

3.6 CYPRUS

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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 States¹;
- > 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 adjusted² nominal value³ 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 Creditors⁴ 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