rating on the issuing or sponsor bank. Only if a covered bond can be isolated from that risk can S&P rate the covered bonds on a de-linked basis from the issuer.

When the program is exposed to asset-liability mismatch (ALMM) risk, the maximum potential rating uplift the covered bond rating can achieve above the issuer credit rating is seven notches. Therefore, this approach results in the assignment of "AAA" ratings only to covered bonds of highly rated issuers, provided that S&P believes the program has sufficient credit enhancement to cover (all) relevant risks, in particular market value risk arising from the asset-liability mismatch.

To arrive at a covered bond rating, S&P considers six main factors in its covered bond rating analysis, which are depicted in the following chart and described below.

> FIGURE 1: COVERED BOND RATINGS FRAMEWORK - BASED ON PRINCIPLES OF RATINGS


COVERED BOND ISSUER-SPECIFIC FACTORS
Legal & Regulatory Risks
Jurisdiction specific analysis
Operational & Administrative Risks
Program & issuer specific analysis
Initial Analysis
COVERED POOL SPECIFIC FACTORS
Asset Credit Quality
Asset & jurisdiction specific analysis
Payment Structure & Cash Flow Mechanics
Asset-liability mismatch (ALMM)
Maximum Achievable Covered Bond Rating
EXTERNAL FACTORS
Counterparty Risk
RL
Counterparty risk criteria framework
Covered bond counter-party risk criteria
COUNTERPARTY ICR AND/OR COVERED BOND ISSUER ICR
Country Risk
RL
Country risk criteria
Non-sovereign ratings in EMU criteria
SOVEREIGN RATING
Covered Bond Rating
NO
YES
Structure specific analysis
ALMM risk criteria - 5 step process
RL
COVERED BOND ISSUER ICR
1. ALMM Classification
2. Program Categorization
3. The Maximum Potential Covered Bond Rating
4. Cash Flow & Market Value Risk Analysis
5. The Covered Bond Rating
RL
RATING LINKAGE:
- COUNTERPARTY ICR (ISSUER CREDIT RATING)
- COVERED BOND ISSUER ICR
- SOVEREIGN RATING
STANDARD & POOR'S RATINGS SERVICES

ASSET AND CASH FLOW ANALYSIS

Asset analysis

The underlying cover pools typically contain residential mortgage loans, public sector bonds and loans, or some other form of high credit-quality collateral. Using jurisdiction and asset-specific assumptions, S&P analyses these pools to form a view on the expected stressed performance. Ongoing monitoring of the issuer as well as markets allows S&P to incorporate relevant market developments into its covered bond rating assumptions. The credit analysis also incorporates issuer specific aspects such as the impact of its underwriting policies or its collateral management.

Cash flow analysis and market value risk

Established covered bond programs typically issue debt with a broad range of maturities. The supporting cover pool assets generally have a significantly longer dated maturity profile than the covered bonds. Hence, there is an inherent maturity mismatch of assets and liabilities. The timing and weighting of the degree of this mismatch is important in S&P's analysis. Generally, the expected cash flow from the cover pool can partially mitigate some of the ALMM risk. In most circumstances, however, there remains a need for the underlying cover pool assets to be sold or otherwise liquidated to repay each series of covered bonds at its maturity. This raises the prospect of market value risk if the value of the assets sold does not match the covered bond liability. The market value risk assumptions S&P makes are a function of its view of the relative liquidity in the market for the assets.

To assess the effect of asset-liability mismatches, the rating analysis thus focuses on the covered bond program's ability to pay its obligations based on the cover pool. S&P has devised a five-step process to evaluate the maximum potential ratings uplift for a covered bond program based on a combined assessment of its ALMM risk exposure, its country "categorisation" and the available credit enhancement.

> Step 1: Classification of the asset-liability mismatch

S&P first calculates its view of a program's ALMM exposure and classifies this exposure based on its magnitude. In this step S&P includes stresses to the cash flows to cover asset credit risks and any other credit risk to which the covered bonds may be exposed. Any structural features (such as bond extensions or liquidity facilities) that may affect the asset-liability mismatch are also factored into the rating analysis.

S&P then considers the timing of the mismatch in the asset-liability analysis and treats near-term mismatches as being more significant than those occurring in the medium or long term. The ALMM percentage used to classify the program is the maximum cumulative mismatch expressed as a percentage of a program's outstanding liabilities. Based on these stresses and assumptions S&P classifies each program as a "low", "moderate" or "high" ALMM risk. The classification in turn determines the number of maximum notches of potential rating uplift from the issuer's rating.

> Step 2: Program categorisation

Secondly, S&P segments covered bond programs predominantly by country based on the range of external funding options available to the program and S&P's view on the likelihood of obtaining this funding. The programs fall into one of three categories, each of which has a range of maximum potential ratings uplift. The broader the range of funding options and the more well-established and systemically important S&P believes the covered bond product is in a particular country, the higher is the potential uplift.

> Step 3: The maximum potential covered bond rating

In this step S&P evaluates the maximum degree to which a program's rating may potentially exceed the issuing bank's rating. S&P combines its assessments of a program's ALMM exposure (from step 1) and its ability to cover its funding need (as defined by its program categorization from step 2) in the matrix below. The maximum potential rating on a covered bond is calculated as the bank's issuer credit rating increased by the appropriate number of notches derived from the matrix. This potential uplift assumes that the program's available credit enhancement equals the target credit enhancement (see step 4). Covered bonds may be either issued directly by a bank or via a special-purpose entity. In the case of direct issuance by a bank, S&P would expect the bank to have either a public or confidential S&P rating. For programs using a special-purpose entity, S&P applies the criteria of its "Group Methodology", published April 22, 2009.

> Maximum Potential Ratings Uplift From The Issuer's ICR - by number of notches

ALMM risk	Category		
	1	2	3
Zero	Unrestricted	Unrestricted	Unrestricted
Low	7	6	5
Moderate	6	5	4
High	5	4	3

> Step 4: Cash flow and market value analysis

S&P then sizes the target credit enhancement level that, in its view, corresponds to the maximum potential ratings uplift. In this step it analyses the program cash flows and applies market value stress to the cash flows in the situations where asset-liability mismatches occur and there is a funding need. If S&P's analysis indicates that a program can liquidate enough assets to meet such mismatches, while leaving sufficient collateral to service the remaining debt, it can achieve its maximum potential covered bond rating. S&P models market value risk in terms of a "spread shock," by which it calculates the net present value of the cash flows of the assets to be sold using a stressed discount rate. The degree of market value stresses applied depends predominantly on the type of assets in the cover pool, and the location of those assets and their tenor. S&P also incorporates its asset default stresses and any interest and currency stresses to the extent not appropriately hedged.

To analyze whether the credit enhancement provided is commensurate with the maximum achievable rating, S&P reviews the following risks: Asset default risk, interest rate and currency risks, and market value risks arising from asset-liability mismatches.

> Step 5: The covered bond program rating

Lastly, S&P determines a rating on the program that reflects the cover pool's actual level of credit enhancement. In this step, S&P assesses whether the available credit enhancement in a program is equal to or higher than the target credit enhancement for the maximum potential rating given in step 3. If this is the case, the program can achieve the maximum potential rating. If it is not the case, S&P assigns the first notch of uplift if the available credit enhancement covers all credit risks related to the default of the cover pool assets. The remaining credit enhancement is compared to the additional notches of potential ratings uplift to determine the uplift achievable.

The assignment of outlooks

Under S&P's criteria, it assigns an outlook to all covered bond ratings. These provide a view of a program's potential for a rating change and its direction over the intermediate term (see "General Criteria: Use Of CreditWatch And Outlooks," published Sept. 14, 2009). The covered bond outlooks take into account S&P's views on the outlook on the issuer, the level of ratings uplift achieved, the likelihood of changes in ALMM risk, as well as potential rating changes due to the performance of the collateral.

The quarterly publication "Global Covered Bond Characteristics" (see www.standardandpoors.com/coveredbonds) gives an overview on the key credit and cash-flow indicators of the programs that S&P rates.

LEGAL, OPERATIONAL AND ADMINISTRATIVE, AND COUNTERPARTY RISKS

In addition to the analysis of the asset and cash flows outlined above, S&P also reviews any legal risks, operational and administrative risks, and any counterparty exposures to determine whether these are commensurate with the rating being assigned as per step 5 above.

Legal risks

S&P typically reviews the following legal aspects when assigning a rating to a covered bond program:

> The nature of the segregation of the assets and cash flows if the issuing bank fails, (i.e., becomes insolvent);

> Whether there is any acceleration of payments to noteholders if the issuing bank fails—whether payments of interest and principal will continue in accordance with the original terms of the covered bonds;

> Whether there is any payment moratorium or forced restructuring;

> Whether there are any limits to overcollateralisation levels, i.e., if a program may overcollateralise its covered bonds above the minimum limit defined under the legislation or the program documents, and whether this additional overcollateralisation is available to the covered bond holders notwithstanding the issuing bank's failure;

> The treatment of any hedging agreements if the issuing bank fails;

> Whether the program can access funding after the issuing bank's failure; and

> The management of the cover pool both before and after the issuing bank fails.

Operational and administrative risks

S&P also reviews the issuer's origination, underwriting, and servicing operations to assess whether to factor any additional risks into its rating process.

Counterparty risks

To the extent a program benefits from any interest rate or currency hedges to address any interest rate or currency mismatches S&P reviews the underlying agreements to assess whether they conform with its relevant counterparty criteria.

Country risks

When we assess covered bonds we analyze their sensitivity to country risk and the asset portfolio's diversification by jurisdiction. We assign an assessment of "low" or "high" to a covered bond's country risk exposure. We consider asset pools of public sector assets to have "high" exposure to country risk. We classify as "low" the country risk exposure of covered bonds backed by commercial or residential mortgage loans.

We determine the maximum rating differential between sovereign and covered bond ratings based on the sovereign rating level and the covered bond program's country-risk exposure (see " Non-sovereign Ratings That Exceed EMU Sovereign Ratings: Methodology And Assumptions," published on 14 June 2011). This assessment caps any potential further uplift typically available under our criteria for rating covered bonds

(see "Revised Methodology And Assumptions For Assessing Asset-Liability Mismatch Risk In Covered Bonds," published on 16 December 2009).

A covered bond program that has what we consider to be a "high" country-risk exposure would typically only achieve a one-notch uplift above the rating on the country in which the cover pool assets are located. A "low" country-risk exposure allows a maximum uplift of six notches above the investment-grade rating on the country in which the cover pool assets are located. If the sovereign's rating is in the speculative-grade category, the maximum uplift is five notches.

ASSIGNING AND MONITORING THE RATING

The outcome of S&P's rating analysis is a rating on the covered bond program and the bonds that the program issues. S&P is committed to providing a written rationale of its rating decision and any changes to the rating as a result of the ongoing surveillance S&P does on that program.

CHAPTER 5 - COVERED BOND STATISTICS

5.1 INTRODUCTION

By Florian Eichert, Crédit Agricole CIB
and ECBC Statistics & Data Working Group Chairman

INTRODUCTION

The ECBC Statistics and Data Working Group has been collecting statistics on the outstanding volume and annual gross supply of covered bonds at year end for 9 years now. From the start its aim has been to provide a complete set of numbers that can serve as guidance for interested parties from issuer and investors to regulators.

The collection of statistics is a significant undertaking each year which is only possible thanks to the cooperation of the Working Group members, covered bond issuers and banking associations. One representative per country undertakes the initial data collection by approaching each issuer separately in most countries. These figures are then cross checked by a small number of Working Group members. The 2011 numbers were cross checked by:

> Anne Caris and Rondeep Barua from Bank of America Merrill Lynch;

> Florian Hillenbrand from Unicredit Research;

> Jan King from Royal Bank of Scotland; and,

> Michael Spies from DZ Bank.

GENERAL REMARKS

The statistics cover 26 jurisdictions as at the end of 2011 and transparency in most of them has improved markedly in recent years (even though mostly on the asset side, a little less so when it comes to the covered bonds outstanding).

However, despite the effort of all parties involved it is in some cases still very difficult to find a complete and definite set of numbers. In these cases, the biggest uncertainty lies within the more detailed breakdowns and less so in the overall volumes reported. While in these cases it is usually possible to find the overall outstanding volumes in those individual cases, it gets a little more difficult when it comes to the actual issuance figures and the more detailed break downs (e.g. into fixed, floating, etc) are sometimes very hard to impossible to come up with. In these cases, we have tried to resort to third party data providers such as Bloomberg, Bondware or rating agencies reporting to fill in the gaps or we have estimated the break downs based on data from comparable issuers from that country.

The ECBC covered bond statistics are divided into five categories:

1) Covered bonds backed by mortgages, public sector debt, ship loans or a mix thereof;
2) Non-Jumbos or Jumbos;
3) Privately placed or publicly placed covered bonds;
4) Those denominated in euro, those in domestic currency (if not the euro), or those in a currency other than the euro and the domestic currency; and,
5) Fixed-rate or floating-rate covered bonds, or covered bonds with another coupon structure.

We want to make some general remarks about the figures which are necessary to interpret them correctly:

- Covered bonds are divided into those denominated in euro, those in domestic currency (if not the euro), and those in a currency other than the euro and the domestic currency. The exchange rate used to convert non-EUR-denominated bonds is the end-of-year rate published by the European Central Bank.
- The statistics distinguish between covered bonds secured by public sector debt, mortgages, ship loans and a mix thereof. For issuers with more than one type of collateral, we have added them to the mixed category.
- The statistics furthermore distinguish into those distributed via private placement or public placement. For this distinction, we treat bonds listed with an exchange as publicly placed. Because of this definition, bonds that have been retained but are listed, are classified as public placements unless otherwise noted. In Portugal as well as Ireland, they count as private placements as mentioned in the footnote below the country figures.
- In contrast to non-Jumbos, Jumbos have a minimum volume of EUR1bn, a fixed coupon payable once a year in arrears and (soft)-bullet redemption and have been publicly placed. Since the public placement is linked to an exchange listing, retained bonds that are above EUR1bn can in some countries fall into the jumbo category unless otherwise mentioned. Benchmark bonds in currencies other than the EUR that have an issuance volume above EUR equivalent of EUR1bn are classified as non-Jumbos.
- For the purpose of counting the number of issuers and of new issuers the following applies. Issuers are entities with at least one outstanding covered bond at year-end. New issuers are entities with at least one outstanding covered bond at year-end, but with no outstanding covered bond at the prior year-end. The statistics regard the individual entities involved in a SIP as issuers, but do not regard the individual Fondos de Titulización de Activos as issuers.

We include numbers from 26 countries and it is not always possible to fully harmonise them into a common standard. In addition to this, availability of data also differs from country to country. For some countries, national specifics need to be considered as a result:

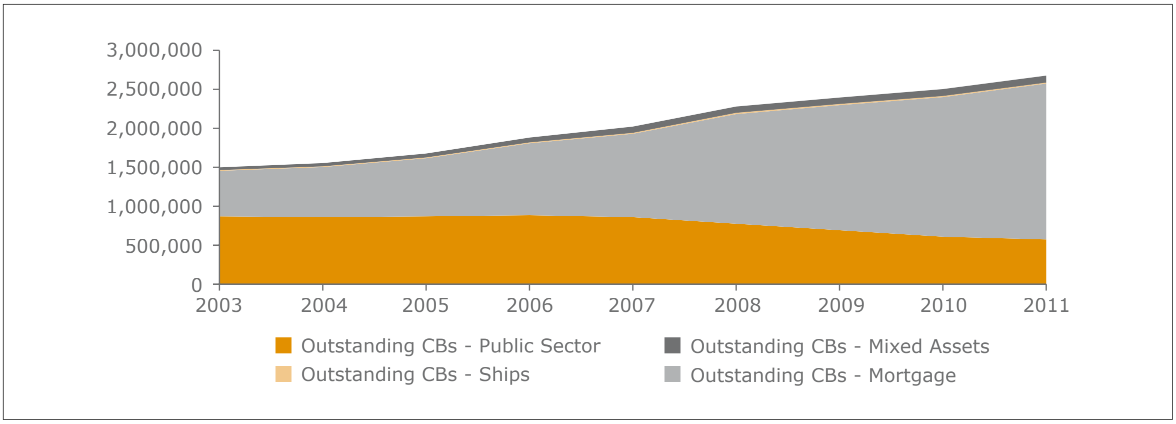
- **Austria:** Consistent statistics are unavailable because the Österreichische Nationalbank stopped releasing covered bond related data in 2004. In the years 2003 to 2005, due to inconsistent data disclosure, there is uncertainty around annual gross supply and the outstanding volume of covered bonds, and their classification. The Pfandbrief Forum has recently started to publish figures on the Austrian covered bond market. This is a big step forward but unfortunately the numbers are not yet as detailled as the ECBC spread sheet and they do not yet include all 24 issuers from Austria (Kommunalkredit Austria is missing from this data set for example as well as a number of smaller issuers). The Austrian figures for 2011 are therefore a combination of Pfandbrief Forum figures and the figures reported by the country representative for Austria. They now include the covered bonds of 17 issuers (14 issuers in the 2010 figures) for the outstanding volumes and 12 issuers for the new issuance volumes (all of the 7 EUR benchmark issuers from Austria are included in both outstanding as well as new issuance numbers).

- **Canada:** Covered bonds backed by mortgages insured against borrower default by the Canada Mortgage and Housing Corporation are classed as mortgage covered bonds.
- **France:** Compagnie de Financement Foncier's cover pool includes public sector debt, mortgages and senior securitisation tranches. The covered bonds of this issuer are therefore grouped into the "mixed" category. In the years 2003 to 2006, due to the lack of information, there is uncertainty around the classification of covered bonds from France or, in some cases, the bonds cannot be classified at all.
- **Germany:** Germany's covered bond statistics are based on Deutsche Bundesbank statistics and exclude secured bonds issued in accordance with the DG Bank Transformation Act of 1998, the DSL Bank Transformation Act of 1999 and the Law Governing Landwirtschaftliche Rentenbank.
- **Italy:** Italy's covered bond statistics include both Obbligazioni Bancarie Garantite (OBG) governed by Law No. 130 of 30 April 1999 (Law 130) as well as Cassa Depositi e Prestiti's covered bonds.
- **Slovakia:** Slovakia adopted the euro on 1 January 2009. From 2009 onwards, it's outstanding bonds were transferred into the bucket for EUR-denominated covered bonds and combined with the previous EUR issuances.
- **Spain:** Spain's covered bond statistics include only cédulas with an official listing in Spain's AIAF (Asociaciòn de Intermediarios de Activos Financieros) as well as USD denominated Cédulas issued under Reg/S or 144a documentation that are not listed in the AIAF. Apart from the USD issuance, Cédulas without an official listing in the AIAF are not included in the statistics. With regards to the number of issuers in Spain, the following applies: In 2011, the number of new issuers includes the new financial institutions established as part of the restructuring of the Spanish banking sector whose inaugural issue occurred during 2011. The number of issuers includes all the former financial institutions with outstanding covered bonds at the end of 2011 - even if as a consequence of the aforementioned restructuring they were integrated into a new one - along with the new institutions. When adjusting for the merger activity, the number of remaining issuers at the end of 2011 was 42. This is a reduction of 17 compared to the end of 2010.
- **Sweden:** Sweden's covered bond statistics exclude retained transactions used for the purpose of accessing central bank liquidity, and include only converted bostadsobligationer (mortgage bonds) and säkerställda obligationer (covered bonds).

COVERED BOND MARKET DEVELOPMENTS

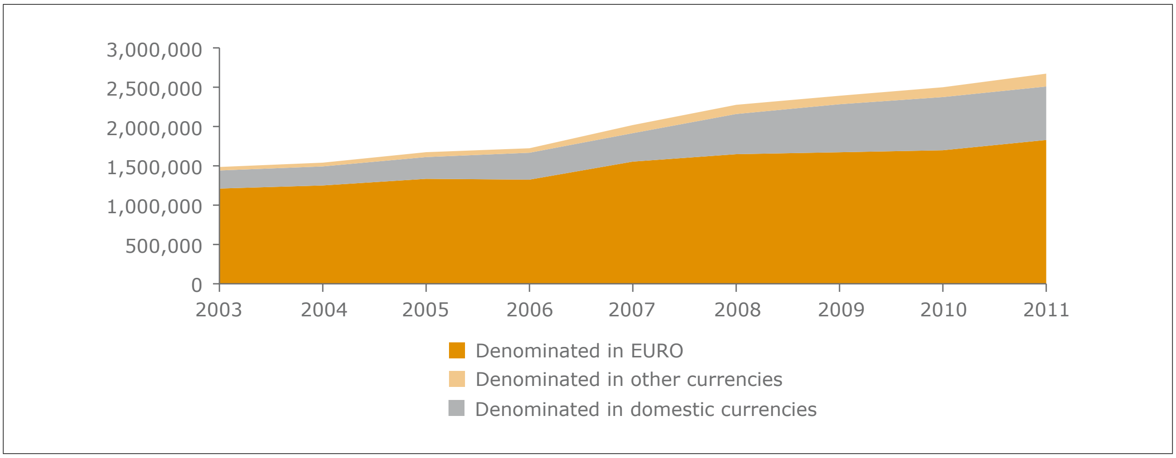
The covered bond market has continued to grow in 2011. The outstanding volume grew by 6.7% from EUR 2,503 bn to EUR 2,676 bn. After both Australia and Cyprus joined the market in 2011, at the end of the year, the market comprised a total of 26 different countries and a total of 319 issuers. This is up from 24 countries and 300 issuers in 2010.

> Figure 1: Outstanding amount covered bonds by collateral type (EUR m)



Source: EMF / ECBC

> Figure 2: Outstanding amount covered bonds by currency (EUR m)

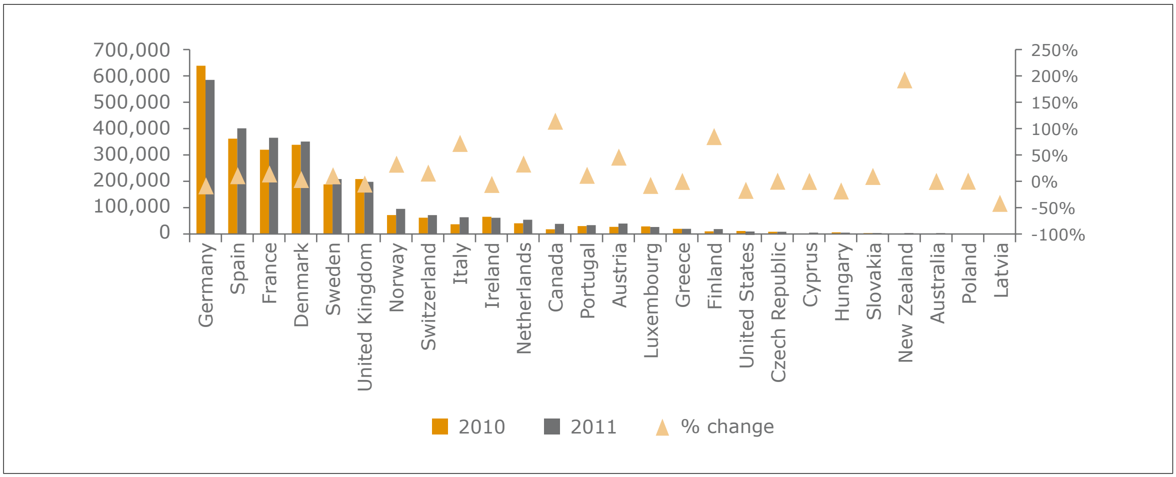


Source: EMF / ECBC

The dominant collateral type in the covered bond market continues to be mortgages. Their share has further increased to 75% up from 72% in 2010. Mortgage refinancing is and remains the main purpose for which issuers make use of covered bonds. Public sector assets back a further 21% of the covered bond market which is down from 24% in 2010. At this point, Luxembourg is the only country in which there is only public sector backed covered bonds. In the other countries they only form a portion of the overall market and their share is either declining (such as in Germany and to some extent Austria) or has never been big (as in Italy, Norway or Spain). After this year's inaugural aircraft Pfandbrief by NordLB, we will have to add a line to the collateral split from next year onwards. However for now, the share of collateral away from mortgages and public sector assets is still tiny at 1%. Only issuers from Denmark and Germany make use of ship assets to back their covered bonds.

With EUR 586 bn, the Pfandbrief market is still the biggest sector by quite a margin. Spain comes in second with EUR 402 bn while France has taken over Denmark to come in third (EUR 366 bn for France vs. EUR 352 bn for Denmark). When it comes to dynamics the picture looks a bit different though. While the German market contracted by 8%, the French market increased by 14%. Further down in the list, growth rates are even much higher than this. Italy's sector expanded by 72% to EUR 64 bn, Canada went up by 114% to EUR 39 bn, Finland by 85% to EUR 19 bn and New Zealand by 193% to EUR 4 bn. A lot of the growth in the covered bond market is happening in new countries as the globalisation of the market continues. This trend has also been prominent in 2012 with a significant jump in issuance by for example Australian issuers.

> Figure 3: Outstanding covered bonds by country and change vs. 2010 (EUR m)

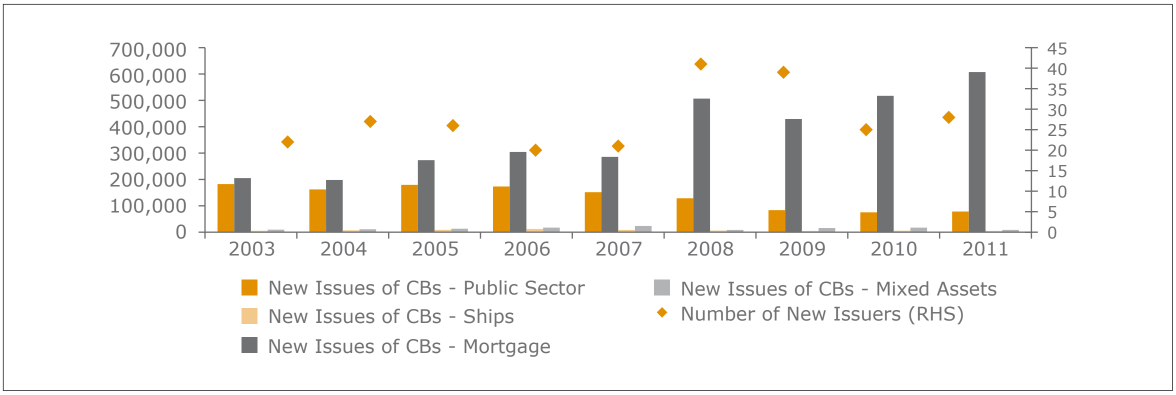


Source: EMF / ECBC

Despite the low interest rate environment, the covered bond market still remains dominated by fixed rate deals. Covered bond FRNs did grow at a somewhat faster rate than fixed rate deals (+8% for FRNs vs. 7% for fixed rate deals) their overall volume of EUR 558 bn is a mere 21% of the overall market though.

Similarly to the outstanding amounts, new issuance of covered bonds in 2011 surpassed last years numbers. The overall volume of covered bonds issued stood at EUR 695,497 m which is an increase of 13% compared to 2010. Mortgage backed covered bonds had a share of 87% in this after 84% in 2010. The share of public sector backed covered bonds in new issuance volumes went down to 11% from 12% in 2010. The only country in which the PS share went up was Spain. A total of EUR 20.3 bn of Cedulas Territoriales were issued in 2011 after EUR 5.9 bn in 2010. Not more than EUR 1 bn in covered bonds backed by ship assets were issued in 2011. The share in overall issuance volumes remains negligible at 0.1% after 0.5% in 2010.

> Figure 4: New issuance covered bonds by collateral type and number of issuers (EUR m)



Source: EMF / ECBC

The market is still divided approximately 50:50 between jumbo and sub jumbo covered bonds (51% Jumbo / 49% non-Jumbo). When it comes to the coupon structure, the above mentioned fixed rate dominance can still be seen when looking at the issuance figures as well (71% of issuance was in fixed rate bonds). The dynamics are more in favour of FRNs here though as their share in new issuance volumes has jumped quite a bit from 19% in 2010 to 28% in 2011.

The biggest new issuance volumes continue to be found in Denmark. Danish banks issued EUR 145 bn in 2011. The reason why the country is not moving up the rankings when it comes to outstanding volumes is due to the fact that Danish banks often issue short dated bullet bonds that are rolled over to the next year at auctions. Consequently, the issuance volume has remained virtually flat going down by a mere 2% compared to 2010. The same cannot be said for French issuers who have issued a total of EUR 102 bn in 2011 (+40% compared to 2010) and as mentioned earlier have overtaken Danish covered bonds in overall market size. German issuers which are still the biggest market overall have issued EUR 73 bn which is a reduction of 16% compared to 2010. An ongoing shrinkage of the German public sector backed covered bond market is the main driver behind this trend that has been going on for a number of years by now. At the same time, issuance by countries from outside Europe continues to grow. A total of EUR 25 bn of covered bonds from countries such as Australia, Canada and New Zealand are almost double the EUR 13.9 bn of 2010. When looking at 2012, this trend is continuing as Australia had a very late start in 2011 with only 2 USD benchmark covered bonds. The country's issuers have by now opened up EUR as well as AUD markets and continued to be active in USD.

5.2 STATISTICS

5.2.1 TOTAL

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector	869714	858645	869924	884038	859452	775234	691790	608675	573774
Outstanding CBs - Mortgage	584148	643687	745455	923289	1069825	1406900	1604937	1791050	1999780
Outstanding CBs - Ships	10087	9542	10586	11341	12167	16327	15151	14527	12640
Outstanding CBs - Mixed Assets	34530	41350	50040	61930	80097	80631	82572	88693	89768
Total Outstanding	**1498479**	**1553224**	**1676006**	**1880598**	**2021540**	**2279092**	**2394450**	**2502945**	**2675962**
Outstanding Jumbo	682671	745862	838717	966788	1047092	1156872	1241712	1250513	1350922
Outstanding non-Jumbo	805058	796612	837289	913810	974448	1122220	1152738	1252432	1325040
Sum	1487729	1542474	1676006	1880598	2021541	2279091	2394450	2502945	2675962
Total Outstanding Public Placement	1030751	1017513	1166260	1248021	1504442	1722920	1820437	1916395	2089386
Total Outstanding Private Placement	391109	446011	450067	477974	517098	556171	574013	586549	586575
Sum	1421859	1463524	1616327	1725996	2021540	2279091	2394450	2502945	2675961
Denominated in EURO	1212927	1252336	1336544	1326319	1556014	1650415	1675012	1700492	1831331
Denominated in domestic currency	230340	242569	277283	342495	362173	511807	611534	677359	680937
Denominated in other currencies	44461	47568	62178	57181	103354	116870	107904	125095	163690
Sum	1487728	1542473	1676005	1725995	2021540	2279091	2394450	2502945	2675959
Outstanding fixed coupon	1241859	1261062	1378903	1504409	1738151	1748971	1844260	1949534	2082861
Outstanding floating coupon	155423	177148	177237	201488	251701	498371	518256	515959	558792
Outstanding other	24578	25313	27225	20098	31688	31751	31934	36885	34308
Sum	1421859	1463524	1583365	1725996	2021540	2279093	2394450	2502378	2675961
Number of Issuers	140	167	194	213	233	266	299	301	319
Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector	182482	162269	179523	173361	151771	128713	83614	75387	78351
New Issues of CBs - Mortgage	205204	198078	273240	304384	285732	506675	429393	517240	607412
New Issues of CBs - Ships	2421	1785	3579	3334	3143	6289	2221	3325	1016
New Issues of CBs - Mixed Assets	9600	11150	13150	17263	23682	8549	15824	17261	8719
Total Issuance	**399707**	**373282**	**469492**	**498342**	**464327**	**650226**	**531052**	**613213**	**695498**
Issuance Jumbo	109327	112300	136847	194903	231757	222572	257184	307533	351921
Issuance non-Jumbo	277949	249832	315690	303438	232569	427655	273868	305680	343576
Sum	387276	362132	452537	498342	464326	650227	531052	613213	695497
Total Issuance Public Placement	316385	294286	377324	384473	360294	505112	420535	522248	603740
Total Issuance Private Placement	80362	78996	88363	113869	104033	145115	110518	90965	91757
Sum	396747	373282	465687	498342	464327	650227	531052	613213	695497
Denominated in EURO	283572	267724	284343	343990	332710	382406	303840	373527	436680
Denominated in domestic currency	98710	96391	152467	125409	101148	251174	215381	204065	208087
Denominated in other currencies	14593	9167	28876	28942	30468	16647	11830	35621	50728
Sum	396876	373282	465686	498341	464327	650227	531051	613212	695496
Issuance fixed coupon	319503	309181	375583	396247	375467	350869	404168	492763	497012
Issuance floating coupon	50741	44735	67057	54233	83263	292499	122353	118093	195566
Issuance other	10403	10765	13977	5828	5596	6858	4530	2357	2918
Sum	380647	364682	456617	456308	464326	650226	531052	613213	695497
Number of New Issuers	22	27	26	20	21	41	39	26	30

Note: Data is provisional
Source: EMF/ECBC

5.2.2 TOTAL 2011 STATISTICS BY TYPE OF ASSETS

COVERED BONDS OUTSTANDING 2011 in EUR million

	Public Sector	Mortgage	Ships	Mixed Assets	TOTAL
Australia	0	2,142	0	0	2,142
Austria	27,223	12,547	0	0	39,770
Canada	0	38,610	0	0	38,610
Cyprus	0	5,200	0	0	5,200
Czech Republic	0	8,546	0	0	8,546
Denmark	0	345,529	5,999	0	351,528
Finland	0	18,758	0	0	18,758
France	77,835	198,395	0	89,768	365,998
Germany	355,673	223,676	6,641	0	585,990
Greece	0	19,750	0	0	19,750
Hungary	0	5,175	0	0	5,175
Ireland	31,760	30,007	0	0	61,767
Italy	12,999	50,768	0	0	63,767
Latvia	0	37	0	0	37
Luxembourg	26,700	0	0	0	26,700
Netherlands	0	54,243	0	0	54,243
New Zealand	0	3,656	0	0	3,656
Norway	3,759	91,852	0	0	95,611
Poland	112	527	0	0	639
Portugal	1,400	32,283	0	0	33,683
Slovakia	0	3,768	0	0	3,768
Spain	32,657	369,208	0	0	401,865
Sweden	0	208,894	0	0	208,894
Switzerland	0	71,881	0	0	71,881
United Kingdom	3,656	194,783	0	0	198,439
United States	0	9,546	0	0	9,546
Total	**573,774**	**1,999,780**	**12,640**	**89,768**	**2,675,962**

Source: EMF/ECBC

COVERED BONDS Issuance 2011 in EUR million

	Public Sector	Mortgage	Ships	Mixed Assets	TOTAL
Australia	0	2,142	0	0	2,142
Austria	7,114	3,664	0	0	10,778
Canada	0	20,441	0	0	20,441
Cyprus	0	5,200	0	0	5,200
Czech Republic	0	770	0	0	770
Denmark	0	145,147	121	0	145,268
Finland	0	9,883	0	0	9,883
France	8,851	84,416	0	8,719	101,986
Germany	30,990	40,911	895	0	72,796
Greece	0	5,000	0	0	5,000
Hungary	0	2,264	0	0	2,264
Ireland	0	9,290	0	0	9,290
Italy	5,900	29,261	0	0	35,161
Latvia	0	0	0	0	0
Luxembourg	2,788	0	0	0	2,788
Netherlands	0	14,143	0	0	14,143
New Zealand	0	2,409	0	0	2,409
Norway	2,374	28,135	0	0	30,509
Poland	0	269	0	0	269
Portugal	0	7,255	0	0	7,255
Slovakia	0	867	0	0	867
Spain	20,334	72,077	0	0	92,411
Sweden	0	69,800	0	0	69,800
Switzerland	0	15,379	0	0	15,379
United Kingdom	0	38,689	0	0	38,689
United States	0	0	0	0	0
Total	**78,351**	**607,412**	**1,016**	**8,719**	**695,498**

Source: EMF/ECBC

5.2.3 AUSTRALIA

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector									
Outstanding CBs - Mortgage									2142
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding									**2142**
Outstanding Jumbo									
Outstanding non-Jumbo									2142
Sum									2142
Total Outstanding Public Placement									2142
Total Outstanding Private Placement									
Sum									2142
Denominated in EURO									
Denominated in domestic currency									
Denominated in other currencies									2142
Sum									2142
Outstanding fixed coupon									2142
Outstanding floating coupon									
Outstanding other									
Sum									2142
Number of Issuers									3

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector									
New Issues of CBs - Mortgage									2142
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance									**2142**
Issuance Jumbo									
Issuance non-Jumbo									2142
Sum									2142
Total Issuance Public Placement									2142
Total Issuance Private Placement									
Sum									2142
Denominated in EURO									
Denominated in domestic currency									
Denominated in other currencies									2142
Sum									2142
Issuance fixed coupon									2142
Issuance floating coupon									
Issuance other									
Sum									2142
Number of New Issuers									3

5.2.4 AUSTRIA

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector	6750	6750	13038	15615	15200	17326	19617	19555	27223
Outstanding CBs - Mortgage	4000	4000	4000	3880	4125	4973	5317	7645	12547
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding	**10750**	**10750**	**17038**	**19495**	**19325**	**22299**	**24934**	**27200**	**39770**
Outstanding Jumbo			6000	6000	7000	8000	8000	13500	9000
Outstanding non-Jumbo			11038	13495	12325	14298	16934	13700	30770
Sum			17038	19495	19325	22298	24934	27200	39770
Total Outstanding Public Placement				10235	10987	12931	12161	14100	22877
Total Outstanding Private Placement				9260	8338	9367	12773	13100	16893
Sum				19495	19325	22298	24934	27200	39770
Denominated in EURO			15691	17703	17304	19664	24002	21510	32741
Denominated in domestic currency									
Denominated in other currencies			1347	1792	2021	2634	932	5690	7029
Sum			17038	19495	19325	22298	24934	27200	39770
Outstanding fixed coupon			13497	17207	18111	19189	16593	17900	21806
Outstanding floating coupon			3324	2062	1029	3110	6309	6600	9862
Outstanding other			217	226	185		2032	2700	8102
Sum			17038	19495	19325	22299	24934	27200	39770
Number of Issuers	12	15	22	23	24	25	26	23	24

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector	1802		3591	3110	3131	9361	2501	8125	7114
New Issues of CBs - Mortgage	1029		214	2176	1959	1321	1442	3600	3664
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance	**2831**		**3805**	**5286**	**5090**	**10682**	**3943**	**11725**	**10778**
Issuance Jumbo				1000	1000	1000	1000	9725	3500
Issuance non-Jumbo				4286	4090	9682	2943	2000	7277
Sum				5286	5090	10682	3943	11725	10777
Total Issuance Public Placement				1677	1531	3361	2599	9725	6683
Total Issuance Private Placement				3609	3559	7321	1344	2000	4094
Sum				5286	5090	10682	3943	11725	10777
Denominated in EURO				4899	4861	10362	3943	10725	10007
Denominated in domestic currency									
Denominated in other currencies				387	229	320		1000	770
Sum				5286	5090	10682	3943	11725	10777
Issuance fixed coupon				3807	4577	8255	3252	10200	5922
Issuance floating coupon				1478	490	2262	435	525	4561
Issuance other				0	23	165	256	1000	295
Sum				5286	5090	10682	3943	11725	10778
Number of New Issuers	1	3	7	1	1	1	1	2	1

5.2.5 CANADA

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Outstanding CBs - Public Sector									
Outstanding CBs - Public Sector									
Outstanding CBs - Mortgage					2000	6574	7525	18003	38610
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding					**2000**	**6574**	**7525**	**18003**	**38610**
Outstanding Jumbo					2000	6250	6250	4250	4250
Outstanding non-Jumbo						324	1275	13753	34360
Sum					2000	6574	7525	18003	38610
Total Outstanding Public Placement					2000	6250	7201	18003	38610
Total Outstanding Private Placement						324	324		
Sum					2000	6574	7525	18003	38610
Denominated in EURO					2000	6574	6574	4250	4250
Denominated in domestic currency							496	1201	2043
Denominated in other currencies							455	12552	32317
Sum					2000	6574	7525	18003	38610
Outstanding fixed coupon					2000	6250	6999	17763	38610
Outstanding floating coupon						324	526	240	
Outstanding other									
Sum					2000	6574	7525	18003	38610
Number of Issuers					1	3	3	5	7

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector									
New Issues of CBs - Mortgage					2000	4574	951	12650	20441
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance					**2000**	**4574**	**951**	**12650**	**20441**
Issuance Jumbo					2000	4250			
Issuance non-Jumbo						324	951	12650	20441
Sum					2000	4574	951	12650	20441
Total Issuance Public Placement					2000	4250	951	12650	20441
Total Issuance Private Placement						324			
Sum					2000	4574	951	12650	20441
Denominated in EURO					2000	4250			
Denominated in domestic currency							496	638	832
Denominated in other currencies						324	455	12012	19608
Sum					2000	4574	951	12650	20441
Issuance fixed coupon					2000	4250	749	12650	20441
Issuance floating coupon							202		
Issuance other						324			
Sum					2000	4574	951	12650	20441
Number of New Issuers					1	2	0	2	2

5.2.6 CYPRUS

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector									
Outstanding CBs - Mortgage									5200
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding									**5200**
Outstanding Jumbo									
Outstanding non-Jumbo									5200
Sum									5200
Total Outstanding Public Placement									5200
Total Outstanding Private Placement									
Sum									5200
Denominated in EURO									5200
Denominated in domestic currency									
Denominated in other currencies									
Sum									5200
Outstanding fixed coupon									
Outstanding floating coupon									5200
Outstanding other									
Sum									5200
Number of Issuers									2

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector									
New Issues of CBs - Mortgage									5200
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance									**5200**
Issuance Jumbo									
Issuance non-Jumbo									5200
Sum									5200
Total Issuance Public Placement									5200
Total Issuance Private Placement									
Sum									5200
Denominated in EURO									5200
Denominated in domestic currency									
Denominated in other currencies									
Sum									5200
Issuance fixed coupon									
Issuance floating coupon									5200
Issuance other									
Sum									5200
Number of New Issuers									2

5.2.7 CZECH REPUBLIC

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector									
Outstanding CBs - Mortgage	1638	1956	4452	5543	8245	8098	8314	8513	8546
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding	**1638**	**1956**	**4452**	**5543**	**8245**	**8098**	**8314**	**8513**	**8546**
Outstanding Jumbo									
Outstanding non-Jumbo	1638	1956	4452	5543	8245	8098	8314	8513	8546
Sum	1638	1956	4452	5543	8245	8098	8314	8513	8546
Total Outstanding Public Placement	1537	1721	3710	4682	6639	6508	5529	5152	5194
Total Outstanding Private Placement	100	235	742	861	1607	1590	2785	3361	3352
Sum	1638	1956	4452	5543	8245	8098	8314	8513	8546
Denominated in EURO				42	39	35	120	137	111
Denominated in domestic currency	1638	1956	4452	5501	8206	8064	8194	8376	8435
Denominated in other currencies									
Sum	1638	1956	4452	5543	8245	8098	8314	8513	8546
Outstanding fixed coupon	1572	1796	3619	4615	5894	5758	3818	3474	3740
Outstanding floating coupon	66	160	833	928	1681	1271	3964	3909	4119
Outstanding other					670	1070	532	563	687
Sum	1638	1956	4452	5543	8245	8098	8314	7946	8546
Number of Issuers	5	5	8	8	9	8	8	8	8

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector									
New Issues of CBs - Mortgage	666	744	2558	956	3514	939	750	635	770
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance	**666**	**744**	**2558**	**956**	**3514**	**939**	**750**	**635**	**770**
Issuance Jumbo									
Issuance non-Jumbo	666	744	2558	956	3514	939	750	635	770
Sum	666	744	2558	956	3514	939	750	635	770
Total Issuance Public Placement	565	610	2068	875	3359	939	190	461	711
Total Issuance Private Placement	100	135	490	81	155	0	560	174	59
Sum	666	744	2558	956	3514	939	750	635	770
Denominated in EURO				42	0	0	90	20	0
Denominated in domestic currency	666	744	2558	914	3514	939	660	615	770
Denominated in other currencies									
Sum	666	744	2558	956	3514	939	750	635	770
Issuance fixed coupon	666	650	1897	903	1328	55	77	464	378
Issuance floating coupon		94	661	53	1705	790	673	37	169
Issuance other					482	95	0	134	223
Sum	666	744	2558	956	3514	939	750	635	770
Number of New Issuers	1	0	3	0	1	0	0	0	0

5.2.8 DENMARK

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector									
Outstanding CBs - Mortgage	204695	216133	246411	260367	244696	255140	319434	332505	345529
Outstanding CBs - Ships	6915	6330	6915	6672	7754	7045	7197	6722	5999
Outstanding CBs - Mixed Assets									
Total Outstanding	**211610**	**222463**	**253326**	**267039**	**252450**	**262185**	**326631**	**339227**	**351528**

Outstanding Jumbo	122126	136804	159665	180563	194157	189974	247205	258871	255583
Outstanding non-Jumbo	89484	85659	93661	86476	58293	72211	79426	80356	95945
Sum	211610	222463	253326	267039	252450	262185	326631	339227	351528

Total Outstanding Public Placement	211610	222463	253326	267039	252450	260844	322198	334116	343262
Total Outstanding Private Placement						1341	4433	5111	8266
Sum	211610	222463	253326	267039	252450	262185	326631	339227	351528

Denominated in EURO	17457	18315	18432	18743	19547	22520	37675	42848	43753
Denominated in domestic currency	194153	204148	234894	248296	232903	238324	287317	294019	302938
Denominated in other currencies						1341	1639	2360	4837
Sum	211610	222463	253326	267039	252450	262185	326631	339227	351528

Outstanding fixed coupon	193578	202936	209667	208623	178953	184636	254894	267075	275092
Outstanding floating coupon	5735	7877	32729	48232	73497	77549	71737	72152	76436
Outstanding other	12297	11650	10930	10184					
Sum	211610	222463	253326	267039	252450	262185	326631	339227	351528

Number of Issuers	8	8	8	8	9	9	9	9	9

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector									
New Issues of CBs - Mortgage	99727	95009	149708	114014	70955	103230	125484	148475	145147
New Issues of CBs - Ships	318	139	1837	960	2515	235	935	136	121
New Issues of CBs - Mixed Assets									
Total Issuance	**100045**	**95148**	**151545**	**114974**	**73470**	**103465**	**126419**	**148611**	**145268**

Issuance Jumbo					61239	75100	100157	117729	104313
Issuance non-Jumbo	100045	95148	151545	114974	12231	28365	26262	30882	40955
Sum	100045	95148	151545	114974	73470	103465	126419	148611	145268

Total Issuance Public Placement	100045	95148	151545	114974	73470	102124	125014	147933	143542
Total Issuance Private Placement						1341	1405	678	1726
Sum	100045	95148	151545	114974	73470	103465	126419	148611	145268

Denominated in EURO	8455	5556	8850	8844	14415	13186	22255	24833	25415
Denominated in domestic currency	91590	89591	142695	106130	59055	90279	101183	122374	116911
Denominated in other currencies							2981	1404	2942
Sum	100045	95148	151545	114974	73470	103465	126419	148611	145268

Issuance fixed coupon	97916	91267	123590	93771	50757	89888	122851	133846	128195
Issuance floating coupon	2128	3881	27955	21203	22713	13577	3568	14765	17073
Issuance other	1								
Sum	100045	95148	151545	114974	73470	103465	126419	148611	145268

Number of New Issuers	0	0	0	0	1	0	0	0	0

Note: The Danish numbers have been revised in the 2010 edition of the ECBC Factbook. The main revision is due to the refinancing activity of interest reset loans based on bullet bonds at the end of the year, both the new bonds issued for refinancing and the bonds they are replacing have up untill the 2009 edition been included in ultimo figures. As of the 2010 this double count has been excluded in the data to give an appropriate figure for the total outstanding.

Since most of the Danish Mortgage Covered Bonds are tapped issued over a period of typically 3 years, Jumbo issues and outstandings are defined as covered bond with more than 1 bn. euro in the year, where the bond reach 1 bn. euro. The whole outstanding amount will be reported as Jumbo the year the bond exceed 1 bn. euro. This definition coveres both covered bonds denominated in Danish crowns and in euro. Most of the Danish Covered bonds denominated in euro are issued via VP Lux in Luxembourg. Theses bonds issued via VP Lux are included in the Danish data..

5.2.9 FINLAND

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector									
Outstanding CBs - Mortgage		250	1500	3000	4500	5750	7625	10125	18758
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding		**250**	**1500**	**3000**	**4500**	**5750**	**7625**	**10125**	**18758**
Outstanding Jumbo			1000	2000	3000	4000	5250	7250	14750
Outstanding non-Jumbo		250	500	1000	1500	1750	2375	2875	4008
Sum		250	1500	3000	4500	5750	7625	10125	18758
Total Outstanding Public Placement		250	1500	3000	4500	5750	7625	10125	18536
Total Outstanding Private Placement									222
Sum		250	1500	3000	4500	5750	7625	10125	18758
Denominated in EURO		250	1500	3000	4500	5750	7625	10125	18372
Denominated in domestic currency									
Denominated in other currencies									386
Sum		250	1500	3000	4500	5750	7625	10125	18758
Outstanding fixed coupon			1000	2250	3750	4750	6500	9250	17782
Outstanding floating coupon		250	500	750	750	1000	1125	875	976
Outstanding other									
Sum		250	1500	3000	4500	5750	7625	10125	18758
Number of Issuers		1	2	2	3	3	3	4	4

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector									
New Issues of CBs - Mortgage		250	1250	1500	1500	1250	2125	5250	9883
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance		**250**	**1250**	**1500**	**1500**	**1250**	**2125**	**5250**	**9883**
Issuance Jumbo			1000	1000	1000	1000	1250	4000	8500
Issuance non-Jumbo		250	250	500	500	250	875	1250	1383
Sum		250	1250	1500	1500	1250	2125	5250	9883
Total Issuance Public Placement		250	1250	1500	1500	1250	2125	5250	9661
Total Issuance Private Placement									222
Sum		250	1250	1500	1500	1250	2125	5250	9883
Denominated in EURO		250	1250	1500	1500	1250	2125	5250	9497
Denominated in domestic currency									
Denominated in other currencies									386
Sum		250	1250	1500	1500	1250	2125	5250	9883
Issuance fixed coupon			1000	1250	1500	1000	2000	5000	9532
Issuance floating coupon		250	250	250		250	125	250	351
Issuance other									
Sum		250	1250	1500	1500	1250	2125	5250	9883
Number of New Issuers		1	1	0	1	0	0	1	0

5.2.10 FRANCE

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector	31340	37600	42600	49660	56403	64756	71905	75548	77835
Outstanding CBs - Mortgage	21079	26816	32133	43012	63555	119092	134757	156239	198395
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets	34530	41350	50040	61930	80097	80631	82572	88693	89768
Total Outstanding	**86949**	**105766**	**124773**	**154602**	**200055**	**264479**	**289234**	**320480**	**365998**
Outstanding Jumbo	64757	75307	80132	102577	102550	155318	173536	204913	257150
Outstanding non-Jumbo	22192	30459	44641	52025	97505	109161	115698	115567	108848
Sum	86949	105766	124773	154602	200055	264479	289234	320480	365998
Total Outstanding Public Placement	21079	26083	61465		194593	223753	209116	236474	284169
Total Outstanding Private Placement		733	20668		5461	40727	80118	84006	81828
Sum	21079	26816	82133		200054	264479	289234	320480	365998
Denominated in EURO	77109	94104	109236		165779	226922	256798	285501	327874
Denominated in domestic currency									
Denominated in other currencies	9840	11662	15537		34276	37558	32436	34979	38123
Sum	86949	105766	124773		200055	264480	289234	320480	365998
Outstanding fixed coupon	21079	26333	30465		174388	204729	236106	266080	284266
Outstanding floating coupon					10502	48633	42600	43710	75068
Outstanding other		483	1668		15165	11117	10528	10690	6665
Sum	21079	26816	32133		200055	264479	289234	320480	365998
Number of Issuers	5	5	5	6	7	10	14	16	19

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector	6500	8600	9070	12134	15271	11354	13915	12508	8851
New Issues of CBs - Mortgage	6181	5737	6397	12637	21670	59734	29373	42895	84416
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets	9600	11150	13150	17263	23682	8549	15824	17261	8719
Total Issuance	**22281**	**25487**	**28617**	**42034**	**60623**	**79637**	**59112**	**72664**	**101986**
Issuance Jumbo	10562	8640	7210	29471	33200	29130	32700	47943	77842
Issuance non-Jumbo	2119	5697	8257	12563	27423	50507	26412	24721	24144
Sum	12681	14337	15467	42034	60623	79637	59112	72664	101986
Total Issuance Public Placement	17492	16611	16963	32437	52393	54352	43608	58469	76859
Total Issuance Private Placement	4660	8877	11654	9597	8230	25285	15504	14195	25128
Sum	22152	25487	28617	42034	60623	79637	59112	72664	101987
Denominated in EURO	19774	21369	20637	34172	50700	73930	56155	64375	96020
Denominated in domestic currency									
Denominated in other currencies	2507	4119	7980	7862	9923	5708	2957	8289	5967
Sum	22281	25488	28617	42034	60623	79637	59112	72664	101986
Issuance fixed coupon	6052	12279	14904		57009	37158	50443	64503	67612
Issuance floating coupon		1004	526		2614	42224	8519	7953	34286
Issuance other		3605	4117		1000	255	150	208	89
Sum	6052	16887	19547		60623	79637	59112	72664	101986
Number of New Issuers	0	0	0	1	1	3	4	4	3

5.2.11 GERMANY

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector	797492	760264	734713	720835	677656	578974	486406	412090	355673
Outstanding CBs - Mortgage	256027	246636	237547	223306	206489	217367	225100	219947	223676
Outstanding CBs - Ships	3172	3212	3670	4669	4413	9282	7954	7805	6641
Outstanding CBs - Mixed Assets									
Total Outstanding	**1056691**	**1010112**	**975930**	**948810**	**888558**	**805623**	**719460**	**639842**	**585990**

Outstanding Jumbo	413700	391400	372600	345640	312358	279176	233500	178818	149752
Outstanding non-Jumbo	642991	618712	603330	603170	576200	526447	485960	461024	436238
Sum	1056691	1010112	975930	948810	888558	805623	719460	639842	585990

Total Outstanding Public Placement	672091	576463	567910	512621	427073	362461	317755	245056	213731
Total Outstanding Private Placement	384600	433649	408020	436189	461485	443162	401705	394786	372259
Sum	1056691	1010112	975930	948810	888558	805623	719460	639842	585990

Denominated in EURO	1030959	985370	952485	922878	863594	778623	690510	620420	565529
Denominated in domestic currency									
Denominated in other currencies	25732	24742	23445	25932	24964	27000	28950	19422	20461
Sum	1056691	1010112	975930	948810	888558	805623	719460	639842	585990

Outstanding fixed coupon	901004	838345	845386	823130	789338	689124	619364	546791	493983
Outstanding floating coupon	144270	160693	120681	121754	90552	107522	90136	78105	74340
Outstanding other	11417	11075	9863	3926	8668	8976	9959	14946	17667
Sum	1056691	1010112	975930	948810	888558	805623	719460	639842	585990

Number of Issuers	41	48	54	57	58	59	61	63	66

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector	151690	131506	137235	129452	107913	89522	52251	41574	30990
New Issues of CBs - Mortgage	57621	40773	33722	35336	26834	57345	56852	42216	40911
New Issues of CBs - Ships	2103	1646	1742	2374	628	6054	1286	3189	895
New Issues of CBs - Mixed Assets									
Total Issuance	**211414**	**173925**	**172699**	**167162**	**135375**	**152921**	**110389**	**86979**	**72796**

Issuance Jumbo	49725	44075	47950	42660	33105	27415	19275	16850	21100
Issuance non-Jumbo	161689	129850	124749	124502	102270	125506	91114	70129	51696
Sum	211414	173925	172699	167162	135375	152921	110389	86979	72796

Total Issuance Public Placement	138958	109423	106895	76935	57973	67337	43507	38985	42357
Total Issuance Private Placement	72456	64502	65804	90227	77402	85584	66882	47994	30439
Sum	211414	173925	172699	167162	135375	152921	110389	86979	72796

Denominated in EURO	203206	172085	163931	159340	131807	149137	107488	84459	68585
Denominated in domestic currency									
Denominated in other currencies	8208	1840	8768	7822	3568	3784	2901	2520	4211
Sum	211414	173925	172699	167162	135375	152921	110389	86979	72796

Issuance fixed coupon	155531	130723	138259	143869	113085	111309	89605	62518	54023
Issuance floating coupon	45685	36559	27077	18859	20099	40156	20091	23468	16692
Issuance other	10198	6643	7363	4434	2191	1456	693	993	2081
Sum	211414	173925	172699	167162	135375	152921	110389	86979	72796

Number of New Issuers	3	7	6	4	2	4	5	5	3

5.2.12 GREECE

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector									
Outstanding CBs - Mortgage						5000	6500	19750	19750
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding						**5000**	**6500**	**19750**	**19750**
Outstanding Jumbo							1500	1500	1500
Outstanding non-Jumbo						5000	5000	18250	18250
Sum						5000	6500	19750	19750
Total Outstanding Public Placement						5000	6500	19750	19750
Total Outstanding Private Placement									
Sum						5000	6500	19750	19750
Denominated in EURO						5000	6500	19750	19750
Denominated in domestic currency									
Denominated in other currencies									
Sum						5000	6500	19750	19750
Outstanding fixed coupon							1500	1500	1500
Outstanding floating coupon						5000	5000	18250	18250
Outstanding other									
Sum						5000	6500	19750	19750
Number of Issuers						3	3	4	4

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector									
New Issues of CBs - Mortgage						5000	1500	17250	5000
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance						**5000**	**1500**	**17250**	**5000**
Issuance Jumbo							1500		
Issuance non-Jumbo						5000		17250	5000
Sum						5000	1500	17250	5000
Total Issuance Public Placement						5000	1500	17250	5000
Total Issuance Private Placement									
Sum						5000	1500	17250	5000
Denominated in EURO						5000	1500	17250	5000
Denominated in domestic currency									
Denominated in other currencies									
Sum						5000	1500	17250	5000
Issuance fixed coupon							1500		
Issuance floating coupon						5000		17250	5000
Issuance other									
Sum						5000	1500	17250	5000
Number of New Issuers						3	0	2	1

5.2.13 HUNGARY

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector									
Outstanding CBs - Mortgage	3568	4962	5072	5924	5987	7105	7375	6323	5175
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding	**3568**	**4962**	**5072**	**5924**	**5987**	**7105**	**7375**	**6323**	**5175**
Outstanding Jumbo						1000	1050		
Outstanding non-Jumbo	3568	4962	5072	5924	5987	6105	6325	6323	5175
Sum	3568	4962	5072	5924	5987	7105	7375	6323	5175
Total Outstanding Public Placement	2151	2993	3182	4188	4131	4955	6500	5581	4493
Total Outstanding Private Placement	1417	1970	1890	1736	1856	2150	875	742	682
Sum	3568	4962	5072	5924	5987	7105	7375	6323	5175
Denominated in EURO		350	540	1547	1784	2879	3799	2904	2167
Denominated in domestic currency	3568	4612	4532	4377	4203	4209	3559	3419	2934
Denominated in other currencies						17	17		74
Sum	3568	4962	5072	5924	5987	7105	7375	6323	5175
Outstanding fixed coupon	3182	4556	4587	5214	5080	4086	6737	5713	3195
Outstanding floating coupon	297	316	398	635	907	3019	638	610	1980
Outstanding other	89	90	87	75					
Sum	3568	4962	5072	5924	5987	7105	7375	6323	5175
Number of Issuers	3	3	3	3	3	3	3	3	3

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector									
New Issues of CBs - Mortgage	2961	2381	808	1418	331	3331	3209	542	2264
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance	**2961**	**2381**	**808**	**1418**	**331**	**3331**	**3209**	**542**	**2264**
Issuance Jumbo						1000			
Issuance non-Jumbo	2961	2381	808	1418	331	2331	3209	542	2264
Sum	2961	2381	808	1418	331	3331	3209	542	2264
Total Issuance Public Placement	2135	1815	618	1412	158	3091	3205	542	2194
Total Issuance Private Placement	826	566	190	6	173	240	4		70
Sum	2961	2381	808	1418	331	3331	3209	542	2264
Denominated in EURO		350	190	1007	291	1407	1102	300	1600
Denominated in domestic currency	2961	2031	618	411	40	1907	2107	242	565
Denominated in other currencies						17			99
Sum	2961	2381	808	1418	331	3331	3209	542	2264
Issuance fixed coupon	2779	2377	718	1168	116	2275	3200	477	538
Issuance floating coupon	177		90	250	215	1056	9	65	1726
Issuance other	4	4							
Sum	2961	2381	808	1418	331	3331	3209	542	2264
Number of New Issuers	0	0	0	0	0	0	0	0	0

5.2.14 IRELAND

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector	12362	27204	40965	49914	51204	52613	50951	36492	31760
Outstanding CBs - Mortgage		2000	4140	11900	13575	23075	29725	29037	30007
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding	**12362**	**29204**	**45105**	**61814**	**64779**	**75688**	**80676**	**65529**	**61767**
Outstanding Jumbo	11490	25418	32607	39417	41440	41916	42113	26287	24365
Outstanding non-Jumbo	872	3787	12499	22397	23339	33772	38563	39241	37402
Sum	12362	29204	45105	61814	64779	75688	80676	65529	61767
Total Outstanding Public Placement	11999	27278	35190	43557	43833	46224	45305	30468	27666
Total Outstanding Private Placement	363	1926	9916	18257	20947	29464	35371	35061	34101
Sum	12362	29204	45105	61814	64779	75688	80676	65529	61767
Denominated in EURO	10881	26696	37452	52800	52328	60056	67626	54940	53054
Denominated in domestic currency									
Denominated in other currencies	1481	2508	7654	9014	12451	15632	13050	10589	8713
Sum	12362	29204	45105	61814	64779	75688	80676	65529	61767
Outstanding fixed coupon	12027	28460	40717	55832	56094	48817	43717	40069	35853
Outstanding floating coupon	335	631	2095	3028	5299	23294	36909	25460	25914
Outstanding other	0	114	2294	2954	3386	3577	50		
Sum	12362	29204	45105	61814	64779	75688	80676	65529	61767
Number of Issuers	2	3	3	4	4	5	6	6	6
Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector	12362	15047	13576	9722	9533	12665	3174	60	
New Issues of CBs - Mortgage		2000	2000	7753	1675	9506	14801	6000	9290
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance	**12362**	**17047**	**15576**	**17475**	**11208**	**22171**	**17975**	**6060**	**9290**
Issuance Jumbo	11490	14000	6907	12259	3883	7250	10250		
Issuance non-Jumbo	872	3047	8669	5216	7325	14921	7725	6060	9290
Sum	12362	17047	15576	17475	11208	22171	17975	6060	9290
Total Issuance Public Placement	11999	15285	8597	12508	5314	8250	10250		
Total Issuance Private Placement	363	1761	6980	4967	5894	13921	7725	6060	9290
Sum	12362	17047	15576	17475	11208	22171	17975	6060	9290
Denominated in EURO	10881	15816	10663	15035	6612	18741	17975	6060	9290
Denominated in domestic currency									
Denominated in other currencies	1481	1231	4914	2440	4596	3430			
Sum	12362	17047	15576	17475	11208	22171	17975	6060	9290
Issuance fixed coupon	12027	16467	12033	15537	8183	4600	4175	210	
Issuance floating coupon	335	466	1445	1101	2351	17240	13750	5850	9290
Issuance other		114	2097	837	674	331	50		
Sum	12362	17047	15576	17475	11208	22171	17975	6060	9290
Number of New Issuers	2	1	0	1	0	1	1	0	0

Note: internal and Self issuance are reported as private placement

5.2.15 ITALY

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector			4000	8063	8063	8063	9063	10092	12999
Outstanding CBs - Mortgage						6500	14000	26925	50768
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding			**4000**	**8063**	**8063**	**14563**	**23063**	**37017**	**63767**
Outstanding Jumbo			4000	8000	8000	9000	14500	24000	40200
Outstanding non-Jumbo				63	63	5563	8563	13017	23567
Sum			4000	8063	8063	14563	23063	37017	63767
Total Outstanding Public Placement			4000	8000	8000	14500	23000	36925	63767
Total Outstanding Private Placement				63	63	63	63	92	
Sum			4000	8063	8063	14563	23063	37017	63767
Denominated in EURO			4000	8000	8000	14500	23000	36925	63668
Denominated in domestic currency									
Denominated in other currencies				63	63	63	63	92	99
Sum			4000	8063	8063	14563	23063	37017	63767
Outstanding fixed coupon			4000	8063	8063	10063	15563	27100	44954
Outstanding floating coupon						500	500	2825	18814
Outstanding other						4000	7000	7092	
Sum			4000	8063	8063	14563	23063	37017	63767
Number of Issuers			1	1	1	4	7	11	12

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector			4000	4063			3000	2000	5900
New Issues of CBs - Mortgage						6500	7500	12925	29261
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance			**4000**	**4063**		**6500**	**10500**	**14925**	**35161**
Issuance Jumbo			4000	4000		1000	7500	10500	15270
Issuance non-Jumbo				63		5500	3000	4425	19891
Sum			4000	4063		6500	10500	14925	35161
Total Issuance Public Placement			4000	4000		6500	10500	14925	35161
Total Issuance Private Placement				63					
Sum			4000	4063		6500	10500	14925	35161
Denominated in EURO			4000	4000		6500	10500	14925	35161
Denominated in domestic currency									
Denominated in other currencies				63					
Sum			4000	4063		6500	10500	14925	35161
Issuance fixed coupon			4000	4000		2000	7500	12600	18750
Issuance floating coupon						500	0	2325	16411
Issuance other				63		4000	3000	0	
Sum			4000	4063		6500	10500	14925	35161
Number of New Issuers			0	0	0	3	3	4	1

5.2.16 LATVIA

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector									
Outstanding CBs - Mortgage	35	54	60	63	90	90	85	63	37
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding	**35**	**54**	**60**	**63**	**90**	**90**	**85**	**63**	**37**
Outstanding Jumbo									
Outstanding non-Jumbo	35	54	60	63	90	90	85	63	37
Sum	35	54	60	63	90	90	85	63	37
Total Outstanding Public Placement	35	54	60	63	90	90	85	63	37
Total Outstanding Private Placement									
Sum	35	54	60	63	90	90	85	63	37
Denominated in EURO	0	0	0	20	56	69	64	45	25
Denominated in domestic currency	35	36	38	34	28	17	17	14	12
Denominated in other currencies	0	18	21	8	6	4	4	4	
Sum	35	54	60	63	90	90	85	63	37
Outstanding fixed coupon	26	27	26	21	15	26	26	27	12
Outstanding floating coupon	9	27	34	41	75	64	59	36	25
Outstanding other									
Sum	35	54	60	63	90	90	85	63	37
Number of Issuers	1	1	1	4	5	5	5	4	2

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector									
New Issues of CBs - Mortgage	11	22	4	20	19	25			
New Issues of CBs - Ships	0	0	0	0					
New Issues of CBs - Mixed Assets	0	0	0	0					
Total Issuance	**11**	**22**	**4**	**20**	**19**	**25**	**0**	**0**	**0**
Issuance Jumbo									
Issuance non-Jumbo	11	22	4	20	19	25			
Sum	11	22	4	20	19	25	0	0	0
Total Issuance Public Placement	11	22	4	20	19	25			
Total Issuance Private Placement	0	0	0	0					
Sum	11	22	4	20	19	25	0	0	0
Denominated in EURO				20	19	25			
Denominated in domestic currency	11	3	4						
Denominated in other currencies	0	18							
Sum	11	22	4	20	19	25	0	0	0
Issuance fixed coupon	9	3				25			
Issuance floating coupon	2	18	4	20	19				
Issuance other									
Sum	11	22	4	20	19	25	0	0	0
Number of New Issuers	0	0	0	3	1	0	0	0	0

5.2.17 LUXEMBOURG

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector	16870	19627	24968	28360	33741	35467	31645	28889	26700
Outstanding CBs - Mortgage				150	150	150			
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding	**16870**	**19627**	**24968**	**28510**	**33891**	**35617**	**31645**	**28889**	**26700**
Outstanding Jumbo	5000	4000	2000	2000	2250	2250	2250	2250	1000
Outstanding non-Jumbo	11870	15627	22968	26510	31641	33367	29395	26639	25700
Sum	16870	19627	24968	28510	33891	35617	31645	28889	26700
Total Outstanding Public Placement	12384	12358	16577	18833	21993	21295	18398	15659	12778
Total Outstanding Private Placement	4486	7270	8391	9677	11898	14322	13247	13230	13922
Sum	16870	19627	24968	28510	33891	35617	31645	28889	26700
Denominated in EURO	9473	11032	10909	12319	16172	18147	16592	15826	15496
Denominated in domestic currency									
Denominated in other currencies	7397	8595	14059	16191	17719	17470	15053	13063	11204
Sum	16870	19627	24968	28510	33891	35617	31645	28889	26700
Outstanding fixed coupon	11631	12236	15427	19077	22573	22267	21126	20390	16547
Outstanding floating coupon	4465	5489	7376	7217	9210	11270	9355	7710	9377
Outstanding other	774	1902	2165	2216	2108	2080	1164	789	776
Sum	16870	19627	24968	28510	33891	35617	31645	28889	26700
Number of Issuers	3	3	3	3	5	5	5	5	5

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector	4528	5516	9611	9730	10052	3967	3083	3524	2788
New Issues of CBs - Mortgage				150					
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance	**4528**	**5516**	**9611**	**9880**	**10052**	**3967**	**3083**	**3524**	**2788**
Issuance Jumbo	750				250				
Issuance non-Jumbo	3778	5516	9611	9880	9802	3967	3083	3524	2788
Sum	4528	5516	9611	9880	10052	3967	3083	3524	2788
Total Issuance Public Placement	3197	2870	6749	6798	4819	878	500	750	100
Total Issuance Private Placement	1331	2646	2862	3082	5233	3089	2583	2774	2688
Sum	4528	5516	9611	9880	10052	3967	3083	3524	2788
Denominated in EURO	2131	3589	2468	3628	5773	2639	2661	3260	2422
Denominated in domestic currency									
Denominated in other currencies	2397	1927	7143	6252	4279	1328	422	264	366
Sum	4528	5516	9611	9880	10052	3967	3083	3524	2788
Issuance fixed coupon	2828	3516	7511	8092	5425	1423	1526	1213	336
Issuance floating coupon	1500	1600	1700	1601	4448	2471	1530	2289	2452
Issuance other	200	400	400	187	178	73	27	22	
Sum	4528	5516	9611	9880	10051	3967	3083	3524	2788
Number of New Issuers	0	0	0	0	2	0	0	0	0

5.2.18 NETHERLANDS

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector									
Outstanding CBs - Mortgage			2000	7500	15727	20977	28367	40764	54243
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding			**2000**	**7500**	**15727**	**20977**	**28367**	**40764**	**54243**
Outstanding Jumbo			2000	5500	11000	14000	20250	29150	38850
Outstanding non-Jumbo				2000	4727	6977	8117	11614	15393
Sum			2000	7500	15727	20977	28367	40764	54243
Total Outstanding Public Placement			2000	6650	13817	18970	25306	34985	44979
Total Outstanding Private Placement				850	1910	2007	3061	5779	9264
Sum			2000	7500	15727	20977	28367	40764	54243
Denominated in EURO			2000	6400	14319	19157	26525	37437	50068
Denominated in domestic currency									
Denominated in other currencies				1100	1408	1819	1842	3326	4175
Sum			2000	7500	15727	20976	28367	40764	54243
Outstanding fixed coupon			2000	7200	13725	17807	25370	38157	52762
Outstanding floating coupon					1647	3120	2947	2546	1421
Outstanding other				300	355	50	50	60	60
Sum			2000	7500	15727	20977	28367	40764	54243
Number of Issuers			1	1	2	5	5	5	5

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector									
New Issues of CBs - Mortgage			2000	5500	8227	5608	7725	13731	14143
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance			**2000**	**5500**	**8227**	**5608**	**7725**	**13731**	**14143**
Issuance Jumbo			2000	3500	5500	3000	6250	9750	9700
Issuance non-Jumbo				2000	2727	2608	1475	3981	4443
Sum			2000	5500	8227	5608	7725	13731	14143
Total Issuance Public Placement			2000	4650	7167	5118	6415	11164	11167
Total Issuance Private Placement				850	1060	491	1310	2567	2977
Sum			2000	5500	8227	5609	7725	13731	14143
Denominated in EURO			2000	4400	7919	5191	7725	12407	13207
Denominated in domestic currency									
Denominated in other currencies				1100	308	418	0	1324	937
Sum			2000	5500	8227	5609	7725	13731	14143
Issuance fixed coupon			2000	5200	6525	4033	7535	13654	14013
Issuance floating coupon					1647	1575	190	77	130
Issuance other				300	55				
Sum			2000	5500	8227	5608	7725	13731	14143
Number of New Issuers			1	0	1	3	0	0	0

5.2.19 NEW ZEALAND

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector									
Outstanding CBs - Mortgage								1247	3656
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding								**1247**	**3656**
Outstanding Jumbo								1000	2500
Outstanding non-Jumbo								247	1156
Sum								1247	3656
Total Outstanding Public Placement								1247	3297
Total Outstanding Private Placement									358
Sum								1247	3656
Denominated in EURO								1000	2500
Denominated in domestic currency								247	606
Denominated in other currencies									550
Sum								1247	3656
Outstanding fixed coupon								1247	3477
Outstanding floating coupon									179
Outstanding other									
Sum								1247	3656
Number of Issuers								1	4

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector									
New Issues of CBs - Mortgage								1247	2409
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance								**1247**	**2409**
Issuance Jumbo								1000	1500
Issuance non-Jumbo								247	909
Sum								1247	2409
Total Issuance Public Placement								1247	2050
Total Issuance Private Placement									358
Sum								1247	2409
Denominated in EURO								1000	1500
Denominated in domestic currency								247	358
Denominated in other currencies									550
Sum								1247	2409
Issuance fixed coupon								1247	2229
Issuance floating coupon									179
Issuance other									
Sum								1247	2409
Number of New Issuers								1	3

5.2.20 NORWAY

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector							751	1837	3759
Outstanding CBs - Mortgage					6371	21924	53582	70178	91852
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding					**6371**	**21924**	**54333**	**72015**	**95611**
Outstanding Jumbo					4500	12046	34280	42433	50376
Outstanding non-Jumbo					1871	9877	20052	29582	45235
Sum					6371	21924	54333	72015	95611
Total Outstanding Public Placement					6371	17742	51621	67773	88232
Total Outstanding Private Placement						4182	2712	4242	7379
Sum					6371	21924	54333	72015	95611
Denominated in EURO					4500	12847	17064	22022	29953
Denominated in domestic currency					1433	8351	37269	45581	55324
Denominated in other currencies					438	725	0	4413	10333
Sum					6371	21924	54333	72016	95610
Outstanding fixed coupon					5718	14750	17064	28808	44813
Outstanding floating coupon					653	7174	37269	43207	50798
Outstanding other									
Sum					6371	21924	54333	72015	95611
Number of Issuers					3	7	22	22	23

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector							751	1421	2374
New Issues of CBs - Mortgage					6458	15660	30105	21410	28135
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance					**6458**	**15660**	**30856**	**22831**	**30509**
Issuance Jumbo					4500	7546	18964	12722	13986
Issuance non-Jumbo					1958	8114	11892	10109	16523
Sum					6458	15660	30856	22831	30509
Total Issuance Public Placement					6458	12630	29271	21073	27229
Total Issuance Private Placement					0	3030	1585	1758	3280
Sum					6458	15660	30856	22831	30509
Denominated in EURO					4500	8346	2044	10950	8800
Denominated in domestic currency					1521	7042	28744	8087	15808
Denominated in other currencies					438	272	67	3794	5901
Sum					6458	15660	30855	22831	30508
Issuance fixed coupon					5754	9020	2206	16143	15960
Issuance floating coupon					704	6640	28649	6688	14548
Issuance other									
Sum					6458	15660	30855	22831	30508
Number of New Issuers					2	4	15	1	1

5.2.21 POLAND

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector					131	137	139	126	112
Outstanding CBs - Mortgage	160	220	558	453	676	561	583	511	527
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding	**160**	**220**	**558**	**453**	**807**	**698**	**722**	**636**	**639**

Outstanding Jumbo									
Outstanding non-Jumbo	160	220	558	453	807	698	722	636	639
Sum	160	220	558	453	807	698	722	636	639

Total Outstanding Public Placement	91	91	265	339	725	627	710	631	639
Total Outstanding Private Placement	69	129	293	114	82	71	12	5	
Sum	160	220	558	453	807	698	722	636	639

Denominated in EURO	37	62	62	62	56	56	4		
Denominated in domestic currency	111	115	440	357	726	617	711	636	639
Denominated in other currencies	11	43	56	34	25	25	7		
Sum	159	220	558	453	807	698	722	636	639

Outstanding fixed coupon	4	4	4	4	1	1	4		
Outstanding floating coupon	156	216	554	450	806	697	718	636	639
Outstanding other									
Sum	160	220	558	453	807	698	722	636	639

Number of Issuers	1	1	2	2	2	3	3	3	2

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector					131	24		25	
New Issues of CBs - Mortgage	123	63	224	52	206	197	88	138	269
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance	**123**	**63**	**224**	**52**	**337**	**222**	**88**	**164**	**269**

Issuance Jumbo									
Issuance non-Jumbo	123	63	224	52	337	222	88	164	269
Sum	123	63	224	52	337	222	88	164	269

Total Issuance Public Placement	91	0	174	52	337	222	88	164	269
Total Issuance Private Placement	32	63	50						
Sum	123	63	224	52	337	222	88	164	269

Denominated in EURO	23	25							
Denominated in domestic currency	100	7	211	52	337	222	88	164	269
Denominated in other currencies		31	12						
Sum	123	63	223	52	337	222	88	164	269

Issuance fixed coupon									
Issuance floating coupon	123	63	224	52	337	222	88	164	269
Issuance other									
Sum	123	63	224	52	337	222	88	164	269

Number of New Issuers	0	0	1	0	0	1	0	0	0

5.2.22 PORTUGAL

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector						150	1150	1400	1400
Outstanding CBs - Mortgage				2000	7850	14870	22120	28770	32283
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding				**2000**	**7850**	**15020**	**23270**	**30170**	**33683**

Outstanding Jumbo				2000	6500	12150	18150	17900	15358
Outstanding non-Jumbo					1350	2870	5120	12270	18325
Sum				2000	7850	15020	23270	30170	33683

Total Outstanding Public Placement				2000	6500	12150	18150	17900	15358
Total Outstanding Private Placement					1350	2870	5120	12270	18325
Sum				2000	7850	15020	23270	30170	33683

Denominated in EURO				2000	7850	15020	23270	30170	33683
Denominated in domestic currency									
Denominated in other currencies									
Sum				2000	7850	15020	23270	30170	33683

Outstanding fixed coupon				2000	6500	12150	18150	18300	15758
Outstanding floating coupon					1350	2870	5120	11870	17925
Outstanding other									
Sum				2000	7850	15020	23270	30170	33683

Number of Issuers				1	2	5	6	7	9

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector						150	1000	250	
New Issues of CBs - Mortgage				2000	5850	7020	7250	11800	7255
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance				**2000**	**5850**	**7170**	**8250**	**12050**	**7255**

Issuance Jumbo				2000	4500	5650	6000	3000	
Issuance non-Jumbo				0	1350	1520	2250	9050	7255
Sum				2000	5850	7170	8250	12050	7255

Total Issuance Public Placement				2000	4500	5650	6000	3000	
Total Issuance Private Placement				0	1350	1520	2250	9050	7255
Sum				2000	5850	7170	8250	12050	7255

Denominated in EURO				2000	5850	7170	8250	12050	7255
Denominated in domestic currency									
Denominated in other currencies									
Sum				2000	5850	7170	8250	12050	7255

Issuance fixed coupon				2000	4500	5650	6000	3400	
Issuance floating coupon					1350	1520	2250	8650	7255
Issuance other									
Sum				2000	5850	7170	8250	12050	7255

Number of New Issuers				1	1	3	1	1	2

Note: Retained bonds – i.e. bonds issued to be posted as collateral for repo facilities at the ECB – are reported as private placements.

5.2.23 SLOVAKIA

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector									
Outstanding CBs - Mortgage	510	1052	1583	2214	2738	3576	3608	3442	3768
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding	**510**	**1052**	**1583**	**2214**	**2738**	**3576**	**3608**	**3442**	**3768**
Outstanding Jumbo									
Outstanding non-Jumbo	510	1052	1583	2214	2738	3576	3608	3442	3768
Sum	510	1052	1583	2214	2738	3576	3608	3442	3768
Total Outstanding Public Placement	436	953	1435	1731	2111	2676	2900	1790	1935
Total Outstanding Private Placement	73	100	148	482	627	900	708	1652	1833
Sum	510	1052	1583	2214	2738	3576	3608	3442	3768
Denominated in EURO				280	510	1189	3516	3350	3625
Denominated in domestic currency	510	1052	1583	1934	2161	2296			
Denominated in other currencies					68	92	92	92	143
Sum	510	1052	1583	2214	2738	3576	3608	3442	3768
Outstanding fixed coupon	510	1052	1223	1405	1666	1992	1845	1571	1886
Outstanding floating coupon			360	809	1073	1584	1762	1871	1882
Outstanding other									
Sum	510	1052	1583	2214	2738	3576	3608	3442	3768
Number of Issuers	6	8	9	9	8	8	8	8	8

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector									
New Issues of CBs - Mortgage	355	549	584	676	803	1414	707	1179	867
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance	**355**	**549**	**584**	**676**	**803**	**1414**	**707**	**1179**	**867**
Issuance Jumbo									
Issuance non-Jumbo	355	549	584	676	803	1414	707	1179	867
Sum	355	549	584	676	803	1414	707	1179	867
Total Issuance Public Placement	289	516	482	296	380	565	224	424	303
Total Issuance Private Placement	66	33	101	380	423	849	483	755	564
Sum	355	549	584	676	803	1414	707	1179	867
Denominated in EURO				280	230	679	707	1179	820
Denominated in domestic currency	355	549	584	396	505	711			
Denominated in other currencies					68	24			47
Sum	355	549	584	676	803	1414	707	1179	867
Issuance fixed coupon	355	549	223	227	539	902	529	349	414
Issuance floating coupon			360	449	264	512	178	830	452
Issuance other									
Sum	355	549	584	676	803	1414	707	1179	867
Number of New Issuers	0	2	1	0	0	0	0	0	0

5.2.24 SPAIN

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector	4900	7200	9640	11590	17054	17749	16724	19098	32657
Outstanding CBs - Mortgage	57111	94707	150213	214768	266959	315055	336750	343401	369208
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding	**62011**	**101907**	**159853**	**226358**	**284013**	**332804**	**353474**	**362499**	**401865**
Outstanding Jumbo	60598	98683	155463	220058	268723	309503	312686	317556	346975
Outstanding non-Jumbo	1413	3224	4390	6300	15290	23301	40788	44943	54890
Sum	62011	101907	159853	226358	284013	332804	353474	362499	401865
Total Outstanding Public Placement	62011	101907	159853	226358	284013	332804	353474	362499	401865
Total Outstanding Private Placement									
Sum	62011	101907	159853	226358	284013	332804	353474	362499	401865
Denominated in EURO	62011	101907	159853	226358	283334	332085	352780	361751	401092
Denominated in domestic currency									
Denominated in other currencies					679	719	694	748	773
Sum	62011	101907	159853	226358	284013	332804	353474	362499	401865
Outstanding fixed coupon	61921	100417	153588	212878	238952	262198	291929	310499	343067
Outstanding floating coupon	90	1490	6265	13480	45061	70606	61545	52000	58797
Outstanding other									
Sum	62011	101907	159853	226358	284013	332804	353474	362499	401865
Number of Issuers	50	61	65	67	69	66	68	59	64

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector	5600	1600	2440	5150	5739	1670	500	5900	20334
New Issues of CBs - Mortgage	28502	37835	57780	69890	51801	54187	43580	51916	72077
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance	**34102**	**39435**	**60220**	**75040**	**57540**	**55857**	**44080**	**57816**	**92411**
Issuance Jumbo	31800	36335	58780	69230	50955	42510	31108	36620	57125
Issuance non-Jumbo	2302	3100	1440	5810	6585	13347	12972	21196	35286
Sum	34102	39435	60220	75040	57540	55857	44080	57816	92411
Total Issuance Public Placement	34102	39435	60220	75040	57540	55857	44080	57816	92411
Total Issuance Private Placement									
Sum	34102	39435	60220	75040	57540	55857	44080	57816	92411
Denominated in EURO	34102	39435	60220	75040	56861	55857	44080	57816	92411
Denominated in domestic currency									
Denominated in other currencies					679				
Sum	34102	39435	60220	75040	57540	55857	44080	57816	92411
Issuance fixed coupon	33312	38635	55545	66125	36549	21957	37480	50891	52507
Issuance floating coupon	790	800	4675	8915	20991	33900	6600	6925	39904
Issuance other									
Sum	34102	39435	60220	75040	57540	55857	44080	57816	92411
Number of New Issuers	14	11	4	2	2	1	4	1	8

Source: AIAF

Note: In 2011, the number of new issuers includes the new financial institutions established as part of the restructuring of the Spanish banking sector whose inaugural issue occurred during 2011. The number of issuers includes all the former financial institutions with outstanding covered bonds at the end of 2011 - even if as a consequence of the aforementioned restructuring they were integrated into a new one - along with the new institutions.

5.2.25 SWEDEN

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector									
Outstanding CBs - Mortgage				55267	92254	117628	133903	188750	208894
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding				**55267**	**92254**	**117628**	**133903**	**188750**	**208894**
Outstanding Jumbo				5283	11114	40100	45941	35785	35814
Outstanding non-Jumbo				49984	81140	77528	87962	152965	173079
Sum				55267	92254	117628	133903	188750	208894
Total Outstanding Public Placement				54781	90780	115259	130049	184276	203291
Total Outstanding Private Placement				486	1474	2369	3855	4474	5603
Sum				55267	92254	117628	133903	188750	208894
Denominated in EURO				5283	13171	21126	25787	35697	37554
Denominated in domestic currency				49474	77436	93374	103809	144969	159628
Denominated in other currencies				510	1648	3128	4308	8085	11712
Sum				55267	92254	117628	133903	188750	208894
Outstanding fixed coupon				55029	88944	112648	126116	172693	191013
Outstanding floating coupon				21	3046	4259	7169	16013	17659
Outstanding other				217	265	721	619	45	222
Sum				55267	92254	117628	133903	188750	208894
Number of Issuers				3	6	7	7	7	7

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector									
New Issues of CBs - Mortgage				17569	36638	43488	53106	79910	69800
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance				**17569**	**36638**	**43488**	**53106**	**79910**	**69800**
Issuance Jumbo				5283	5875	16721	14480	16494	12579
Issuance non-Jumbo				12286	30762	26767	38626	63417	57222
Sum				17569	36638	43488	53106	79910	69800
Total Issuance Public Placement				17482	36084	42631	50402	79000	68651
Total Issuance Private Placement				87	554	856	2704	910	1150
Sum				17569	36638	43488	53106	79910	69800
Denominated in EURO				5283	7085	10975	6705	20797	13263
Denominated in domestic currency				11794	28417	31490	44354	55117	52118
Denominated in other currencies				492	1135	1023	2047	3997	4419
Sum				17569	36638	43488	53106	79910	69800
Issuance fixed coupon				17560	35779	39135	47375	68023	53137
Issuance floating coupon				2	752	4353	5376	11888	16562
Issuance other				7	107		354		102
Sum				17569	36638	43488	53106	79910	69800
Number of New Issuers				3	3	1	0	0	0

5.2.26 SWITZERLAND

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Total Covered Bonds Outstanding									
Outstanding CBs - Pfandbriefe	30326	29941	29010	29395	29013	36180	43283	58046	60729
Outstanding CBs - Structured							3000	4000	11152
Total Outstanding	**30326**	**29941**	**29010**	**29395**	**29013**	**36180**	**46283**	**62046**	**71881**
Outstanding Jumbo							3000	7000	10250
Outstanding non-Jumbo	30326	29941	29010	29395	29013	36180	43283	55046	61631
Sum	30326	29941	29010	29395	29013	36180	46283	62046	71881
Total Outstanding Public Placement	30326	29941	29010	29395	29013	34917	39431	55456	63100
Total Outstanding Private Placement						1263	6852	6590	8781
Sum	30326	29941	29010	29395	29013	36180	46283	62046	71881
Denominated in EURO							3000	7000	10250
Denominated in domestic currency	30326	29941	29010	29395	29013	36180	43283	55046	60729
Denominated in other currencies									902
Sum	30326	29941	29010	29395	29013	36180	46283	62046	71881
Outstanding fixed coupon	30326	29941	29010	29395	29013	36180	46283	62046	71752
Outstanding floating coupon									
Outstanding other									129
Sum	30326	29941	29010	29395	29013	36180	46283	62046	71881
Number of Issuers	2	2	2	2	2	2	3	4	4

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Pfandbriefe	3027	2755	4171	4967	4559	5316	9414	10834	11227
New Issues of CBs - Structured							3000	4000	4152
Total Issuance	**3027**	**2755**	**4171**	**4967**	**4559**	**5316**	**12414**	**14834**	**15379**
Issuance Jumbo							3000	4000	3250
Issuance non-Jumbo	3027	2755	4171	4967	4559	5316	9414	10834	12129
Sum	3027	2755	4171	4967	4559	5316	12414	14834	15379
Total Issuance Public Placement	2500	2342	3940	4047	4559	4053	6236	14834	15250
Total Issuance Private Placement	527	413	231	920		1263	6178		129
Sum	3027	2755	4171	4967	4559	5316	12414	14834	15379
Denominated in EURO							3000	4000	3250
Denominated in domestic currency	3027	2755	4171	4967	4559	5316	9414	10834	11227
Denominated in other currencies									902
Sum	3027	2755	4171	4967	4559	5316	12414	14834	15379
Issuance fixed coupon	3027	2755	4171	4967	4559	5316	12414	14834	15250
Issuance floating coupon									
Issuance other									129
Sum	3027	2755	4171	4967	4559	5316	12414	14834	15379
Number of New Issuers	0	0	0	0	0	0	1	1	0

Note: from 2008 only Limmat bonds are considered as “Private Placements”

5.2.27 UNITED KINGDOM

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector							3439	3548	3656
Outstanding CBs - Mortgage	5000	14959	26778	50548	81964	204278	201096	205370	194783
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding	**5000**	**14959**	**26778**	**50548**	**81964**	**204278**	**204535**	**208918**	**198439**
Outstanding Jumbo	5000	14250	23250	43750	61000	60689	60750	68049	85249
Outstanding non-Jumbo		709	3528	6798	20964	143589	143785	140869	113190
Sum	5000	14959	26778	50548	81964	204278	204535	208918	198439
Total Outstanding Public Placement	5000	14959	26778	50548	81964	204278	204535	206868	194932
Total Outstanding Private Placement								2049	3507
Sum	5000	14959	26778	50548	81964	204278	204535	208918	198439
Denominated in EURO	5000	14250	24384	44884	69672	76697	70683	76884	102616
Denominated in domestic currency		709	2335	3127	4704	118937	125491	122353	86104
Denominated in other currencies			60	2536	7588	8644	8361	9681	9718
Sum	5000	14959	26778	50548	81964	204278	204535	208918	198439
Outstanding fixed coupon	5000	14959	24689	48467	76515	78613	71668	81586	109307
Outstanding floating coupon			2089	2081	4563	125505	132867	127332	89132
Outstanding other					886	160			
Sum	5000	14959	26778	50548	81964	204278	204535	208918	198439
Number of Issuers	1	3	5	8	8	19	22	22	17

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector							3439		
New Issues of CBs - Mortgage	5000	9959	11819	23770	31874	121030	30431	28636	38689
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance	**5000**	**9959**	**11819**	**23770**	**31874**	**121030**	**33870**	**28636**	**38689**
Issuance Jumbo	5000	9250	9000	20500	17250		3750	17200	23256
Issuance non-Jumbo		709	2819	3270	14624	121030	30120	11436	15433
Sum	5000	9959	11819	23770	31874	121030	33870	28636	38689
Total Issuance Public Placement	5000	9959	11819	23770	31874	121030	33870	26587	36361
Total Issuance Private Placement								2049	2329
Sum	5000	9959	11819	23770	31874	121030	33870	28636	38689
Denominated in EURO	5000	9250	10134	20500	24788	7763	5535	21871	27979
Denominated in domestic currency		709	1626	745	1841	113267	28335	5747	9229
Denominated in other currencies			60	2525	5245			1018	1482
Sum	5000	9959	11819	23770	31874	121030	33870	28636	38689
Issuance fixed coupon	5000	9959	9730	23770	28424	2618	3750	20541	35633
Issuance floating coupon			2089		2564	118253	30120	8095	3056
Issuance other					886	159			
Sum	5000	9959	11819	23770	31874	121030	33870	28636	38689
Number of New Issuers	1	2	2	3	0	11	4	1	0

Please note that this data includes private placements, floating rate covered bonds and self-retained issuances that may have been used to access central bank liquidity.

5.2.28 UNITED STATES

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Covered Bonds Outstanding									
Outstanding CBs - Public Sector									
Outstanding CBs - Mortgage				4000	12859	12937	12888	11497	9546
Outstanding CBs - Ships									
Outstanding CBs - Mixed Assets									
Total Outstanding				**4000**	**12859**	**12937**	**12888**	**11497**	**9546**
Outstanding Jumbo				4000	11500	11500	11500	10000	8000
Outstanding non-Jumbo					1359	1437	1388	1497	1546
Sum				4000	12859	12937	12888	11497	9546
Total Outstanding Public Placement				4000	12859	12937	12888	11497	9546
Total Outstanding Private Placement									
Sum				4000	12859	12937	12888	11497	9546
Denominated in EURO				4000	11500	11500	11500	10000	8000
Denominated in domestic currency					1359	1437	1388	1497	1546
Denominated in other currencies									
Sum				4000	12859	12937	12888	11497	9546
Outstanding fixed coupon				4000	12859	12937	12888	11497	9546
Outstanding floating coupon									
Outstanding other									
Sum				4000	12859	12937	12888	11497	9546
Number of Issuers				1	2	2	2	2	2

Issuance (in EUR million)									
Total Covered Bonds Issuance									
New Issues of CBs - Public Sector									
New Issues of CBs - Mortgage				4000	8859				
New Issues of CBs - Ships									
New Issues of CBs - Mixed Assets									
Total Issuance				**4000**	**8859**	**0**	**0**	**0**	**0**
Issuance Jumbo				4000	7500				
Issuance non-Jumbo					1359				
Sum				4000	8859	**0**	**0**	**0**	**0**
Total Issuance Public Placement				4000	8859				
Total Issuance Private Placement									
Sum				4000	8859	**0**	**0**	**0**	**0**
Denominated in EURO				4000	7500				
Denominated in domestic currency					1359				
Denominated in other currencies									
Sum				4000	8859	**0**	**0**	**0**	**0**
Issuance fixed coupon				4000	8859				
Issuance floating coupon									
Issuance other									
Sum				4000	8859	**0**	**0**	**0**	**0**
Number of New Issuers				1	1	0	0	0	0

ECBC Fact Book 2012

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EUROPEAN MORTGAGE FEDERATION