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TABLE OF CONTENTS

FOREWORD 21

Foreword 21
By Antonio Torío, ECBC Chairman and Annik Lambert, EMF Secretary General

About the ECBC 25
By Luca Bertalot, Head of the European Covered Bond Council

ECBC Members 27

CHAPTER 1 - KEY THEMES OF THE YEAR 29

1.1 Introduction 31
By Uwe Burkert and Christian Enger, LBBW

1.2 Covered Bonds and EU Banking Regulations 33
By Fritz Engelhard, Barclays Capital and Florian Eichert Crédit Agricole CIB

1.3 Covered bonds under Solvency II – "It's the end of the world as they know it…" 43
By Florian Eichert, Crédit Agricole CIB

1.4 Covered Bond Triggers 51
By Heiko Langer, BNP Paribas

1.5 Public vs. Mortgage Collateral in Times of Government Debt Crisis 55
By Franz Rudolf and Florian Hillenbrand, UniCredit Research

1.6 Covered Bonds vs Senior Unsecured Bank Debt 61
By Frank Will, RBS

1.7 Covered Bond Pricing Factors 72
By José Sarafana, Société Générale

1.8 Covered Bonds and Asset Encumbrance 79
By John Kiff, Jay Surti, International Monetary Fund
and Andreas (Andy) Jobst, Bermuda Monetary Authority

1.9 The growth of the sub-Jumbo sector 83
By Richard Kemmish, Credit Suisse and Michael Schulz, Nord/LB

1.10 The investor's perspective 86
By Fritz Engelhard, Barclays Capital

Annex The Covered Bond Investor Council 91
By Nathalie Aubry-Stacey, International Capital Market Association

1.11 The Non-Benchmark Side of the Covered Bond Market 92
By Leef H. Dierks, Morgan Stanley

CHAPTER 2 - GENERIC SECTION 95

2.1 Overview of Covered Bonds 97
By Ralf Burmeister, LBBW, Ralf Grossmann, SG CIB
and Otmar Stöcker, Association of German Pfandbrief Banks

2.2 RMBS vs. Covered Bonds 109
By Bernd Volk, Deutsche Bank

2.3 Covered Bonds and REPO 117
By Frank Will and Michael Michaelides, RBS

2.4 Covered Bonds Beyond Bank Funding: the Macro-Economic Dimension of Covered Bonds 144
By Frank Will, RBS and Jan King, LBBW

CHAPTER 3 - THE ISSUER'S PERSPECTIVE 153

3.1	Australia *By Alex Sell, Australian Securitisation Forum*	155
3.2	Austria *By Bernhard Freudenthaler, Hypothekenverband (Austrian Pfandbrief-Forum Secretary)* *Martin Schweitzer, Erste Group Bank (Austrian Pfandbrief-Forum Speaker)*	163
3.3	Belgium *By Carol Wandels, Dexia Bank Belgium*	169
3.4	Bulgaria *By Yolanda Hristova, UniCredit Bulbank and Franz Rudolf, UniCredit Research*	175
3.5	Canada *By Hiren Lalloo, RBC Capital Markets*	181
3.6	Cyprus *By Doros Theodorou and Dimitrios Spathakis, Marfin Popular Bank*	193
3.7	Czech Republic *By Pavel Kuhn, Ceska Sporitelna a.s.*	201
3.8	Denmark *By Mette Saaby Pedersen, Association of Danish Mortgage Banks and Svend Bondorf, Nykredit*	207
3.9	Finland *By Timo Ruotsalainen, Aktia Real Estate Mortgage Bank plc and Ralf Burmeister, LBBW*	217
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*	221
3.11	Germany *Wolfgang Kälberer and Otmar Stöcker, Association of German Pfandbrief Banks*	241
3.12	Greece *By Alexander Metallinos, Karatzas & Partners Law Firm*	249
3.13	Hungary *By Andras Gabor Botos, Association of Hungarian Mortgage Banks*	255
3.14	Ireland *By Nicholas Pheifer, Depfa Bank, Ray Lawless, Bank of Ireland* *and Russell Waide, Anglo Irish Bank*	261
3.15	Italy *By Alfredo Varrati, Italian Bankers Association*	269
3.16	Latvia *By Kaspars Gibeiko, Mortgage and Land Bank of Latvia*	275
3.17	Luxembourg *By Frank Will, RBS and Reinolf Dibus, EUROHYPO Europäische Hypothekenbank S.A.*	281
3.18	The Netherlands *By Daniëlle Boerendans, ABN AMRO Bank N.V., Rezah Stegeman, Clifford Chance LLP* *and Kees Westermann, Linklaters LLP*	287
3.19	New Zealand *By Mahes Hettige, Bank of New Zealand and Frank Will, RBS*	295
3.20	Norway *By Stein Sjølie, FNO and Bernd Volk, Deutsche Bank*	301
3.21	Poland *By Agnieszka Drewicz-Tułodziecka, Mortgage Credit Foundation* *and Piotr Cyburt, BRE Bank Hipoteczny*	307
3.22	Portugal *By Alda Pereira, Caixa Geral de Depósitos*	315
3.23	Romania *By Martin Schweitzer, Erste Group and Adrian Sacalschi, FHB Bank*	325

3.24 Russia 331
By Tim Lassen, EUROHYPO AG, Representative Office, Moscow

3.25 Slovak Republic 347
By Viktória Múčková, Mortgage trustee, CSOB

3.26 Slovenia 355
By Sonja Anadolli, Bank Association of Slovenia

3.27 Spain 361
By Gregorio Arranz, Spanish Mortgage Association

3.28 Sweden 369
By Tomas Tetzell, Association of Swedish Covered Bond Issuers (ASCB)

3.29.1 Switzerland - Pfandbriefe 381
By Jörg Schmid, Pfandbriefbank schweizerischer Hypothekarinstitute AG

3.29.2 Switzerland - Structured Covered Bonds 389
By Richard Kemmish, Credit Suisse and Chris Spyridis, UBS

3.30 Turkey 393
By Fritz Engelhard, Barclays Capital and Batuhan Tufan, Garanti Bank

3.31 Ukraine 397
By Anton Sergeev, Arsen Nizelsky and Konstantin Kuczerenko,
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3.32 United Kingdom 403
By Jussi Harju, Barclays Capital and John Millward, HSBC

3.33 United States 415
By Sabine Winkler, Credit Suisse Securities (Europe) Limited

CHAPTER 4 - RATING AGENCIES & METHODOLOGY 429

4.1 Covered Bond Ratings: Stability Affected by Changes in Criteria and Sovereign Downgrades 431
By Boudewijn Dierick, BNP Paribas and ECBC Rating Agency
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4.2 Fitch Covered Bonds Rating Methodology 433
By Hélène M. Heberlein and Beatrice Mezza, Fitch Ratings

4.3 Moody’s Covered Bond Rating Method 440
By Juan Pablo Soriano, Nicholas Lindstrom and Jane Soldera, Moody’s

4.4 Standard & Poor’s 444
By Karen Naylor, Karlo Fuchs, Sabrina Miehs and Nicolas Malaterre, Standard & Poor’s

CHAPTER 5 - COVERED BOND STATISTICS 449

5.1 Introduction 451
By Johannes Rudolph, HSBC Trinkaus and Sabine Winkler,
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5.2 Statistics 456

- 5.2.1 Total 456
- 5.2.2 Total 2010 Statistics by type of assets 457
- 5.2.3 Austria 458
- 5.2.4 Canada 459
- 5.2.5 Czech Republic 460
- 5.2.6 Denmark 461
- 5.2.7 Finland 462
- 5.2.8 France 463
- 5.2.9 Germany 464

5.2.10 Greece 465
5.2.11 Hungary 466
5.2.12 Ireland 467
5.2.13 Italy 468
5.2.14 Latvia 469
5.2.15 Luxembourg 470
5.2.16 Netherlands 471
5.2.17 New Zealand 472
5.2.18 Norway 473
5.2.19 Poland 474
5.2.20 Portugal 475
5.2.21 Slovakia 476
5.2.22 Spain 477
5.2.23 Sweden 478
5.2.24 Switzerland 479
5.2.25 United Kingdom 480
5.2.26 United States 481

FOREWORD

With over EUR 2.5 trillion outstanding at the end of 2010, covered bonds continue, more than ever, to play a key role in bank funding strategies. The EUR 600 bn issuance during 2010 evidences the ability of the asset class to provide essential access to capital markets, even during volatile market conditions, notably thanks to a stable investor base. Their consistently strong performance and quality features have attracted the attention of regulators and market participants worldwide, which has in turn led to an increasing recognition of the macroprudential value of this asset class.

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

Although the origins of the covered bond are deeply linked to the financial tradition of the Old Continent, today we are witnessing a growing worldwide appetite for the asset class with market stakeholders pushing for covered bond legislation in countries as diverse as Australia, Brazil, Canada, Japan, Mexico, South Korea and the US. A key driver in this development is the fact that the asset class constitutes a private sector, long-term funding tool which ensures lending to the real economy.

From an issuer perspective, covered bonds provide an important 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.

After several years of turmoil in the financial markets, it is essential that we now look critically at our current funding models in order to further increase their resilience in the event of future funding crises.

Against this background, the covered bond community is committed to developing a quality label for covered bonds. This initiative is intended to result in multiple benefits with an enhancement of the overall recognition of and trust in the asset class. The ECBC label initiative will facilitate access to relevant and comprehensive information for investors, regulators and other market participants. This demonstrates the determination of the covered bond community to tackle the challenges arising from the crisis and its active engagement in the maintenance of the high quality of the collateral assets, the improvement of transparency, and eventually, the promotion of liquidity, and the strengthening of secondary market activity.

In this light, we need to be aware that overextending the dependence of the system on covered bond funding or relaxing the asset eligibility may result in a weakening of the system we are trying to preserve.

It is therefore understandable that, in some jurisdictions where covered bond legislation is in the process of being adopted such as Australia, Canada and the United States, regulators and supervisors are recognising the need to draw from best practices in established covered bond jurisdictions.

Indeed, regulation in different European jurisdictions places clear limits on covered bond issuance by requiring licenses and imposing strict collateral asset eligibility criteria. These regulatory and/or legal limitations have proven effective in helping to safeguard depositors' and senior debt holders' interests.

However, the anticipated increase in long-term funding needs in 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 going forward. Such pressures could tempt some market participants to innovate using covered bonds as the new tool for collateralised funding generally.

The restoration of investor confidence in the ABS market is very important for the future of the banking industry as this market will be expected to provide funding for a range of asset classes going forward. It may not, however, be the best option to transform the valuable covered bond asset class into a new, all-purpose form of collateralised funding.

The European Covered Bond Council which represents over 95% of the covered bond industry holds a strong view on the subject - the quality of the asset class, which has served us so well, 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 which is designed to properly assign collateral in case of resolution is also an important feature.

It is also 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 have been making good progress in macro level information:

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

> The ECBC Fact Book is the most widely read source of market intelligence.

However, the market keeps asking for more and better. Further down the line, improved market liquidity and higher levels of post-trade transparency will only increase the attractiveness of the asset class for investors.

As such, market participants recognise the need for further work to be undertaken and are keen to press ahead in order to further secure the value of covered bonds not only from the perspective of the banking industry but also in terms of their general impact on financial stability. Indeed, their increased recognition by policymakers and regulators reinforces the need for an appropriate regulatory framework for covered bonds at European and international levels.

This Sixth Edition of the ECBC European Covered Bond Fact Book aims to build on the success of the first five editions, as the benchmark and the most comprehensive source of information on the asset class. Chapter I presents an analysis of ten of the key themes of the year, 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 and Solvency II. This chapter also includes articles investigating the relationship between covered bonds and other asset classes such as senior unsecured and government bonds. A comparison of public sector and mortgage collateral is also provided, as well as an analysis of the role of private placement and the growth of the sub-Jumbo sector. The chapter includes a guest article from the IMF on the issue of covered bonds and asset encumbrance.

Chapter II provides a detailed explanation of covered bond fundamentals whilst 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 2011 edition of the ECBC European Covered Bond Fact Book.

Antonio Torío
ECBC Chairman

Annik Lambert
EMF Secretary General

European Covered Bond Council

The Covered Bond Voice of the European Mortgage Federation

ABOUT THE 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 2011, 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 Paul O'Connor, 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 Horst Bertram, 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 ECBC 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.

Membership of the ECBC continues to grow and its agenda for the coming year is already filled with numerous activities. 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, 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.

Anglo Irish Bank

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

Barclays

Barclays Capital

Bayerische Landesbank - Bayern LB

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 Económica Montepio Geral

Caixa Geral de Depósitos S.A.

Caja Madrid

Citigroup

Clifford Chance LLP

CM-CIC Home Loan SFH

Commerzbank Securities

Council of Mortgage Lenders - CML

Crédit Agricole Corporate & Investment Bank

Crédit Agricole Home Loan SFH

Crédit Foncier

Crédit Mutuel Arkéa

Credit Suisse

Danish Ship Finance

Danske Bank

DBRS

Depfa ACS Bank

Deutsche Bank AG

Deutsche Hypothekenbank AG

Deutsche Pfandbriefbank AG

Dexia Capital Markets

Dexia Municipal Agency

DLR Kredit A/S

DnB NOR Bolligkreditt

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 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
MarketAxess
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
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
UK RCBC
UniCredit Group
Verband Deutscher Pfandbriefbanken e.V. - vdp
Westfälische Landschaft Bodenkreditbank AG
WestLB AG

August 2011

CHAPTER 1 - KEY THEMES OF THE YEAR

1.1 INTRODUCTION

By Uwe Burkert and Christian Enger, LBBW

Developments in 2011 have shown that the financial and economic crisis is far from over. Fears expressed in last year's Fact Book (i.e. that the road back to normality would be long and slow) have therefore proved to be correct. The financial crisis which began in 2007 and which was initially dismissed as a purely monetary problem, quickly led to huge problems for the entire financial sector. The crisis then came to a head with the default of Lehman Brothers in the autumn of 2008.

A complete meltdown was prevented through unprecedented state support measures for the banking sector in the form of injections of capital and liquidity aid. However, the aim now is to prevent a repeat of the undesirable practices and unaddressed risks which came to light. There has therefore been a thorough review of the regulation of the banking sector, leading to Basel III and, at European level, CRD IV (see Article 1.2 on Basel III/CRD IV by Fritz Engelhard and Florian Eichert). There have also been significant developments in the regulation of the insurance sector (see Article 1.3 on Solvency II by Florian Eichert). Banks and insurance companies are both important investors in covered bonds. The regulations in question can and will therefore have a major impact on demand structures in the market.

Another aspect of the reforms is that in future, the private sector is expected to shoulder a greater part of the costs of any potential bank restructuring. On the plus side in this respect, it is worth mentioning that special resolution regimes passed so far in Germany, Denmark, Ireland and the UK do not envisage any involvement of covered bonds. This strengthens the safety of the product in relation to senior unsecured bonds (see Article 1.6 on CBs Vs Senior Unsecured by Frank Will). However, a reduced probability of support for the banking sector means that it is necessary to carry out a more thorough analysis of default triggers (see Article 1.4 on Covered Bond Triggers by Heiko Langer). A number of countries have stipulated a ceiling for the encumbrance of assets in order to avoid a strong structural subordination of senior unsecured creditors as a result of covered bonds having priority claim on valuable assets. At the moment, however, this ceiling is not a limiting factor for the funding of issuers active in the market, a topic discussed in a guest Article from the IMF (see Article 1.8 on Covered Bonds and Asset Encumbrance by John Kiff, Andreas Jobst and Jay Surti).

Even though the situation in the financial markets looked as if it was stabilising in 2009, this deceptive calm did not last long. The reason for this was that state support measures and the economic correction in many countries brought to light problems with state finances which have again hit the market badly. Since there are covered bonds with public sector assets as collateral in a number of countries, this raises the question as to whether pure mortgage pools should not have priority in the investment process (see Article 1.5 Public Collateral in Times of Government Debt Crisis by Franz Rudolf and Florian Hillenbrand). Fundamentally, the analysis of influence factors on pricing continues (see Article 1.7 on Covered Bond Pricing Factors by José Sarafana), whereby weak liquidity in the secondary market significantly hampers actual pricing.

The success of covered bonds as a product is ultimately determined by demand. The perspective of investors is therefore of prime importance (see Article 1.10 on the Investors Perspective by Fritz Engelhard). Measured in relation to credit spreads, issue volume (see Article 1.9 on the growth of the sub-Jumbo sector by Michael Schulz and Richard Kemmish) – including of private placements (see Article 1.11 on the Non-Benchmark Side of the Covered Bond Market by Leef Dierks) and in terms of indicators which

can be derived from the changes in regulations, the product is gaining an increasingly important position in the funding plans of banks as a stable instrument. There is no doubt that financial markets are still volatile. Even the covered bond market cannot escape this fact. However, we are confident that it should be possible to cope with any challenges that arise through the loyalty of investors and a constructive dialogue with the regulatory authorities.

1.2 COVERED BONDS AND EU BANKING REGULATIONS

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

This chapter gives an overview on capital requirements for covered bonds under the European Commission's regulations for credit institutions. It also describes the treatment of covered bonds under the newly proposed liquidity risk management rules.

Compared with previous rules and proposals, the proposed regulation contains a new calculation method for the risk weightings of covered bonds within the standard approach, a broader potential scope of assets that may qualify for liquidity buffer portfolios, the ability to take into account particular business models when applying liquidity risk management and leverage rules, and rather long testing periods, with ample powers assigned to the European Banking Authority (EBA).

On 20 July 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.

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)[1] 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.

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.

The major change in the articles regulating the risk weighting of covered bonds 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 standardised 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 standardised approach (covered bond rating not assigned)

Credit quality step (issuer)	1	2	3	4	5	6
Rating* (issuer)	1	2	3	4	5	6
Risk weight	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. Importantly, there is no limitation on any asset class that qualifies as level 1 or level 2 assets. 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, in contrast to the March draft of the CRD IV, the use of Securitization Special Purpose Entities (SSPEs) has been removed from the list of assets explicitly excluded from liquidity buffer portfolios. However, the application of this broader definition of liquid assets is unclear. This is because article 403 also refers to "Annex III", which contains a much narrower set of rules, specifically differentiating certain asset classes, limiting covered bonds to those fulfilling the full set of rules stipulated in article 124 and excluding explicitly SSPEs again.

According to article 481(2), the EBA has the mandate to develop "appropriate uniform" definitions of level 1 and level 2 assets. In this process, it shall "test the adequacy of the following criteria and the appropriate levels for such definitions: (1) minimum trade volume, (2) minimum outstanding volume, (3) transparent pricing and post-trade information, (4) credit quality steps, (5) proven record of price stability, (6) average volume traded and average trade size, (7) maximum bid/ask spread, (8) remaining time to maturity and (9) minimum turnover ratio. Below we give some evidence to what extend covered bonds fulfill 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 the EBA 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 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 EBA shall report by end of 2013 on adequate definitions for level 1 and level 2 assets. By 31 December 2015 it 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

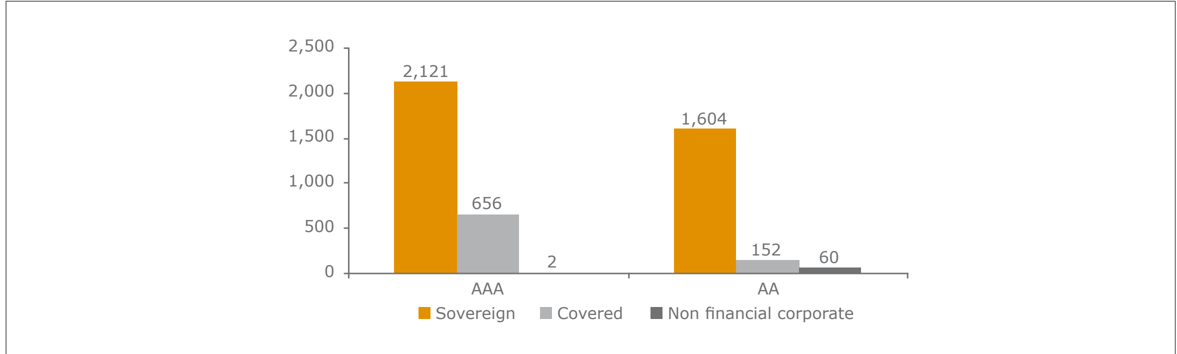
The proposed regulation provides room for the eligibility criteria for the LCR to move away from simple bond type and rating rules. The overall framework is more flexible and enables a focus more on the actual liquidity of the instrument in question. This is a development that we welcome as the liquidity of a bond is certainly not only a function of bond type and rating but also 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.

The EBA 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 2010, the overall volume stood at EUR 2.5 trillion. Looking only at the Jumbo market, and taking the Basel III Framework's AA- rating level as the lower limit for eligibility, the volume of eligible assets comes in at EUR 807 bn. This compares to for example only EUR 61 bn of non-financial corporate bonds rated at least AA-.

> FIGURE 5: OUTSTANDING VOLUME (EUR BN) SOVEREIGN, JUMBO COVERED AND BENCHMARK CORPORATE BONDS RATED AT LEAST AA-



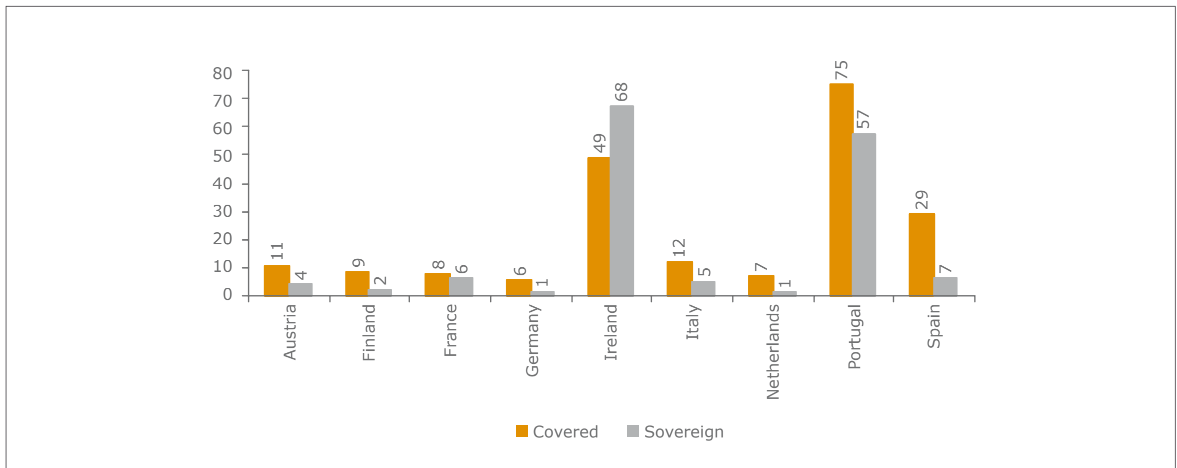
Source: : iBoxx, Crédit Agricole CIB

BID-ASK SPREADS

Bid-ask spreads are one additional criterion that the EBA is mandated to review when assessing which assets can be assigned into the "extremely high liquidity" and "high liquidity" categories. To get a feeling for the relative size of this metric for different market sectors, we have calculated historical bid-ask spreads for 3-5y Jumbo covered bonds as well as comparable 3-5y sovereign bonds.

When looking at the numbers, it becomes apparent that sovereigns are not automatically the asset class that always have the tightest bid-ask spreads. Particularly in stressed sectors such as Ireland or Portugal, the opposite holds true and in countries such as France or Austria, differences are fairly small. In addition, when looking beyond the average numbers and focusing on the largest and strongest issuers from each given country, the differences between covered bonds and sovereign bonds narrow even further.

> FIGURE 6: AVERAGE BID-ASK SPREADS PER PRODUCT AND COUNTRY IN 2011 YTD, EURO AREA COUNTRIES



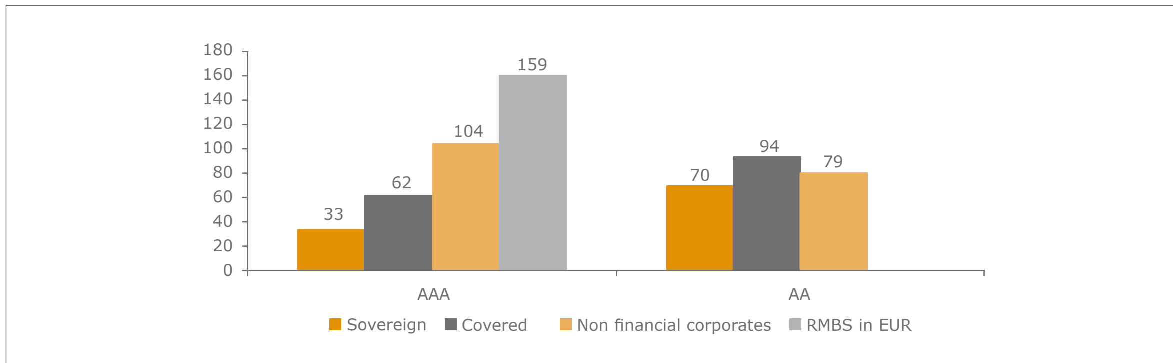
Source: Bloomberg, Crédit Agricole CIB

SPREAD VOLATILITY

We have analysed spread data from the six largest covered bond markets: Denmark, Germany, France, Spain, Sweden and UK. For all of these countries except for Denmark, the data was taken from the individual bonds included in the iBoxx covered bond indices. The Danish data was drawn from the components of the Nykredit Mortgage Bond Index, the most widely used index of Danish covered bonds. The data we used covers the period from 4 July 2007 to 31 July 2011. This period covers arguably the most volatile times in recent history. This timeframe captures the highest levels of volatility which fits with the aim of the liquidity ratios in the Basel III framework to assess the degree of liquidity those eligible assets offer in the worst case scenario and calibrate the limits and haircuts accordingly.

We have used the methodology developed and used by the insurance regulator EIOPA (formerly CEIOPS) in their Solvency II Calibration Paper[2]. The model is calibrated to deliver a shock consistent with a VaR 99.5% level following a widening of spreads. This serves as a measure of the maximum, or worst case scenario of spread volatility. We used daily asset swap spreads and calculated the 30 day differences of the daily spread data, along with the rank and percentile of those spread differences. The 99.5 percentile spread widening number was then compared between the three different bond types.

> Figure 7: Empirical evidence for spread volatility (99.5 percentile spread widening in 30 day timeframe) between 04/07/2007 and 20/10/2010, in basis points



Sources: iBoxx, Bloomberg, Credit Agricole CIB

BOND TYPE AND RATING COMPARISON

Looking at the AAA rated spread volatility figures for covered, sovereign and corporate bonds, it can be observed that covered bonds are much closer to the sovereign world than to the corporate credit world. While the difference between covered bonds relative to sovereign bonds is just 29bp, the number compared to non-financial corporate bonds comes in at 42bp. For AA rated covered bonds, the difference to sovereigns, which comes in at 24bp only is even closer to the difference in the AAA sector.

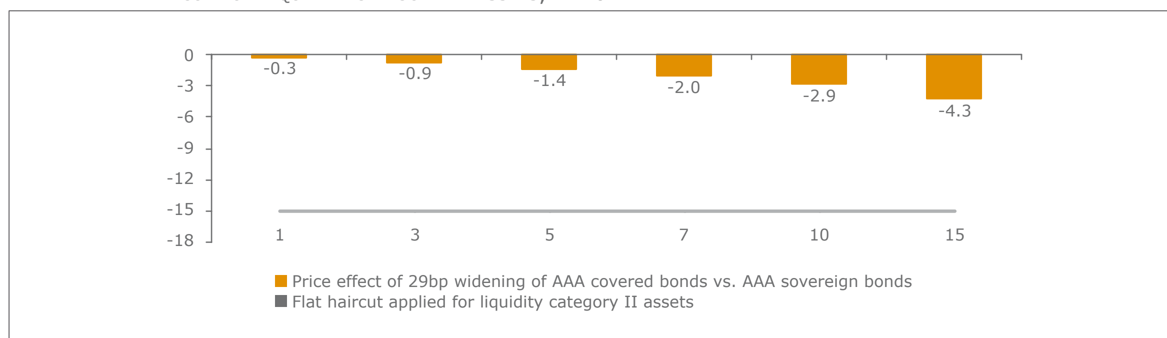
ANALYSIS OF SPREAD WIDENING ON DIFFERENT MATURITY BUCKETS

In the LCR as set out in the Basel III Framework, no haircut at all is foreseen for Level 1 liquid assets. For Level 2 assets, a minimum haircut of 15% is applied to the current market value of each Level 2 asset. This haircut applies to all bonds irrespective of their maturity.

2 http://ec.europa.eu/internal_market/insurance/docs/solvency/qis5/ceiops-calibration-paper_en.pdf

However, by definition longer dated bonds show higher price sensitivity to interest rate and spread changes because of their longer duration. Therefore, only if the spread movements of the short dated bonds were to be much higher than those of longer dated bonds, could it make theoretical sense to apply one single haircut along the curve. For the timeframe observed, the 99.5 percentile spread widening was very similar for the 1-3 year index, the 5-7 year index and the 10 year plus index. In fact the difference between the three was below 5bp. We have therefore used the above mentioned 29bp differential between AAA covered bonds and AAA sovereign bonds along the curve in order to calculate the impact this additional spread widening of covered bonds compared to the sovereign bonds had on the prices of covered bonds.

> Figure 8: Price effect of 29bp spread widening of covered bonds vs. sovereign bonds compared to the 15% flat haircut for liquidity category II assets, in %



Sources: iBoxx, Basel Committee, Credit Agricole CIB

Comparing the above mentioned numbers to the 15% haircut, it immediately becomes apparent that even for long dated 15 year bonds, the 29 bp spread difference between AAA rated covered bonds and sovereign bonds leads to a relative price decline that is far below the 15%. For short dated bonds out to 3 years duration, we are looking a price decline (-0.3%) that is a mere 2% of the 15% decline currently modelled in. Recent market developments in sovereign markets which were subject to increased swap spread volatility also highlight that swap spreads of covered bonds issued out of the same jurisdictions have proven to be more stable and there has been also investor demand for covered bonds yielding 100bp less than underlying government bonds.

ASSESSMENT

We regard the new proposal 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. In addition, the difference between the broader liquid asset rules in article 404

and the narrow rules in Annex III appear contradictive. 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 over the next two years. In the meantime, to be on the save, 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.

1.3 COVERED BONDS UNDER SOLVENCY II – "IT'S THE END OF THE WORLD AS THEY KNOW IT..."

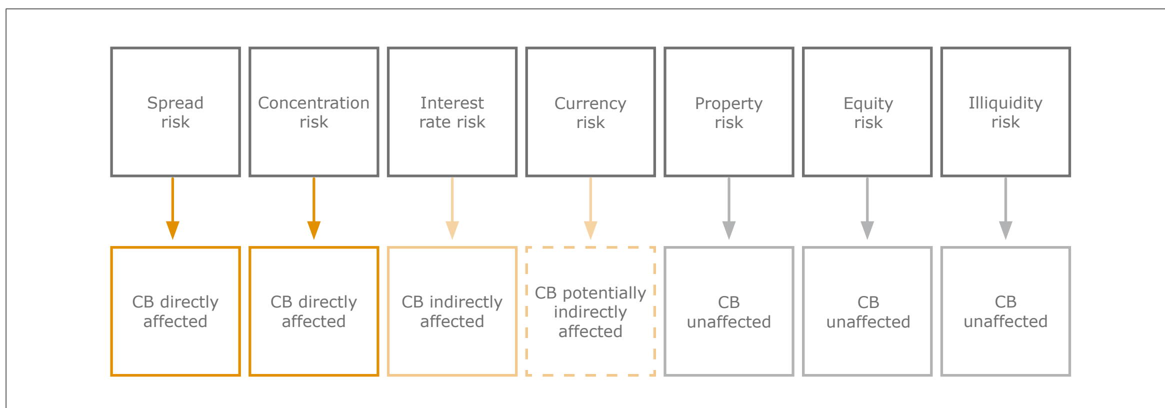
By Florian Eichert, Crédit Agricole CIB

"It's the end of the world as they know it" – this slightly adjusted REM song title is the perfect characterisation of what will happen to insurance companies from 2013 onwards. In the past, insurance companies had to hold one lump sum of capital which had to cover all of the different risks they ran. There was no differentiation between the individual risk factors. Somewhat similar to the introduction of Basle II for banks, Solvency II will force insurance companies to hold capital based on the individual risks they hold in their balance sheets going forward from underwriting risk to investment risk. This will have significant implications for their investments which will not all be treated equally in this regard. Capital charges will differ by asset class, maturity and rating.

For the purpose of this article, all of the calculations are based on the autumn 2010 calibrations of Solvency II. There is still a chance that final calibrations of Solvency II could change going forward.

Under Solvency II, the capital requirements will be determined by a number of risk modules. One of the modules is the market risk module which in turn is split in a number of components which cover risk factors from interest rate risk to currency, equity, and real estate market risk.

> MARKET RISK MODULES IN SOLVENCY II AND THEIR RELEVANCE FOR COVERED BONDS



Source: EIOPA, Crédit Agricole CIB

The situation of covered bonds in a nutshell: they are treated favourably versus senior unsecured bonds and ABS but are at a vast disadvantage to sovereign bonds. Covered bonds receive special treatment in two risk components. In the concentration risk component, they benefit from a higher concentration limit and in the spread risk component lower capital charges compared to senior unsecured exposure or securitisation.

COVERED BONDS IN THE SPREAD RISK COMPONENT

One of the main influencing factors for ultimate capital charges of bond investments is the spread risk component. While sovereign bonds do not have to be allocated any capital at all in this respect as long as they are at least AA- rated, AAA rated covered bonds will bear a capital charge of 0.6% per year of duration.

> Spread risk factors by bond type and rating per 1Y duration

Type of bond	Rating	Speed risk factor
Corportate bonds, sub + hybrid debt, ABS, CDO	AAA	0.9%
	AA	1.1%
	A	1.4%
	BBB	2.5%
	BB	4.5%
	B or lower	7.5%
	Unrated	3.0%
Covered Bonds	AAA	0.6%
Governments, central banks, multilateral development banks, international organisations	AAA	0.0%
	AA	0.0%
	A	1.1%
	BBB	1.4%
	BB	2.5%
	B or lower	4.5%
	Unrated	3.0%

Source: CEIOPS, Crédit Agricole CIB

The way it looks at the moment, special treatment is however only valid as long as the rating is at AAA. Strangely, AA rated covered bonds are treated like senior unsecured bonds and have a 1.1% capital charge per year of duration even though both logic as well as statistics strongly hint at a better treatment compared to senior unsecured bonds also for the AA rating level.

In this respect, we replicated the approach used by EIOPA when coming up with their QIS5 results using covered bond specific spread data. We have looked at historic spread volatility and compared the 99.5 percentile values for equally rated covered and senior unsecured bonds.

The results clearly show that first of all, the 0.6 spread risk factor for covered bonds should be slightly lower at 0.4%. More importantly however, the numbers strongly suggest a preferential treatment versus senior unsecured also for AA rated covered bonds. The spread risk factor should actually be less than half the current 1.1 coming in at 0.5.

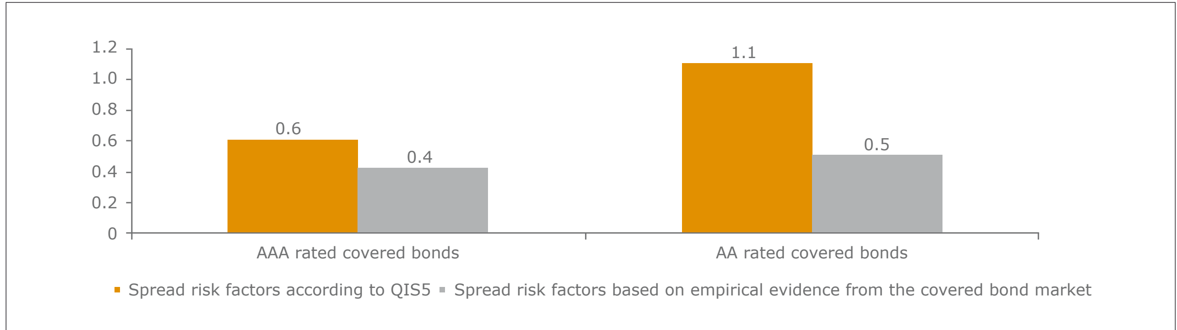
> Empirical evidence spread volatility AAA rated covered and senior unsecured bonds

	Ratio of 99.5 Percentile spread widening covered bonds vs. corporate bonds	Ratio of spread risk factor covered / corporate bond in QIS 5	Actual spread risk factor for covered bonds based on cover ed bond spread date
AAA rated covered bonds	**47%**	**0.6/0.9 = 66%**	**0.9*47% = 0.423**

> Empirical evidence spread volatility AA rated covered and senior unsecured bonds

	Ratio of 99.5 Percentile spread widening covered bonds vs. corporate bonds	Ratio of spread risk factor covered / corporate bond in QIS 5	Actual spread risk factor for covered bonds based on cover ed bond spread date
AA rated covered bonds	**46%**	**1.1/1.1 = 100%**	**1.1*46% = 0.506**

> Overview spread risk factors for covered bonds according to QIS 5 and empirical evidence based on spread data from the covered bond market

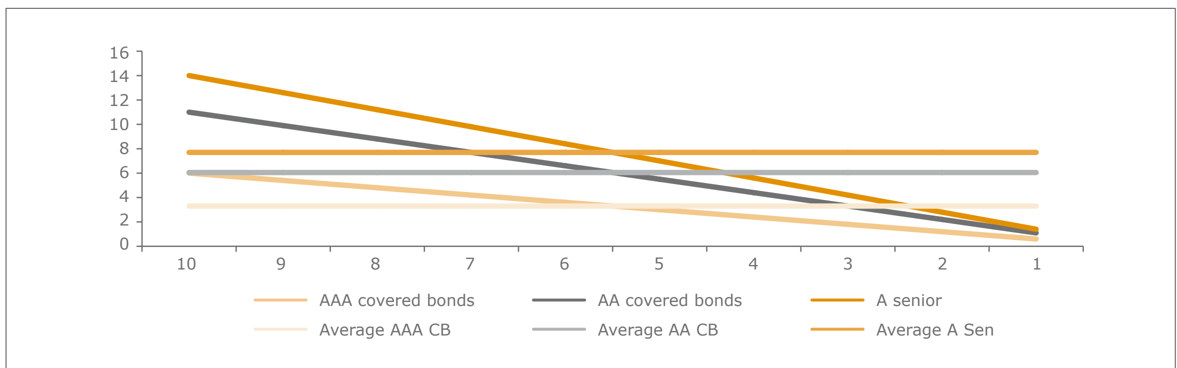


Sources all charts: iBoxx, Bloomberg, Credit Agricole CIB

Irrespective of this statistical evidence, we will have to take the proposed risk factors as a given for the time being and look at possible consequences.

The relationship between the duration of a bond and its capital charge is a linear one. If we look at an AAA rated covered bond with 10Y duration, the capital charge in the first year is therefore 6%, for a AA rated covered bond 9% and for an A rated senior 14%. This number does not stay static over time though. These same positions are one year closer to maturity in one year's time, which means that the capital charge has also gone down to that of a 9Y duration bond. Therefore a buy-and-hold investor will probably also focus on an average capital charge over the lifetime of the bond and not on the first year figure only. For the AAA rated covered bond this average capital charge over the lifetime of the bond comes in at around 3.3%, for the AA rated covered bond 6.1% and for the A rated senior 7.7%.

> Capital charges over time based on remaining duration of the bond as well as average capital charge for 10Y duration bonds which are held to maturity



Source: CEIOPS, Crédit Agricole CIB

Irrespective of the investment horizon, the need to hold higher levels of capital for one investment over another will prompt insurance companies to require compensation for the cost of holding that additional capital. Since the capital charge goes up the longer the bond is, the required spread premium will have to go up as well and spread curves steepen at the long end. To come up with figures for these required spread premiums it is important to make clear that a number of factors are driving this calculation:

> Bond's duration. The longer the duration the higher the capital charge, the higher the required spread.

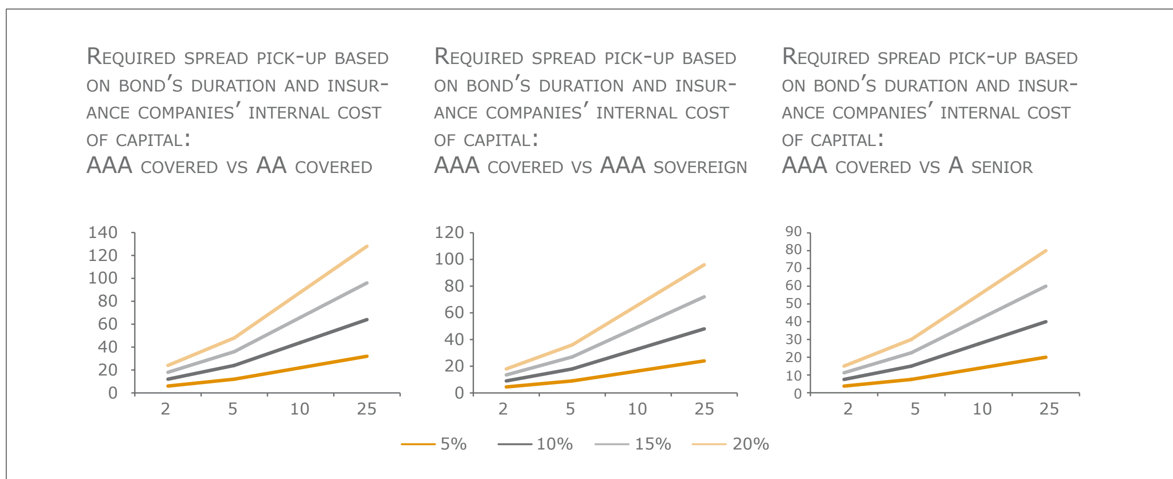
> Bond's rating. The lower the rating the higher the capital charge and as a result the required spread will be.

> Expected investment horizon. The longer the position is held, the lower the average capital charge, the lower the additional spread requirement.

> Internal cost of capital of the insurance company. The higher this is, the more pick-up is needed from the investment to cover the capital cost of the investment.

It is very important to stress that there will be no uniform answer applicable to all insurance companies. The results can and probably will differ from company to company as the input factors into the calculation are company specific.

Below, we have plotted the required spread premiums to make up for the different capital charges for bonds with different durations. To show how different the numbers can be from one insurance company to another, we have calculated the required premiums for different cost of capital levels. We have assumed a buy-and-hold attitude to make things simpler. For this exercise, we compare AAA rated covered bonds to AA rated covered bonds, to AAA rated sovereign bonds and to A rated senior unsecured bonds.



Source: CEIOPS, Crédit Agricole CIB

When running this scenario analysis, the required spread pick-up for an insurance company with an internal cost of capital of 15% is as follows:

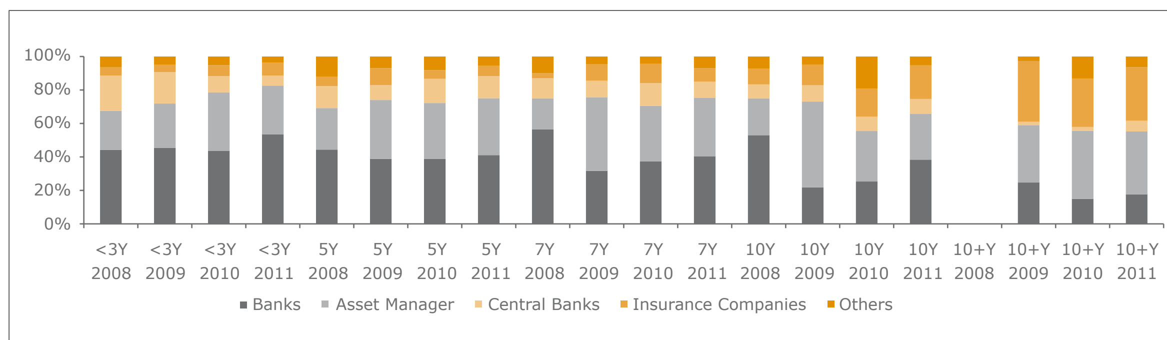
> AA rated covered bond vs AAA rated covered bond: 11bp for 2Y, 23bp for 5Y, 41bp for 10Y and 60bp for 15Y

> AAA rated covered bond vs AAA rated sovereign: 14bp for 2Y, 27bp for 5Y, 50bp for 10Y and 72bp for 15Y

> A rated senior vs AAA rated covered bond: 18bp for 2Y, 36bp for 5Y, 66bp for 10Y and 96bp for 15Y.

One thing to keep in mind at this point is the following. Insurance companies are not the driving force behind spreads at the short to mid part of the curve. They have only bought around 3% of this year's 5Y issuance for example. However number grows to almost one third if looking at deals with a maturity of beyond 10 years. Shorter deals are mostly influenced by banks and asset managers. Basel III and especially the liquidity coverage ratio is pushing banks to shift their investments increasingly from senior unsecured bonds to covered bonds which can form up to 40% of their liquidity portfolio under the LCR. Therefore, as a rule of thumb, out to the 7 year segment, the increased demand by banks should outweigh the new approach by the insurance sector. Beyond this point however, effects of Solvency II will be felt.

> Investor distribution new benchmark covered bond deals by maturity bracket and investor type in %



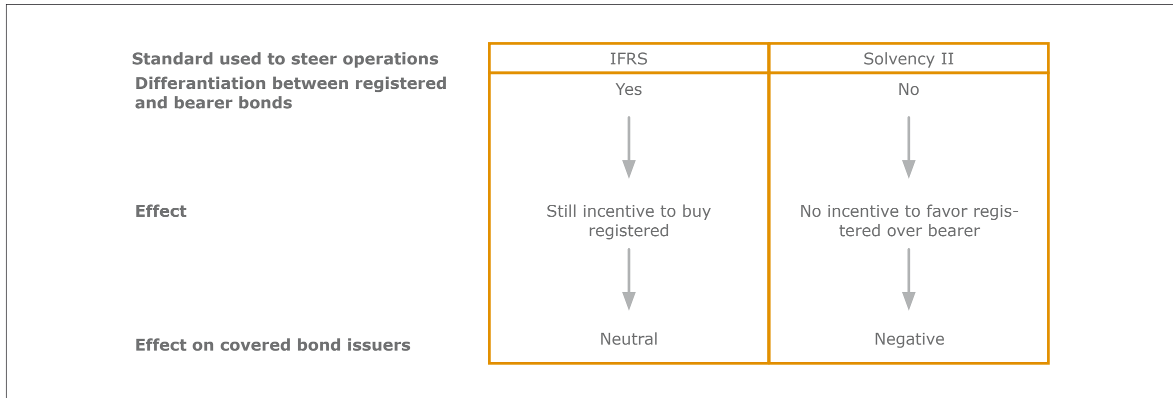
Source: Bloomberg, IIIA, the cover, coveredbondreport.com, Crédit Agricole CIB

WHAT WILL HAPPEN TO THE REGISTERED COVERED BOND / SCHULDSCHEIN MARKETS

One of the main challenges of Solvency II will be a strict mark to market requirement both on the asset as well as on the liability side of insurance companies' balance sheets. This will apply irrespective of the accounting treatment. As a result of this there will be no differentiation between registered and bearer bonds under Solvency II. The fact that insurance companies did not have to worry about mark-to-market losses on the former positions, certainly made it easier for them in the past to also buy long-dated exposure away from the national champions.

One thing to keep in mind at this point however is that accounting benefits of registered bonds under IFRS which are usually classified as held to maturity assets are not affected by Solvency II. Since insurance companies will be faced with conflicting standards as a result, the big question going forward is which standard will be used to steer their operations.

> Effect on covered bond issuers depends on which standards insurance companies use



Source: Crédit Agricole CIB

Should all insurance companies steer their operations based on Solvency II — mark-to-marking every single position irrespective of its accounting treatment — the effects on the registered covered-bond market would be devastating. Worse, though, would be the repercussions for the senior unsecured Schuldschein market. Many smaller issuers would find it very hard to access long-dated senior funding above everything else. Effects will be much more muted on the other hand, if insurance companies continue to steer their operations based on IFRS or national GAAP.

Early indications from the insurance sector seem to suggest that there will be a mix of the two. Some will be steering based on Solvency II, while others will primarily focus on IFRS to make strategic decisions provided they also have sufficient capital to fulfil the solvency requirements at the same time. Solvency II will therefore not be the end of these sectors but it will certainly dampen demand and reduce previously existing spread differences between bearer and registered bonds.

CAPITAL TREATMENT OF MORTGAGES VS. COVERED BONDS – COMPETITION DISTORTION ANYONE...?

If one were to compare the treatment of covered bonds to the way direct mortgages are treated under QIS 5, this disadvantage vs. sovereign bonds seems to become quite negligible. In fact one can get the impression that both the bank and the insurance sector regulators have not had the slightest clue of each other's existence in the past years because they surely have not discussed this one. The way banks and insurance companies have to treat mortgages are light years apart from each other and create massive arbitrage opportunities between the two camps.

> Insurance companies only have to hold 15% capital against the unsecured part of a mortgage

> For the secured part, the same approach to direct real estate risk is applied - a 25% assumed value decline covers all of the risk involved irrespective of the location or use of the property

Effectively this means that for a mortgage with an LTV below 75%, insurance companies do not have to hold capital. If Solvency II is implemented unchanged, the following would be the case:

> A theoretical Pfandbrief (diversified and actively managed cover pool made up of purely German residential mortgages, average LTV of let's say 45%, additional over-collateralisation of 15%) which

offers an additional claim on the issuer will have a higher capital charge than one individual commercial mortgage loan from Dublin, Ireland with an LTV of 75%

We understand, that Solvency II is not yet fully finalised in a number of areas and the treatment of mortgages belongs to those areas. Both EIOPA the insurance regulator and the European Commission seem to have realized the gravity of this divergence and want to harmonise the regulatory landscape for insurance companies and banks in the best possible way. The treatment of mortgages in the current form however would be the mother of all competition distortions and it remains to be seen what is still possible this late in the Solvency II process or what will have to be delayed until the next Solvency update. If approved in its current form, it would cause serious problems above all for specialised commercial real estate lenders. At least until rectified in a later Solvency edition, insurance companies would be far more competitive in this field and in a position to price these banks out of the market in many cases. Since there is no differentiation for capital purposes, we don't think that the residential mortgage market with its much smaller individual loan volumes and lower margins will be a main target for the insurance sector.

EFFECTS OF SOLVENCY II - HOW WILL INSURANCE COMPANIES REPOSITION THEMSELVES...?

The overall effect of Solvency II is still hard to gauge and it will always vary from insurance company to insurance company. There are, however, a few general statements that can be made in our view:

> Because of a strict mark-to-market requirement for all assets and liabilities under Solvency II, the differentiation between registered and bearer bonds will shrink going forward, as Solvency II does not foresee any differences in treatment. Issuers will not get as much out of this sector of the covered bond market as was the case in previous years.

> Insurance companies will continue to focus on long assets to match their long liabilities. They could however aim to achieve this by using long-dated capital-efficient products – such as government bonds – and concentrate capital intensive products towards the short to medium part of the curve. Senior unsecured exposure (which includes non AAA rated covered bonds!) could be shifted to the very short end while AAA rated covered bonds could still be an investment of choice out to let's say the 10-12 year part of the curve.

> The value of a AAA rating will become fairly large for insurance companies. In the example above, the spread difference for AA and a AAA covered bonds with a duration of 10 years is around 40bp if the insurance investor has to generate a RoE of 15% and holds the bonds to maturity. In addition to spread levels, also ultimate demand from the insurance sector will be far lower for below AAA rated covered bonds at the mid to longer end.

> If insurance companies still buy longer-dated capital-intensive products, they are likely to pass on the higher capital charges from the spread-risk component to the issuers. As a result, spread curves will have to steepen at the long end.

> The way QIS5 treated mortgages, insurance companies will have an increased incentive to become active in buying them directly, as opposed to buying mortgage exposure indirectly through covered bonds. This could damage new business prospects for commercial real estate lenders, as they are priced out of the market. There might be some changes to this in the months to come.

A NUMBER OF CHANGES SHOULD STILL BE CONSIDERED IN THE FINAL SOLVENCY II RULES…

As mentioned previously, there are no final rules of Solvency II yet. Since Solvency II will come into force in 2013 and there have already been 5 quantitative impact studies. Therefore, a major overhaul of the system at this stage seems out of question. Smaller changes for the better on the other hand cannot be ruled out in our view.

One area in which some alterations would definitely make sense compared to QIS 5 is the spread risk component. It's current setup encourages insurance companies to focus their long dated investment exposure towards sovereign bonds and reduce the average duration of their capital intensive products. In this respect, there are a few points that we would consider very sensible and useful changes / adjustments to the current setup of Solvency II.

> It would be very beneficial for everyone involved to strengthen the long term investment character of insurance companies. Capital charges should reflect this and not grow in a linear relationship with the investment's duration. If the additional capital charge for later years gets smaller, this could encourage insurance companies to still be active in longer dated bonds.

> It does not make any sense to limit the beneficial treatment of covered bonds to only AAA rated bonds. Recovery assumptions of covered bonds are typically far higher than equally rated senior unsecured bonds irrespective of their absolute rating level. In addition to that, actual spread volatility of AA rated covered bonds during the crisis has been well below that of AA corporate bonds. Therefore, a special treatment of AA covered bonds compared to AA senior unsecured bonds seems justified as well. Implementing Solvency II unchanged would create a massive rating cliff below AAA with capital charges almost doubling and spread requirements for insurance companies going up significantly.

These two changes alone would in our view reduce the overall negative impact of Solvency II on non-sovereign bond markets and help stabilise both banks and insurance companies and lead us to wrap up this article by mentioning the sub title of the REM song from the beginning: "…and I feel fine."

1.4 COVERED BOND TRIGGERS

By Heiko Langer, BNP Paribas

Covered bonds have proven themselves well in the recent financial crisis, showing less spread volatility and a significantly faster market recovery than other asset classes such as unsecured bank debt or mortgage backed securities. However, the significant government support that a large number of banks have received during the crisis has also meant that the security mechanisms inherent in covered bonds have not yet been tested. In most cases, where a covered bond issuing institution was facing the risk of insolvency, alternative measures such as nationalisation, merger with another institution and/or orderly wind-down prevented covered bond investors from having to rely on the cover pool for the payment of interest and capital.

Going forward, government support for failing banks is likely to decrease with more and more countries introducing bank resolution regimes. The aim of such resolution regimes (also referred to as "bail-in regimes") is to help regulators in dealing more efficiently with failing banks while minimizing the potential impact on the tax payer. In certain cases this could also mean that unsecured bondholders will have to share some of the burden of restructuring through haircuts on their claims. The reduced willingness (and in some cases reduced ability) of governments to rescue failing banks means that the probability of an actual covered bond test case is increasing. While this may put more emphasis on the importance of the security offered by the relevant cover pool, it also increases the focus on trigger mechanisms within covered bonds.

What are trigger mechanisms?

A trigger mechanism links a certain event (e.g. insolvency of the issuer) to a gradual or full segregation of the cover pool from the issuer (or the sponsor bank). Trigger mechanisms aim to ensure that the assets that back the preferential claim of covered bondholders do not fall into the general bankruptcy proceedings of the issuer.

The triggers should be unambiguous and objective. Complications, delays and legal uncertainty can be the result of covered bond triggers that leave room for interpretation. Such a scenario could be possible where an authority or other party (e.g. a trustee) can use its discretion regarding the consequences of a trigger event. Market participants should be able to assess without delay if a trigger event has occurred and ideally what action resulted from the trigger event.

Throughout the covered bond market the complexity of trigger mechanisms varies significantly. The complexity of trigger mechanisms is usually higher in frameworks where the preferential claim of covered bondholders and ongoing compliance with coverage requirements is not based on specific provisions within the covered bond law. This is obviously the case in countries where the issuance is based on contractual agreements, but also in countries where a dedicated legal framework had been introduced after issuance of covered bonds (such as the UK and the Netherlands).

Insolvency or bankruptcy of the issuer: This trigger can be found where covered bonds are based on a specific legislation as well as where they are issued on the basis of contractual agreements. In markets with specific legislation the trigger is mostly based on the preferential claim that the framework grants to the covered bondholders. In connection with the stipulation that payments to covered bondholders do not accelerate in case of the issuer's insolvency, the preferential claim usually results in a segregation of the cover pool and covered bonds from the insolvent estate. In some frameworks, the cover assets are not segregated but the preferential claim still ensures that covered bondholders continue to

receive payments as scheduled as long as the cover pool is sufficient. In that sense, the trigger causes covered bondholders to rely on cash flows generated from assets in the cover pool to receive payments of interest and capital as scheduled.

In cases where the issuer is a specialised subsidiary that holds only cover assets (e.g. as in the French Obligations Foncières market), the issuer is by law exempt from any bankruptcy proceedings against its parent company. This means that the segregation of cover assets would be linked to the insolvency or bankruptcy of the parent company and not the issuer itself. The situation can be slightly more complex in markets where the issuing subsidiary holds assets both inside and outside of the cover pool (e.g. Sweden or Ireland). Since the insolvency of the parent company does not automatically lead to the insolvency of the issuing entity, the cover assets are not segregated from the balance sheet of the issuer at that point. There could however be a scenario where the issuer itself would face insolvency after its parent company had become insolvent. This would then trigger the segregation of cover assets or as the case may be covered bonds from the insolvent estate.

Failure to pass an asset coverage test: This trigger is mostly used where the covered bonds are issued on the basis of contractual agreements or where a legislative framework had been implemented to complement an existing covered bond market. Such covered bonds rely on regular asset coverage tests to ensure that the coverage agreements are continuously met and adjustments to the cover pool are being made if needed.

Currently, there are two basic covered bond structures that use asset coverage tests: Covered bonds that use a guaranteeing entity that takes over payments to the bondholders after a trigger event. Such guarantee mechanisms can be found in the UK, the Netherlands, Italy, Canada and New Zealand. Other programmes that rely on asset coverage tests can be found in France (Obligations a l'Habitat) where the covered bonds are backed by loans which are in turn secured by dynamic pool of assets. These secured loans are typically made towards the sponsor bank (e.g. the parent company of the issuer), which also originates and holds the dynamic pool of cover assets.

In the case of covered bonds that use a covered bond guarantor, a breach of the asset coverage test (if it is not remedied within a certain timeframe) will ultimately lead to finalisation of the asset transfer to the covered bond guarantor. In addition, the guarantor will assume payments of interest and capital to the covered bondholders. Where covered bonds are backed by secured loans or advances, a breach of the asset coverage test will lead to the transfer of assets used as security for the loan to the covered bond issuer. In both cases, the trigger can be activated without the issuer or the sponsor bank being insolvent. However, the insolvency of the issuer or the sponsor bank is typically defined as one of several events (apart from the breach of the asset coverage test) that lead to segregation of the cover assets.

Rating-linked triggers

Several covered bond programmes use rating linked triggers to prepare and facilitate the segregation of cover assets in an imminent insolvency of the issuer or sponsor bank. In most programmes where a guarantee structure is employed (such as UK, Netherlands, Canada or Italy) the downgrade of the issuing bank below a certain rating level will lead to a notification of the mortgage borrowers. Upon the notification, mortgage borrowers have to make payments directly to the covered bond guarantor. In certain cases, the downgrade of the issuing bank below a certain level can also trigger the transfer of title of the cover assets to the covered bond guarantor. The main aim of these triggers is to avoid that

mortgage borrowers continue to discharge their mortgage obligations via payments to the issuer during the time between the occurrence of a segregation event and the notification of the mortgage borrowers.

In cases where the covered bonds are backed by secured loans to the parent company or sponsor bank (e.g. French Obligations a l'Habitat) the downgrade of the parent company or sponsor bank below a certain level can cause the issuer to engage in hedging contracts with the parent company or sponsor bank. Prior to such a trigger being hit, all hedging between cover assets and covered bonds is conducted at the level of the parent company or sponsor bank, while the cash flows at the level of the issuer are fully matched. These hedging contracts, which are neutralised through back-to-back swaps until the transfer or the cover assets to the issuer, ensure that the issuer will not end up with mismatched cash flows in an event of default at the level of the parent company or sponsor bank.

Other rating-linked triggers can lead to appointment of alternative service providers which facilitate the potentially imminent segregation of cover assets. Triggers that lead to appointment of alternative cash managers or the establishment of external cash collection accounts aim at de-linking covered bonds from the credit quality of the issuing bank. However, in certain scenarios some rating triggers may also accelerate the trend of a deteriorating liquidity position of a covered bond issuer by channelling cash flows away from the bank's general treasury operation.

Impact of maturity extension (soft bullet)

The use of soft bullet structures in covered bonds can have a delaying impact on the segregation or transfer of cover assets. Soft bullet structures provide for the possibility to extend the maturity of the covered bonds for a certain period of time in case the issuer does not repay the covered bonds at the scheduled maturity date. In cases where the extension can take place before the insolvency of the issuer or the sponsor bank, i.e. where the extension is not triggered by the bankruptcy administrator, the cover assets will not be segregated from the issuer or sponsor bank during the extension period (unless other trigger events occur). In other cases, a maturity extension can only occur after the segregation of cover assets, i.e. it no longer can affect the timing of the trigger event. Which of the two scenarios are applicable depends largely the conditions set in the extension clause and thus on the respective programme documentation. While maturity extensions can have a positive effect for covered bondholders, especially when they help to prevent a fire sale of cover assets, they can in certain cases add to the uncertainty regarding the timing of the asset segregation.

Triggers to limit time subordination

Triggers to limit time subordination do not affect the segregation of cover assets as they are mainly of relevance in a post-bankruptcy scenario. Since claims of covered bondholders with varying maturities are secured by the same pool and covered bonds do not automatically accelerate in an insolvency event, there is a certain level of time subordination in a post-insolvency scenario. Time subordination occurs when the repayment of earlier maturing claims results in a lower repayment ratio of later maturing claims. Within most covered bond frameworks this risk is addressed in two different ways. In frameworks where the preferential claim is based on specific legislation, time subordination is limited by the provision that the covered bonds do not accelerate as long as the cover pool is sufficient to repay all claims. In markets where an asset coverage test is used, time subordination is addressed by an amortisation test. This test, which in essence is a simplified asset coverage test, is conducted regularly once the segregation of assets has been triggered. A breach of the amortisation test will ultimately lead to the acceleration of payments of all outstanding covered bonds. In both cases, time subordination is limited

by the respective measures, but not completely eliminated. A scenario is possible where voluntary over-collateral may be available in the pool and used to settle earlier maturing claims without triggering an acceleration of all payments. This would leave creditors with longer maturities with less or no buffer for potential deterioration in credit quality of the remaining cover pool.

Conclusion

While the focus on trigger mechanisms is likely to increase as a result of waning government support for banks, one has to bear in mind that actual tests of covered bond systems might still remain a rare event. The growing importance of covered bonds as a funding tool for banks means that the product itself could still benefit from a significant level of support even if only from other issuers of covered bonds. Especially in well established covered bond markets the insolvency of a single issuer could result in a transfer of its covered bonds and cover pools to one or several other issuers even before the actual triggers will be hit.

A standardisation of trigger mechanisms across markets and programmes could help to increase transparency in this sector and potentially allow market participants to better assess the additional level of security offered by covered bonds, especially in times of stress. However, greater standardisation of trigger mechanisms is challenged by differences in covered bond frameworks as well as the local bankruptcy regulation in addition to changing rating requirements. Consequently, the variety of triggers is unlikely to decrease; ongoing globalisation of the covered bond market might even lead increasing diversity.

1.5 PUBLIC VS. MORTGAGE COLLATERAL IN TIMES OF GOVERNMENT DEBT CRISIS

By Franz Rudolf and Florian Hillenbrand, UniCredit Research

Since 2007 we have constantly been in crisis mode – sometimes a little more, sometimes a little less. And during the various stages of the crisis or crises we have constantly seen certain things we had taken for granted for ages shattered: spread stability of covered bonds along with secondary market liquidity, banks having access to money and capital markets, similar trading levels of euro area sovereigns, capital market access of Euroland sovereigns etc. In the following, we want to tackle the topic of the Euroland government debt crisis in the context of the valuation and market perception of public sector covered bonds in comparison with mortgage covered bonds.

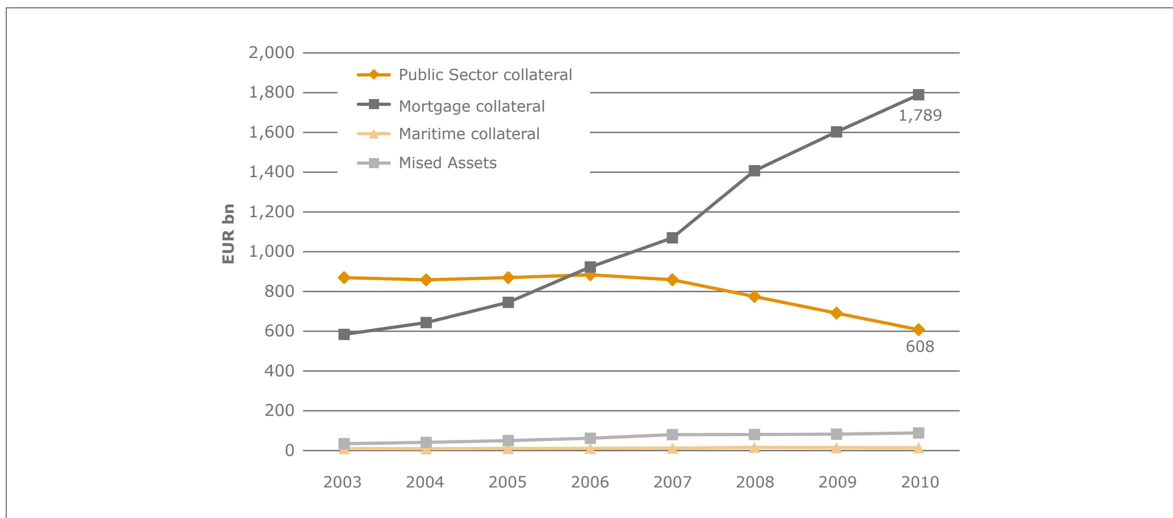
Back in "the glory days" before summer 2007, it was an accepted "law of capital markets" that public sector covered bonds provided quality superior to those bonds collateralized by a pool of mortgage debt of whatever kind. Consequently, public sector covered bonds were – although negligibly in today's terms – statistically significantly trading at richer levels compared to their mortgage backed comparables. Hardly anybody expressed doubts about public credit quality being superior to the already conservative stock of mortgage debts. If we say hardly anybody, we have to mention the discussions surrounding the first appearance of Italian covered bonds. When back in 2005 Cassa Depositi e Prestiti issued its first public covered bond, we indeed had some lively discussions about how reasonable it is to have a covered bond rated Aaa/AAA/AAA backed by mostly local and regional debt of a country that by then was rated Aa2/AA-/AA. Some market participants argued that the default correlation between the assets in the collateral and between the various layers of public authorities was too high to allow a rating up-notch of the covered bonds compared to the sovereign. However, it was also the case that Cassa Depositi e Prestiti – by transferring a humongous amount of collateral (EUR 18 bn of assets collateralizing an inaugural EUR 2 bn transaction) – was able to scotch these discussions quite quickly.

From a purely fundamental perspective, the critics did indeed touch a quite sensitive aspect. In fact a similar discussion reappeared in March 2010. The experience of euro area bonds lacking tradability (Q1 2009) as well as the consequences this lack of tradability had on covered bonds (higher focus on liquidity stresses in covered bond rating methodologies) was still fresh, when Fitch – for the first time – rated a covered bond backed by public sector debt one notch below a mortgage-backed covered bond issued by the same institution – namely Caixa Geral. In order to justify this, Fitch had to bend its covered bond rating methodology slightly. The key argument was that the cover pool backing the covered bonds was made of loans to Portuguese municipalities, which were as-sumed to have a higher correlation with the central government than in other countries. In a theo-retical stress scenario, after a Portuguese sovereign defaulted, it is assumed that a high proportion of the cover pool will have also defaulted. Therefore, Fitch capped the PD-based covered bond rating at AA-, which was equal to the level of the Portuguese sovereign back then. This, however, was two notches below what would have been the outcome using Fitch's official methodology given the Discontinuity Factor of 32%. While in the meantime it is quite common in the periphery to see covered bonds being rated better than the sovereign, so far the situation of public sector covered bonds being rated worse than mortgage covered bonds remains unique.

Nevertheless, discussion is quite lively as to whether public covered bonds or mortgage covered bonds are the better pick in a scenario of a troubled sovereign or even in a complete meltdown scenario. However, before discussing the mechanisms triggered by a troubled sovereign or one in default, let's take a look at how the market for covered bonds is split up today between mortgage and public collateral.

With respect to the number of covered bond programs, around 25% of all programs with benchmark bonds outstanding are backed by public sector collateral, and 75% are (primarily) backed by mortgage collateral. Looking at the absolute amount of all outstanding covered bonds, around 24% or EUR 608bn relate to public sector collateral, 72% to mortgage collateral (EUR 1,789bn) and 4% to mixed or other collateral, e.g. ships. Since 2006, the volume of covered bonds backed by mortgage collateral has been higher than the volume of public sector covered bonds. This trend has accelerated in recent years, as not only the relative share of public sector covered bonds has declined, but also the absolute amount has decreased. The main driver behind this development is the situation on the German Pfandbrief market. Following the abolishment of special guarantee schemes in Germany (Gewährträgerhaftung, Anstaltslast) for public sector banks, the volume of underlying collateral declined significantly.

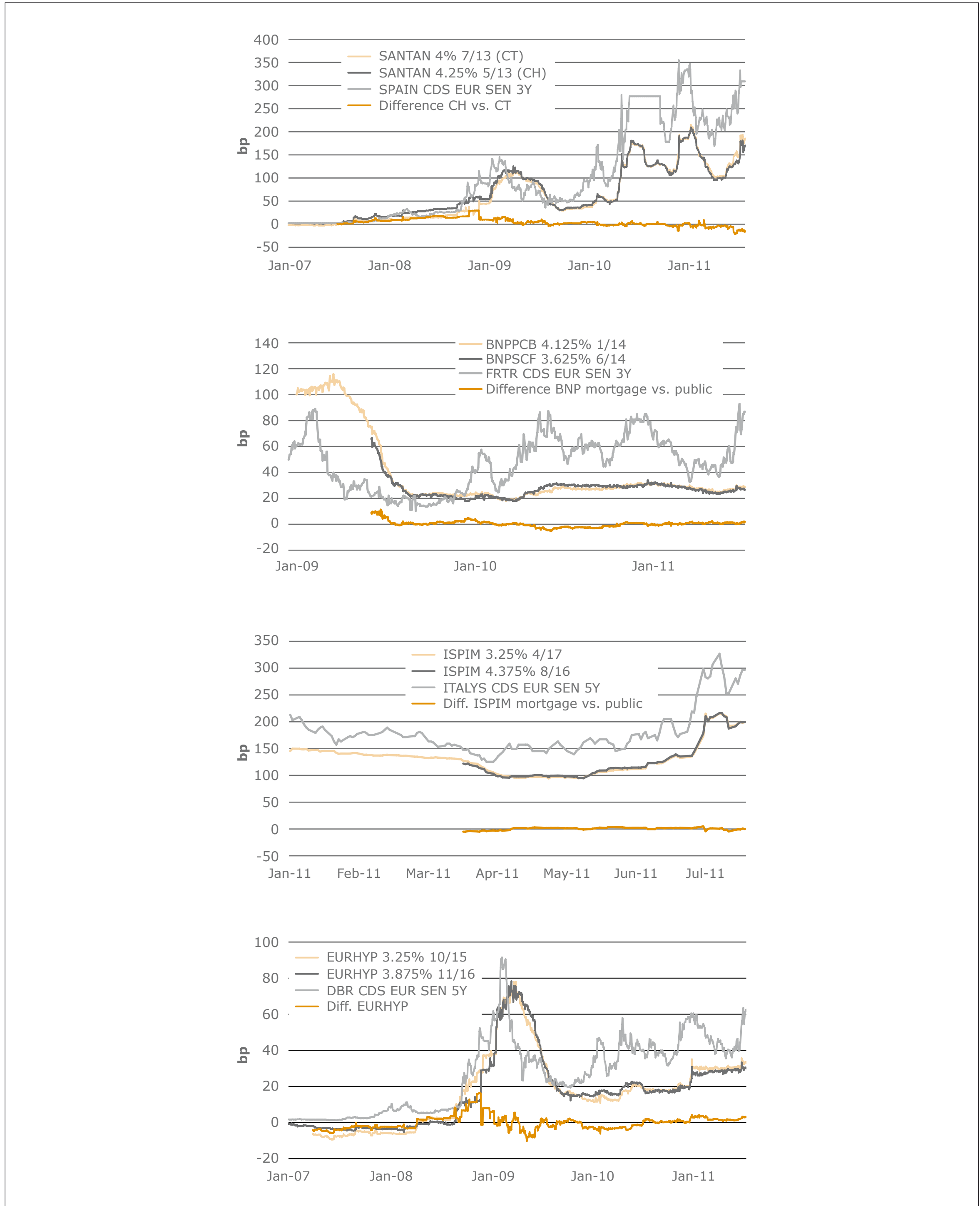
> Figure 1: Development of covered bonds by underlying collateral



THE "GOING CONCERN CASE"

Does the underlying collateral of mortgage covered bonds in comparison to public sector covered bonds make a difference? In a scenario where the issuer is still solvent, the answer is clearly no. For example, we compared the respective covered bonds of different jurisdictions and names, namely Santander, BNP, Intesa, and Eurohypo (see charts below). The reason for the definite no is that the credit quality of the issuer, its business model and the respective sovereign are the key spread drivers and the different underlying collateral makes no difference as long as the issuer remains solvent – at least that seems to be what the market prices in. Even the regional composition does not make any difference. While the regional exposure in the case of public collateral of Santander and Intesa is solely domestic (for both mortgage and public collateral), the regional mix in the case of BNP and Eurohypo is more diversified (BNP public: France 29%, BNP mortgage: 100%; Eurohypo public: Germany 73%, Eurohypo mortgage: Germany 69%).

> Figure 2: Mortgage vs. public sector covered bonds



However, what do things look like if we discuss a worse-case or a worst-case scenario? A worse case scenario would be the default of an institution while the resident sovereign is still solvent, while the worst case is the default of an issuer alongside or triggered by a sovereign default.

In both the worse and the worst case, there are two elements of doom: first, the write-down of collateral assets in particular in a scenario of a troubled sovereign leading to over-indebtedness or looming over-indebtedness, which would therefore trigger a default of the cover pool. Second, the risk of cover assets being sufficiently large but not liquid enough and therefore triggering a default due to illiquidity.

THE "WORSE CASE"

The primary source of trouble in what we call the "worse case" is actually looming illiquidity. The chance of a sudden devaluation of public collateral hardly exist as collateral is mostly valuated in nominal terms. Since we assume the sovereign to be troubled but not in default, potential net present-value calculations are also resilient against market price deterioration of public sector collateral since future cash flows are discounted by using the swap curve. Stresses to these Net Present Value (NPV) calculations are also only based on interest rate moves rather than market valua-tions.

Against this backdrop, the most threatening factor for stand-alone cover pool management is liquidity gaps and the question as to which instruments are available to overcome these gaps. In the following we discuss the entire set of instruments that are available throughout various jurisdictions. Whether in a specific country a specific instrument stipulated and therefore available has to be analyzed in a case by case study. However, for the time being, in our "worse case scenario" it is reasonable to assume that the largest part of the spectrum of possibilities for raising liquidity is still available: selling the entire pool or parts of the pool to another bank, taking on new debt (in a direct or in an indirect way), or raising liquidity by means of central bank operations. Hence, in order to discuss the relative strength of public sector covered bonds vs. mortgage covered bonds in such a scenario, one has to discuss the applicability of the respective collateral to the various instruments.

Certainly, mortgage loans can be sold – both en bloc and on a single loan basis. The disadvantage in trading mortgage loans vs. trading public sector debt, however, is, first, that trading public sector debt is less complicated since there is no complex land register procedure associated with it. Second, public sector debt can be traded across borders without much fuss while selling mortgage loans abroad is close to being a "mission impossible". In the past, we have seen attempts to sell mortgage loans abroad – even within the same groups of banks – but with extraordinarily little success. Hence, from a purely practical point of view, public collateral is certainly easier and therefore quicker to trade than mortgage collateral – and time is a vital factor when raising liquidity against a static cover pool in a post-insolvency scenario. In the particular case of a troubled but still solvent sovereign, a problem is likely to arise from the fact that when disposing of public collateral, the market value is likely to be below the book value and therefore the cover pool administrator or the respective entity in charge would have to realize a potentially fatal loss – a loss that is larger the more troubled the sovereign is. The loss incurred in disposing collateral of a mortgage covered bond of the same issuer might quite easily be smaller – in particular in countries with a highly indebted sovereign in combination with a low-leveraged private sector. Hence, in the "disposal discussion", we see two opposing effects: a higher degree of tradability and a larger number of potential buyers for public sector debt vs. a theoretically more stable private sector. However, we already indicated that selling parts of the pool is not necessarily the only option for raising liquidity against the static pool. Some covered bond systems safeguard central bank access for the cover pool also in a post-insolvency

scenario. The most critical aspect regarding the question of central bank access is whether the stand-alone cover pool continues to have a banking license or not after the default of the issuing bank. In order to give two examples, the UK typical for where the stand-alone cover pool has no banking license, while e.g. the banking license of a German cover pool would not be affected by the default of the issuer. However, provided there is central bank access after a segregation event, one has to judge which assets are eligible for ECB open market operations. According to the eurosystem documentation (the basis for general central bank operations in Europe), public sector debt is largely eligible for central bank operations. This stands in harsh contrast to the ineligibility of residential mortgage debt. Investors sometimes tend to be a bit afraid of commercial mortgage debt as collateral for covered bonds. However, under certain conditions, commercial mortgages are ECB-eligible. This means that, while one could argue that the score is tied between mortgage and public collateral in raising liquidity by selling assets, the discipline of raising liquidity by accessing the central bank is dominated by public collateral. In this discussion we can leave aside the option of new issuance of debt since if this option exists, it exists equally for both mortgage and public collateral. Therefore no collateral type has a specific advantage in this respect. All in all, it appears that in the case of a bank default in the scenario of a sol-vent but troubled sovereign, the likelihood of default is still lower for public sector covered bonds as compared to mortgage backed covered bonds.

So how about the second element of expected loss – loss due to the default of the cover pool? In most countries the consequence of a default of the stand-alone cover pool is a bondholders' meeting. Hence, a prediction of this decision is hardly possible. In fact, this could be anything between a fire-sale and a kind of transformation into a pass-through structure. The least painful measure under the assumed scenario is most likely an agreement to distribute the cash flow from the cover assets as they arrive, which is what we mean by a transformation into a quasi pass-through structure. Since in the "worse case" scenario we do not assume a sovereign default, and given the fact that the average term to maturity of public sector debt is usually much shorter than the average maturity of mortgage loans, public sector Covered Bond investors are likely to achieve recoveries much quicker. Hence, an investor in public covered bonds might be marginally better off than an investor in mortgage covered bonds of the same issuer.

THE "WORST CASE"

Indeed, the move from the "worse case" to the "worst case" is only a small step – but with significant consequences. A simultaneous default of issuer and resident sovereign or a sovereign-default triggered default of an issuer is generally understood as the complete meltdown: if the resident sovereign is in default, it is quite likely that the largest part of sub-sovereign entities (and therefore usually the largest part of the collateral of public covered bonds) are also affected. In such a scenario one has to understand that covered bonds are able to survive singular credit events but will struggle to sustain the end of all financial days in a specific country. The mechanisms mentioned above are largely turned upside down: regarding the disposal of collateral in order to get enough liquidity, it will be hard or even impossible to find another solvent financial institution within that country willing or even able to take on more mortgage assets. In particular, not at a discount small enough to allow the stand-alone cover pool to sustain. On the other hand, given the sovereign has defaulted, it will also be quite a challenge to find other bank or non-bank institutions abroad to take on large amounts of bad public debt. A small chance might remain for issuers that run public covered pools consisting not only of residential public sector assets but a certain international diversification. The situation regarding raising liquidity by central bank operations is also quite limited due to the bad condition of most of the debt. Again internationally diversified cover pools might provide a small straw to hold on to. In any case, we hardly see a chance for a covered bond issuer

to survive such a scenario and a subsequent default of the cover pool seems inevitable – irrespective of what type of collateral is posted.

In other words, this means that in the case of a complete meltdown scenario, the question of relative advantage of mortgage vs. public covered bonds of the same issuer is decided by the estimated recovery values of the respective collateral portfolios. Against this backdrop it appears reasonable to assume a higher default correlation between the sovereign and sub-sovereign entities in comparison to the default correlation of the sovereign with the average mortgage debtor in a specific country – despite the fact that mortgage default rates are likely to rise sharply due to an over-all slump in the economy and higher unemployment rates. Hence, default rates in the cover pool of mortgage covered bonds are likely to be below the rates in a respective collateral pool of public covered bonds. Last but not least, any discussion of potential recovery rates on the defaulted parts of the respective cover pool belongs absolutely in the realm of speculation. However, mortgage loans themselves are also typically overcollateralized by real estate, while public sector debt is unsecured. Thus, in the case of a meltdown scenario, we see a second element that would speak rather in favor of a lower loss from the default of a mortgage cover pool in comparison to a public cover pool.

IN A NUTSHELL

Covered bonds are built to survive single credit events. Following an issuer default in an otherwise more or less functioning market, the range of actions available to avoid a covered bond default is certainly much broader in case of a public sector covered bonds as compared to mortgages. Public assets are more liquid since they can be sold quite easily, both to a domestic and a foreign counterpart. In addition, they can also be used as collateral in central bank operations. Furthermore, with respect to recoveries in case of a default due to illiquidity, public sector covered bonds are in a favorable position. However, the events of the past few months and years have indeed included elements of a partial of full-fledged sovereign default. A sovereign default of any kind might easily result in a meltdown scenario, in turn affecting the broad mass of domestically operating banks as well as large parts of public sector covered bond collateral. In such a case, the additional "OC layer" – the first one being total assets vs. total covered bonds and the second being value of the real estate vs. loan size – is likely to constitute the game winner for mortgage covered bonds.

1.6 COVERED BONDS VS SENIOR UNSECURED BANK DEBT

By Frank Will, RBS

Over the last two 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 gaps between covered bonds and senior unsecured have tightened to the lowest level since 2006 (see chart below). As of July 2011 the iboxx EUR Senior Unsecured Bank Debt index trades even inside of the Covered Bond index and the chart shows that we have not seen negative swap spread differentials in past. 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 at 3.8 and 4.1 years, respectively, as of end-July 2011), we believe that this current market anomaly creates attractive switch opportunities.

> Swap Spread EUR Indices for Senior Unsecured Bank Debt and Covered Bonds

Source: 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.

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 have been 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 in the past. 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 of a senior unsecured into covered bond switch. As highlighted in the table, both assets 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 debt 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 and thirdly the favourable regulatory treatment both for bank treasuries and insurance companies. The latter aspect is discussed in detail below.

> 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 rating than unsecured debt > 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 (under new ECB repo rules, even wider haircut gap between covered bonds and senior unsecured bank bonds) > eligible as liquid assets under upcoming Basel III rules (though with 15% haircut) > no risk of bailing-in > upcoming GGB redemptions likely to be reinvested in SSA debt or highly rated covered bonds	> 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-an-hold investors)

Source: RBS

ECB REPO HAIRCUTS

As part of its open market operations, the European Central Bank (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 ECB applies different valuation haircut for covered bonds and senior unsecured debt. 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 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.

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.

> ECB Haircuts by Liquidity Category and Residual Maturity

Credit Quality Steps 1 and 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 the Reserve Bank of New Zealand, Danmarks Nationalbank, and Norges Bank also favour covered bonds. In Norway, senior unsecured debt will no longer be eligible as collateral for repos from February 2012, 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 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 Liquidity Coverage Ratio (LCR) will be introduced at the beginning 2015. However, the observation period already starts in 2011 and the Committee 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 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 2013. 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 has shown that all these risk types can pose a material threat 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. The table below outlines the risk factors for vanilla bonds below. 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 of 0.6% compared to 0.9% for senior unsecured and corporate bonds with the same rating assuming lower losses in a shock scenario (see below).

> TABLE: SPREAD RISK FACTORS BY ASSET CLASS

	EEA Government Debt**	Non-EEA Government Debt**	Vanilla Corporate & Financials Bonds	AAA rated UCITS Covered Bonds*
AAA	0%	0%	0.9%	0.6%
AA	0%	0%	1.1%	n/a
A	0%	1.1%	1.4%	n/a
BBB	0%	1.4%	2.5%	n/a
BB	0%	2.5%	4.5%	n/a
B or lower	0%	4.5%	7.5%	n/a
Unrated	0%	3.0%	3.0%	n/a

* for covered bonds rated below AAA the vanilla corporate & financials bond risk factors apply

** issued in domestic currency

Source: European Commission, RBS

Under the concentration sub risk module, there are additional charges for high exposures to individual counterparties. Covered bonds meeting the requirements of Article 52(4) of UCITS directive and rated AA or better are subject to a higher concentration threshold of 15% compared to 3% in case of senior unsecured bank debt and 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 paper 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".

- EU

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 a bank, transferring assets and liabilities to another (bridge) bank, and writing down of debt (and/or its conversion to equity) of a failing bank. The Commission emphasised that, in contrast to the German restructuring law, potential writedowns of debt "would not apply to existing bank debt currently in issue". Moreover, covered bonds and certain short-term debt will be excluded from the write-downs. The unsecured debt issued after the implementation of the new resolution regime will include a clause to recognise the broader statutory powers. The Commission is seeking a "fair burden sharing" which avoids use of taxpayer funds. This might include writing down "appropriate classes of the debt of a failing bank to ensure that its creditors bear losses". However, debt write downs would only apply when the standard resolution tools such as the transfer of business to another (bridge) bank, or a 'good bank / bad bank' split are not options due to the nature of the failing bank ('too big to fail'), or because the other tools were insufficient.

To ensure proper functioning of credit markets, the Commission is currently considering that the following instruments would be excluded from write-downs: swap, repo and derivatives counterparties and other trade creditors; short-term debt (defined by a specified maximum maturity); retail and wholesale deposits and secured debt (including covered bonds)

- 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.

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.

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.

- 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 emphasise that cover 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.

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 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 an 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 can retain the bonds to use them for repo transactions with central banks such as the ECB.

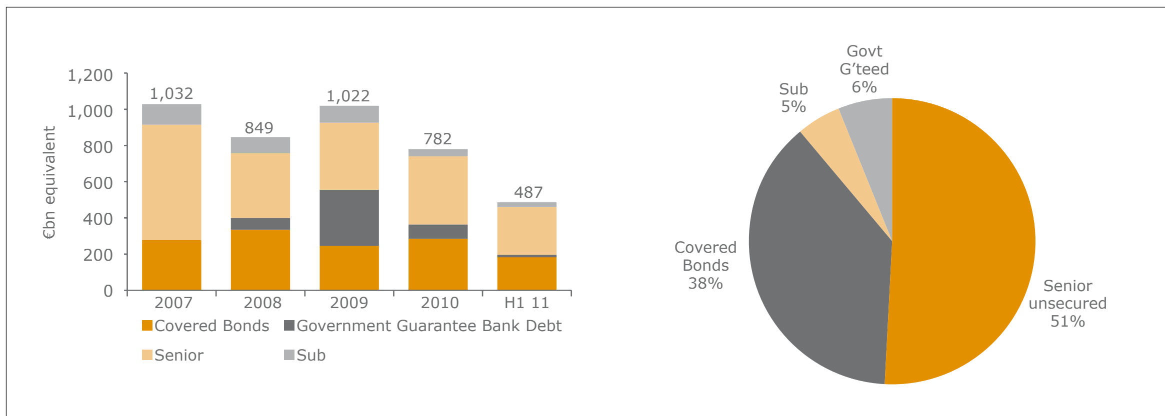
In addition, the potential issue volume of covered bonds is not unlimited. The available eligible assets are a restricting factor for covered bond issuance putting a cap on the actual issue volumes. Also the aforementioned rating agencies' requirements of high over-collateralisation levels further reduce the available headroom for covered bond issuance.

The charts below show that senior unsecured funding still represents more than 50% of European banks' funding. In the period of 2010 to H1 2011, based on Dealogic figures, covered bonds made up 38% of total issuance of European financial institutions (excluding securitisation and short-term funding) compared with 51% of senior unsecured funding and 11% of sub debt and government guaranteed funding.

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 are visibly 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.

> Issuance by European Banks since 2007

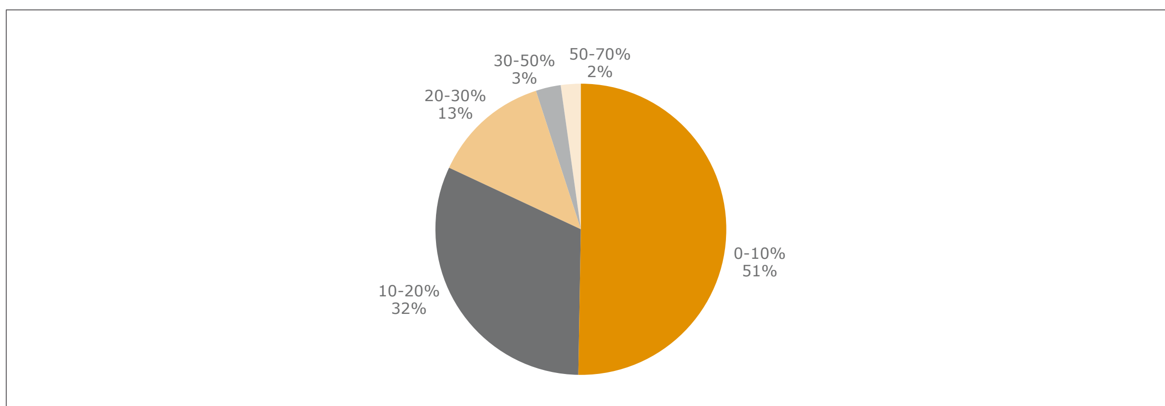
Issuance by European Banks in 2010/H1 2011



Source: dealogic, RBS (excluding short-term debt and securitisation)

Fitch's covered bond study of March 2011 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%. Less than 1 in 5 issuers has a funding reliance of more than 20%. These are almost exclusively specialised mortgage banks.

> Cover Bond Funding Reliance of Issuer



Source: Fitch, RBS (by number of issuers over the 120 CB issuers rated by Fitch; funding reliance is defined as outstanding covered bonds in % of total assets)

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

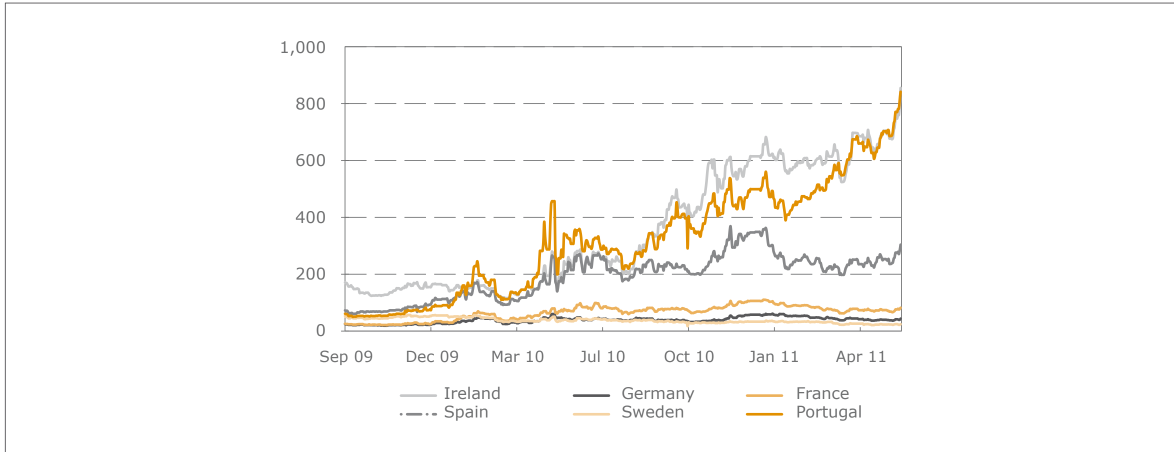
Capital Requirements Directive (CRD), the lower ECB repo haircuts and the prospect of covered bonds qualifying as liquid assets under the upcoming Basel liquid buffer rules. Insurance companies as well would benefit from investing into covered bonds as these instruments will receive a favourable treatment 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.

1.7 COVERED BOND PRICING FACTORS

By José Sarafana, Société Générale

Covered bond spreads have been heavily impacted by sovereigns. Wide sovereign spreads automatically lead to wide covered bond spreads as can be seen in the following graphs. Our impression is that many risk departments set limits by country and then decide which asset class to invest in, whether covered or sovereign.

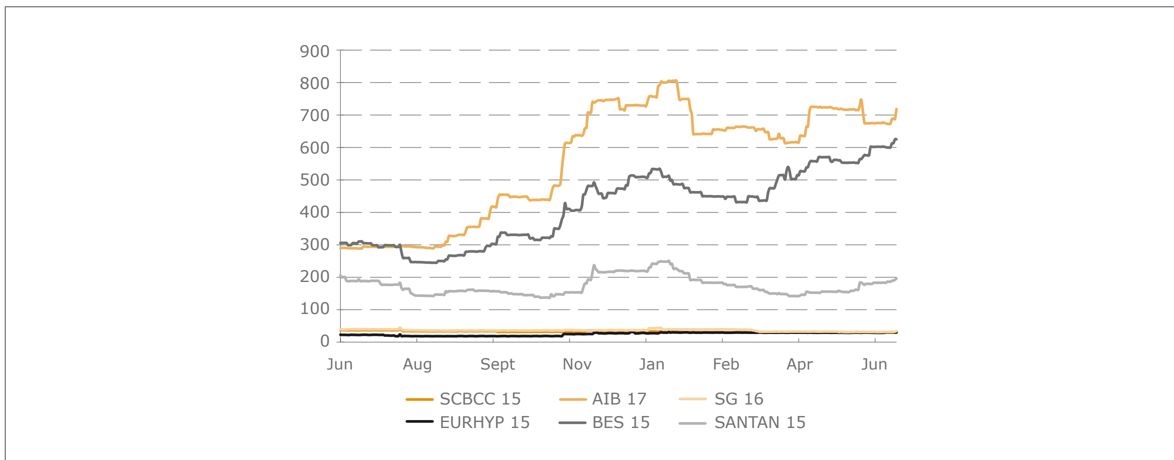
> Figure 1: Sovereign CDS, bp



Source: SG Cross Asset Research

The second step then is to decide in which credit institution to invest. For example, Irish senior unsecured AIB CDS is trading wider than Portuguese BES. A similar picture can be observed in the graph below which shows covered bond spreads. We observe the same pattern for Banco Santander whose bank CDS trades relatively tight compared to Spanish CDS, as does its covered bond.

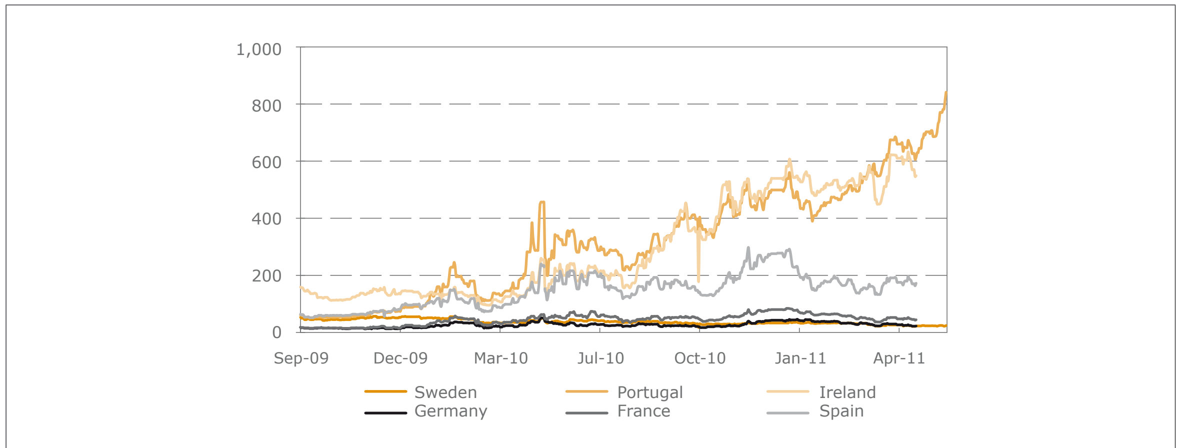
> Figure 2: Bank CDS, bp



Source: SG Cross Asset Research

Covered bond specifics do not seem to count much, given that we consider the Portuguese covered bond law as one of the safest. Portugal did not have a real estate crisis because prices did not rise strongly.

> FIGURE 3: COVERED BOND SPREADS ASW, BP



Source: SG Cross Asset Research

Covered bonds in the peripheral markets follow sovereign bond moves more slowly as they are less liquid. There are several explanations for this:

1) Market makers take sovereign bonds as a proxy to determine where covereds should trade.

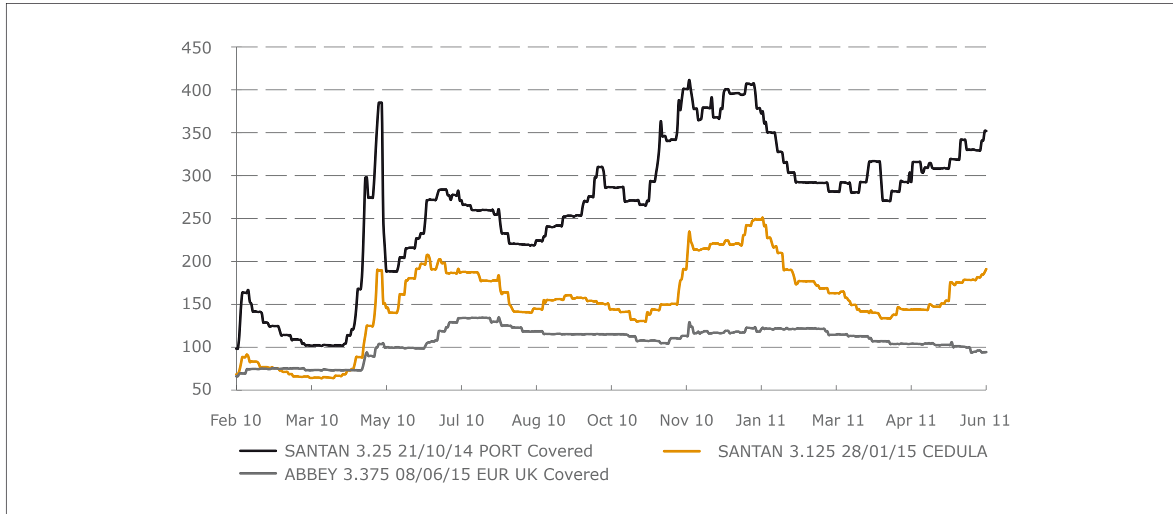
2) Some investors see sovereign bonds as a safer instrument than covered bonds. Should the state have problems, it can increase taxes, even on banks.

3) On the other hand, it could be argued that covered bonds offer less risk of restructuring given the double recourse to banks and the cover pool.

Spreads in core markets such as Germany, France, the Netherlands and the Nordics remain stable as usual. This is a striking contrast and underlines that sovereign risk is the main mover currently in the covered bond world.

Also the following graph underlines the importance of sovereign in covered bond pricing.

> FIGURE 4: COVERED BOND SPREADS ASW, BP

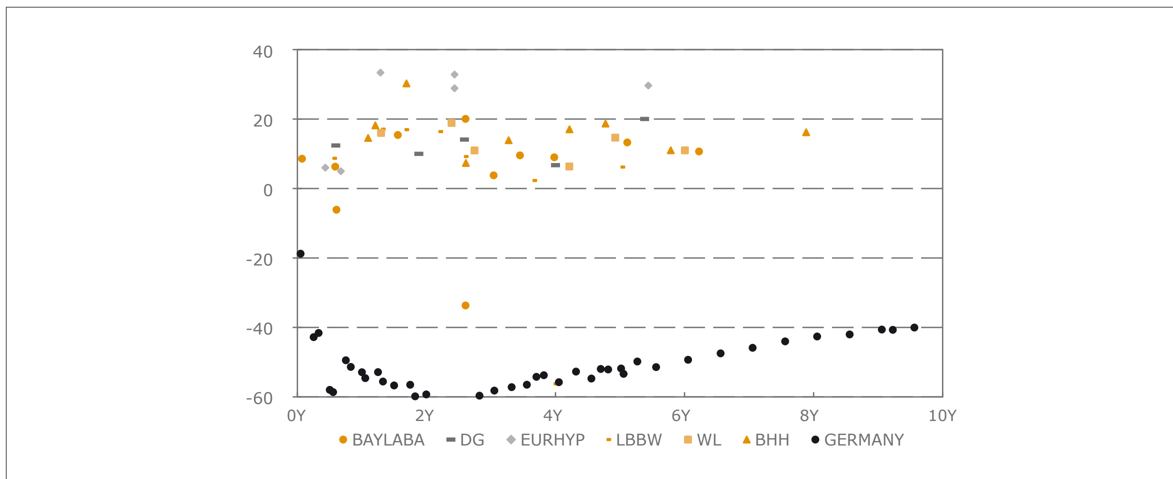


Source: SG Cross Asset Research

Santander group has issued covered bonds under three jurisdictions. Its Portuguese covered bond (black) is trading the widest, in the middle is the Spanish Cédula and the tightest trading is Abbey UK covered bonds. From a pure credit risk point of view, all three covered bonds should trade at similar levels. The only explanation of the enormous spread differences is the impact of sovereign risk which remains the main pricing factor for covered bonds.

Covered bonds mostly trade with a pick up over their respective sovereign. This classical behaviour can be observed in Germany in graph 6. One reason is higher liquidity of sovereign bonds vs covered bonds.

> FIGURE 5: GERMAN COVERED BONDS VS RESPECTIVE SOVEREIGN

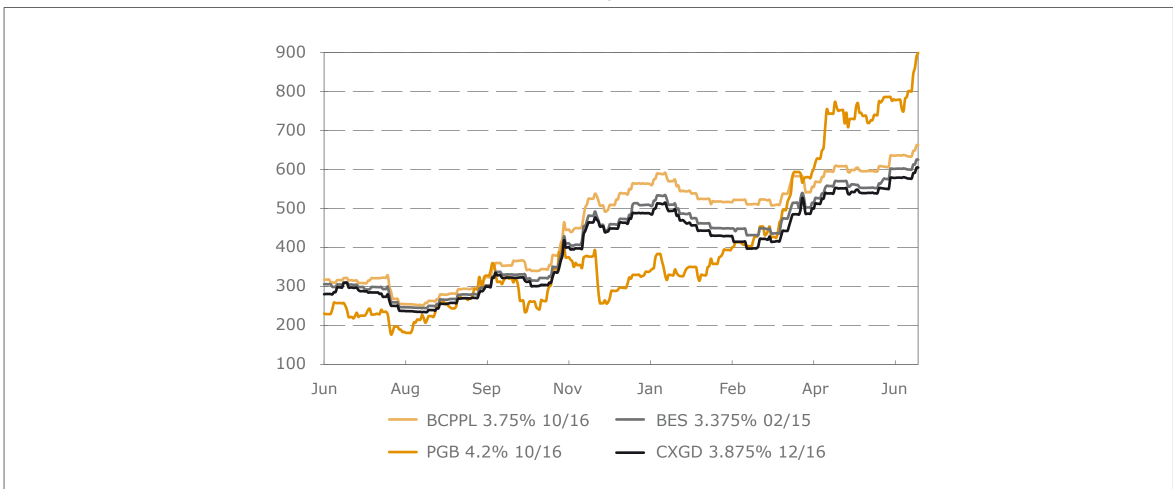


Source: SG Cross Asset Research

What is interesting to note is that in the case of stress, covered bonds trade richer than the respective sovereign bonds. This is similar in Ireland, Portugal and Greece. This makes perfect sense to us given the double recourse structure of covered bonds. Imposing a haircut is extremely difficult.

For example, if a haircut were to be imposed on Greek sovereign and banks alike, all interests of covered bond investors (there is only one from National Bank of Greece sold to the public) must be satisfied by the cover pool. It is backed by individual mortgages which perform.

> Figure 6: Portuguese covered bonds vs sovereign spread, z-spread bp



Source: SG Cross Asset Research

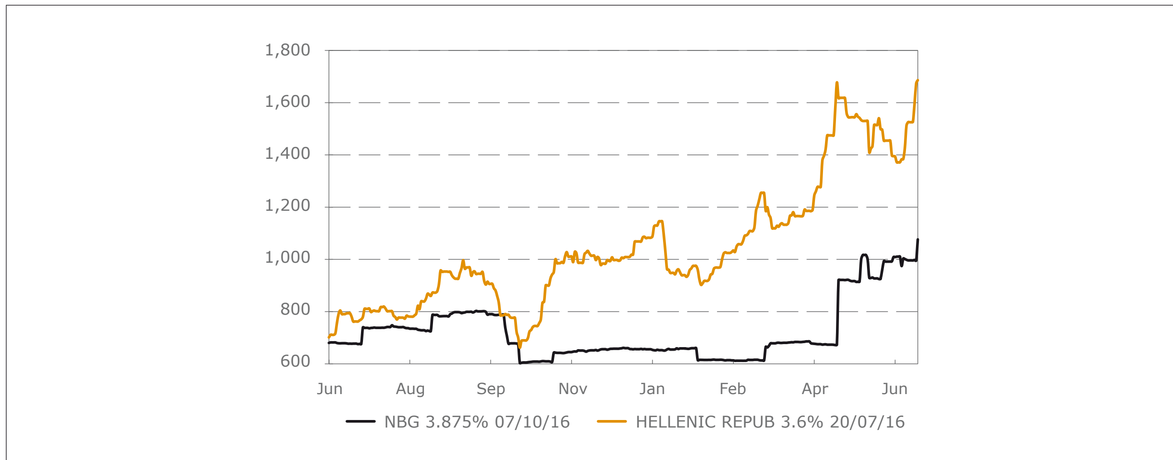
The better performance of peripheral covered bonds against respective sovereign and senior debt reflects:

1) less liquidity in peripheral covered bonds, and

2) less fear of restructuring.

We think the latter is nearly impossible due to the double recourse structure. The only way to make covered bond investors share losses is to ride a horse and carriage through covered bond laws. That would be very hard indeed. So in times of stress, covered bonds continue to prove somewhat safer than sovereign bonds.

> FIGURE 7: GREEK COVERED BOND VS THE RESPECTIVE SOVEREIGN, Z-SPREAD BP



Source: SG Cross Asset Research

Covered bonds are however not completely immune from headline risk. The covered bond rating is linked to the senior unsecured rating of the bank, which itself is often impacted by the sovereign risk as well. This was the case for the rating of the covered bond from the National Bank of Greece, which was lowered from Aaa by Moody's in 2009 to Ba3 today.

Covered bonds vs Senior unsecured

While in the primary market there is substantial interaction between the supply of senior and covered bonds, for pricing in the secondary market this is not the case. For example, sovereign spreads are one of the main input factors for pricing covered bonds, while for senior this is much less the case. Senior bank debt pricing on the other hand interacts with other segments of the credit market such as automotives and utilities.

As both asset classes still move mostly independently of each other, questionable pricings are the result.

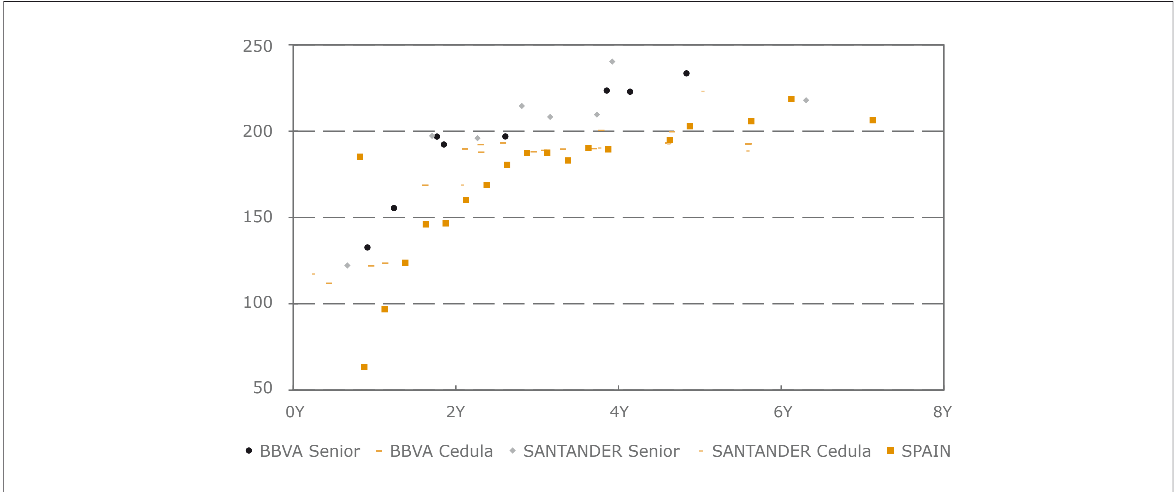
For example, BBVA senior and covered bonds trade on similar levels on the 3-year segment of the curve, while the same is true for Santander bonds in the 4-year segment of the curve.

Such findings are not limited to the Spanish market. In France, BNP senior and covered trade with a single-digit difference in spread in the 2-5 year segment of the curve.

We believe such close spreads between the two asset classes will correct in the long run. Firstly, the banks concerned will be tempted to issue more senior than covered so shifting supply patterns. Secondly as more credit investors enter the covered bond markets and they look at both asset classes, these spreads will be arbitraged out. Covered bonds will perform.

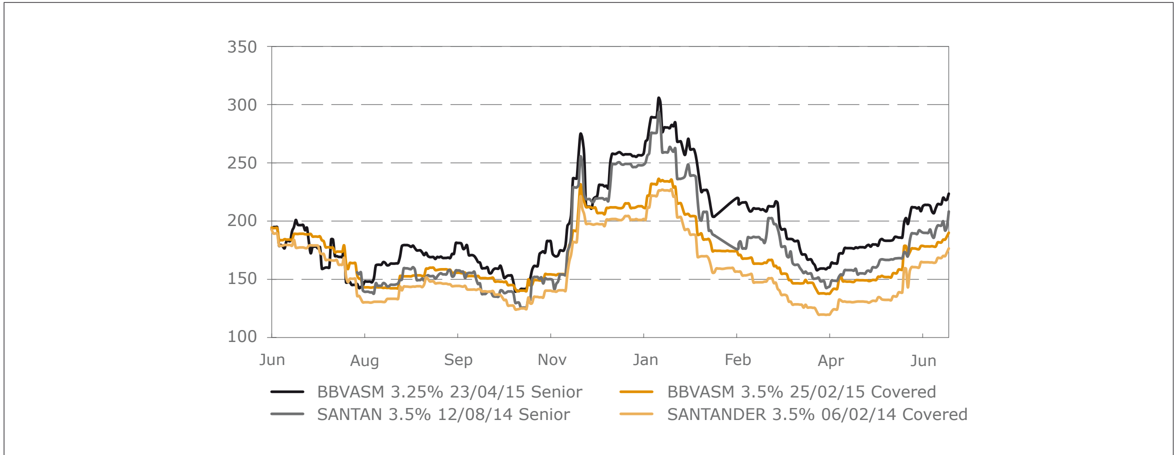
Public statements from some issuers have set the breakeven between covered bond and senior funding at a spread difference of 30-40bp in a 5-year maturity. We also see this as a fair value similar to what can be seen in Graph 11 for Swedish paper.

> Figure 8: Spanish senior vs covered and respective sovereign. Z-spread bp



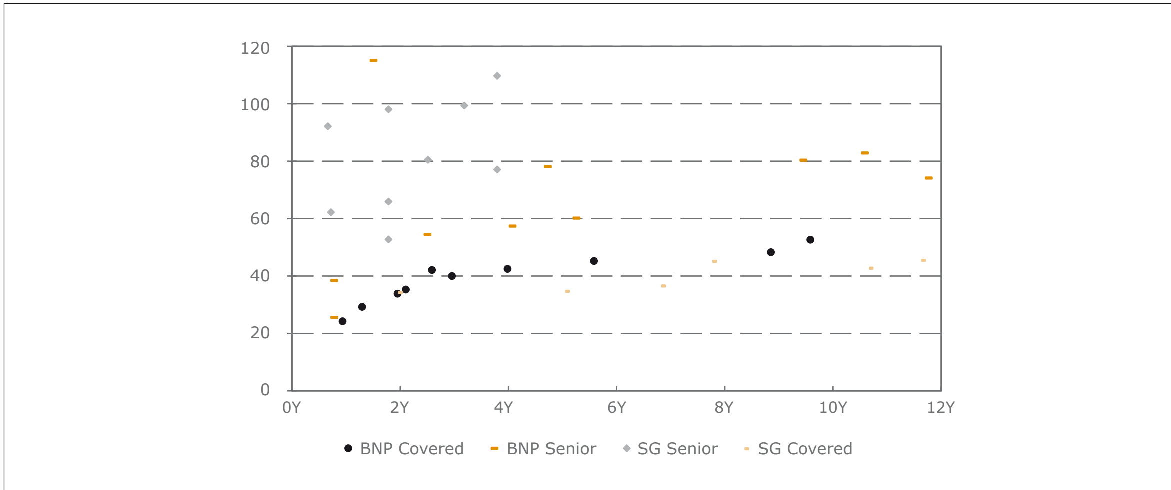
Source: SG Cross Asset Research

> Figure 9: Spanish senior vs covered and respective sovereign. Z-spread bp



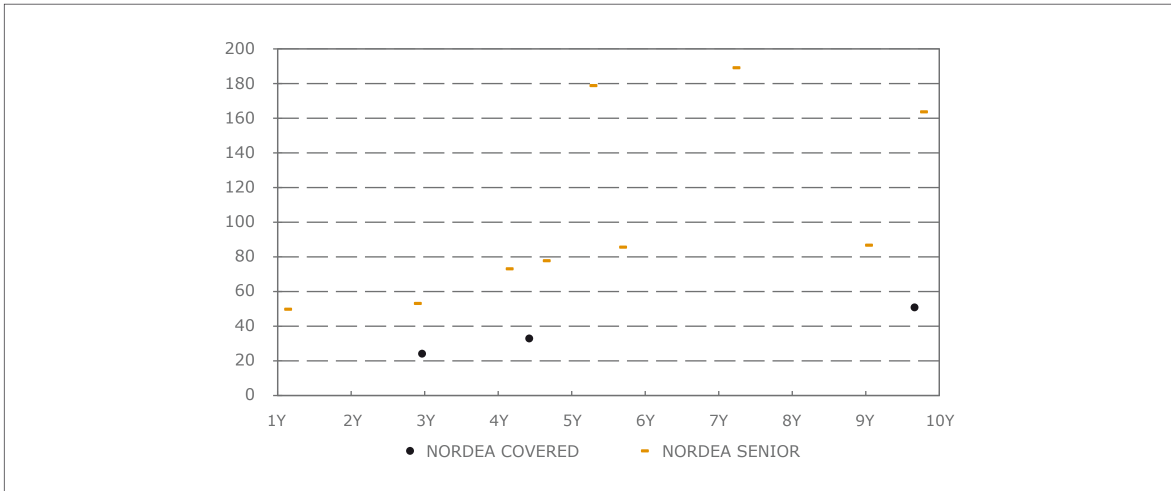
Source: SG Cross Asset Research

> FIGURE 10: FRENCH SENIOR VS COVERED Z-SPREAD, BP



Source: SG Cross Asset Research

> FIGURE 11: SWEDISH SENIOR VS COVERED AND RESPECTIVE SOVEREIGN



Source: SG Cross Asset Research

1.8 COVERED BONDS AND ASSET ENCUMBRANCE

By John Kiff, Jay Surti, International Monetary Fund
and Andreas (Andy) Jobst, Bermuda Monetary Authority[1]

Covered bond funding brings considerable benefits to investors and banks, but public policy should balance these benefits against the potential impact on issuer balance sheets and on the efficacy of bank failure resolution frameworks and deposit guaranty schemes.

Since 2009, covered bonds have come to the fore as one of the main sources of bank capital market funding, with 2010 issuance coming in close to the 2006-07 pre-crisis peaks, and 2011 European volumes looking substantially stronger with a half-on-half increase of over 25 percent compared to the previous year.[2] Furthermore, covered bond legislative frameworks are being either proposed or updated in Australia, Canada, South Korea, the United Kingdom, and the United States. Emerging market economies, such as Brazil and South Africa, are also considering adopting covered bond laws.

> Covered Bond Legislation in Selected Countries

Country	Year of Introduction/Amendment	Encumbrance Limit
Australia	Draft legislation introduced in 2011	Yes
Canada	2007 (amendments introduced in 2011)	No[3]
Denmark	1795 (amended in 2007)	No
France	1999	No
Germany	1769 (amended in 2005 and revised in 2010)	No
Italy	2005	Yes
Netherlands	2008	Case-by-case
South Korea	2009	No
Spain	2003	No
Turkey	2007	No
United Kingdom	2008 (amendments introduced in 2011)	Case-by-case
United States	Draft legislation introduced in 2011	No[4]

Over the recent past, there appears to have been a switch in banks' non-deposit funding away from senior unsecured debt towards covered bonds with European senior bond issuance decreasing by 11 percent in the first half of 2011 relative to a year earlier, at the same time that covered bond issuance rose by 19 percent.[5] This development is largely owed to the relatively lower cost and availability of

1 The views expressed in this article are those of the authors and should not be attributed to the IMF, its Executive Board or its management, or to the BMA.

2 Volk, Bernd, 2011, "EUR Liquid Credit Weekly," Deutsche Bank Global Fixed Income Markets Research, July 7.

3 Canada's banking regulator limits a deposit taking institution's covered bond issuance to four percent of total assets, but there is no issuance limit in the proposed covered bond legislative framework published in May 2011.

4 The U.S. Federal Deposit Insurance Corporation effectively limits insured banks' covered bond issuance to four percent of total liabilities, but there is no issuance limit in the proposed covered bond legislative framework introduced by Congressman Scott Garrett (R-NJ) on March 8, 2011 that is making its way through Congress.

5 Volk, Bernd, 2011, "EUR Liquid Credit Weekly," Deutsche Bank Global Fixed Income Markets Research, July 1.

covered bond funding amid greater demand from insurance companies and pension funds.[6] Positive investor perceptions regarding these on-balance sheet obligations, which provide dual recourse to the issuing banks, and, if the banks default, preferential access to a pool of high-quality assets, was also shaped by the official support to the covered bond market during the financial crisis. For example, the European Central Bank actively supported the market from June 2009 to June 2010 with its EUR 60 bn Covered Bond Purchase Program. Some bank bailouts in Germany during the credit crisis involved large covered bond issuers,[7] leading to perceptions that the German authorities are prepared to offer systemic support to the Pfandbrief brand.[8]

A confluence of regulatory developments—actual and potential—in the wake of financial crisis reflect the importance of diversified funding sources and supported the recent surge in issuance. Covered bonds rated "AA-/Aa3" or higher will be allowed to count towards the liquidity coverage ratio under the proposed Basel III liquidity requirements while securitizations are currently excluded. Also, Solvency II assigns a lower solvency charge for covered bonds compared to other non-government assets. Furthermore, covered bonds will likely be exempted from resolution-related "bail-in" initiatives that will subject unsecured senior debt of failed banks to forced write-downs or conversion into equity.[9]

From a policy perspective, however, an assessment of the salience in covered bonds' rise to post-crisis prominence must consider asset encumbrance. In particular, there are concerns over the associated structural subordination of unsecured bank creditors once a significant proportion of assets is pledged to support covered bonds, increasing uncertainties regarding the evaluation and potential liquidation of collateral in insolvency situations as a result. Surging issuance may amplify the impact of such structural subordination, especially if higher over-collateralization is required to maintain the bonds' high credit ratings.

THE CONSEQUENCES OF ASSET ENCUMBRANCE

Even though a higher share of covered bonds in issuers' funding mix could reduce default probabilities, and, thus, lower funding costs, the implied structural subordination resulting from sizable encumbrance of high-quality assets is prejudicial to unsecured creditors' interest by reducing the debt recovery value of residual assets to support their credit claims.[10] In this regard, depositors and deposit insurers will have a smaller pool of unencumbered and possibly lower quality assets to fall back on in the event of a default

6 If the reference asset portfolio fails to generate sufficient cash flows, or if its market value drops below the notional value of the issued securities, covered bond investors have an unsecured senior claim on the bankruptcy estate of the issuer. The only covered bond issuer bankruptcy was in 1883 – the Austrian issuer *Böhmische Bodencredit*. In that case, the failed bank's covered bond obligations were transferred to another bank two years later, interest payments were reduced, and the bonds redeemed in full in 1901 (Engelhard, Fritz, and Michaela Seimen, 2010, "The AAA Investor," Barclays Capital AAA Research, November 11.). See also Engelhard, Fritz, Harju, Jussi, and Michaela Seimen, 2011, "The AAA Investor," Barclays Capital AAA Research, June 11.

7 However, these bailouts were not related to funding problems caused by covered bonds but large investment losses from cross-border exposures.

8 The banks in question included *Allgemeine Hypothekenbank Rheinboden AG* (October 2005), *Düsseldorfer Hypothekenbank* (April 2008), *Hypo Real Estate* (October 2008), and *EuroHypo AG* (May 2009). For example, in the case of Hypo Real Estate, the covered bonds were seen as being sufficiently collateralized, but there were questions regarding the ability to liquidate it in the wake of the Lehman Brothers bankruptcy (Wookey, Jethro, 2008, "After 200 Years, It's Come to This," *Euromoney*, November).

9 Under the European Union's bank resolution proposal "resolution authorities could be given a statutory power, exercisable in conjunction with the core power when an institution meets the trigger conditions for entry into resolution, to write down by a discretionary amount or convert to an equity claim, all senior debt deemed necessary to ensure the credit institution is returned to solvency".

10 Winkler, Sabine, Cook, Caspar, Thomas, Richard and Alexander Batchvarov, 2011, "Asset Encumbrance and Structural Subordination," Covered Bonds Report, Bank of America Merrill Lynch, February 11. They find that there is a non-linear negative relation between asset encumbrance and recovery rates, which depends on the quality of cover pool assets.

depending on adverse asset selections. Furthermore, to the extent that covered bond funding replaces unsecured funding, the effectiveness of bank failure resolution frameworks will be adversely impacted.

In addition, there could be a negative feedback effect on the issuance costs of both funding vehicles, because covered bond spreads are generally anchored to those on issuers' senior unsecured obligations (see Box). All else equal, a larger share of covered bonds in the funding structure increases the loss-given-issuer default to unsecured senior creditors due to the smaller set of residual assets available outside the cover pool to meet their claims. Lower recovery rates on unsecured senior unsecured debt could in turn increase the relative funding cost of this instrument and result in still heavier reliance on covered bonds, whose privileged position (regarding the seizure and foreclosure of collateral assets) only further weakens unsecured debt credit strength and so on.

Although a number of policy options are being considered or have been adopted in order to deal effectively with these risks there is considerable heterogeneity across jurisdictions in addressing them. In some countries, covered bond legislation imposes a special law principle and/or regulatory caps on issuance with a view towards protecting (retail) depositors and/or representing the interests of (retail) depositors. While the majority of EU countries—particularly those with established covered bond markets (France, Germany)—have eschewed use of this option, some countries have adopted (Canada, Greece, Italy, the Netherlands, Spain, U.K.) or are considering adopting (Australia, New Zealand, United States) these as part of their statutory frameworks.[11] Moreover, requiring banks to regularly disclose asset encumbrance details such as amounts and overcollateralization, including that relating to dedicated subsidiaries, has ranked high on the agenda of policy-makers.[12]

Overall, considering the feedback effects from higher asset encumbrance on on-balance sheet assets, covered bond issuance caps can benefit both covered bond holders and unsecured creditors. These limits can serve to preserve the economic value of full recourse to covered bond investors in the event of issuer insolvency. Also, they reduce the risk of rising cover pool dilution if covered bond issuance increases faster than total liabilities (as a smaller pool of assets is available to meet unsecured credit claims) and/or unencumbered assets on the balance sheet decline in credit quality.

On the other hand, authorities ought to be cognizant that banks and investors will innovate around such limits should there be adequate economic incentives to do so. Ultimately, the balance between the risk and benefits associated with increased covered bond issuance will depend on the dynamic interaction of the issuer's business profile with prevailing funding conditions and its implications for the contingent claims of creditors. Nevertheless, in countries where covered bonds have attained enough systemic importance as a funding instrument that the market has become too big to fail, authorities may want to consider measures that credibly reduce or contain such perceptions.

However, covered bond funding volumes currently do not appear to pose significant risks. For example, Fitch Ratings found that only two out of 120 sampled institutions and banking groups from 18 countries

11 While the draft legislation in the United States (H.R. Bill 940 of the 112th Congress) does not propose caps, the Federal Deposit Insurance Corporation's final policy statement places a cap of four percent of an issuing depository's/thrift's total liabilities for bond holders to avail of legal certainty regarding perfection of their security interests in the event of issuer insolvency.

12 Also useful would be information related contingency plans in the event that encumbrance levels turn out to be substantially larger than estimated.

relied on covered bonds to fund more than half of total assets.[13] At present, Fitch's analysis suggests that banks with a large share of cover pool encumbered assets are primarily specialized institutions that do not avail of deposit funding. This mitigates the policy tensions arising from structural subordination of (retail) deposits. Legislation can also act in practice as an additional mitigant by requiring licenses for covered bond issuance and imposing strict collateral asset eligibility criteria.

However, the interaction of bank funding choices and financial stability considerations bears watching and will remain an open debate among regulators and market participants. Moreover, there are forms of encumbrance other than covered bonds that could be of greater concern, such as collateral pledged against central bank and market repo transactions, and derivative-related contingent collateral arrangements.

> Covered Bond Credit Rating Uplift

Covered bond credit ratings are usually higher than issuers' senior unsecured debt ratings, because a default requires both an issuer default plus insufficient funds/liquidity in the cover pool. Hence, issuer credit ratings can be regarded as a 'floor' to covered bond ratings, and the degree to which the covered bond rating is higher is called the rating "uplift." The covered bond rating methodologies used by the three major rating agencies are broadly similar, but their uplift levels differ, with Standard & Poor's (S&P) providing the greatest uplift and Moody's the least. For example, Moody's assigns the smallest uplift to all "AAA/Aaa"-rated covered bonds because its ratings on the issuers' senior unsecured debt is higher than those assigned by Fitch and S&P. Contrariwise, S&P assigns the lowest unsecured debt ratings so its "AAA/Aaa"-rated covered bond uplifts are always the highest. All of the covered bonds rated "AAA/Aaa" by Moody's and Fitch are issued by banks whose unsecured senior debt is rated "A+/A1" or higher, whereas, for example, Banco Popular's covered bonds were rated "AAA" by S&P assigned, against an "A-" senior debt rating. .

13 Fitch Ratings, 2011, "Banks' Use of Covered Bond Funding on the Rise," Global Special Report Banks/Covered Bonds, March 11. It is worth noting that the specialized banks mentioned in the report were not deposit-taking institutions, which relieves some of the potential asset encumbrance policy tensions.

1.9 THE GROWTH OF THE SUB-JUMBO SECTOR

By Richard Kemmish, Credit Suisse
and Michael Schulz, Nord/LB

THE GROWTH OF THE SUB-JUMBO SECTOR

Issuance volume on the covered bond market reached new record levels in the first few months of 2011. Primary market transactions totalling EUR 40bn were executed in January alone. However, this figure relates only to bonds of which the total outstanding volume amounts to more than EUR 1 bn, the so-called jumbos. Having said that, small, agile "boats" have also established a presence on the large covered bond market, in addition to "ice-breakers". For instance, the issuance volume of covered bonds worth between EUR 500 m and EUR 1,000 m stood at around EUR 14 bn as long ago as 2009. In 2010, the volume of this sub-segment even increased to EUR 33 bn and consequently accounted for some 18% of the benchmark transactions issued in the covered bond segment. In the first six months of 2011, issues worth more than EUR 500 m totalled approximately EUR 135 bn. Of this figure, EUR 14 bn or 10% was attributable to sub-jumbos, while jumbo transactions accounted for the lion's share of 90%.

With regard to the individual months, the proportion of jumbos and sub-jumbos in the issuance volume varies considerably. While sub-jumbos accounted for some 60% of the bonds placed in May 2010 and were consequently more heavily subscribed than large volume transactions, the proportion only stood at 4% in the record month of January. There are also some considerable differences between the countries. While German and Spanish issuers increasingly resorted to sub-jumbos in 2010 and 2011 (ytd) and, in so doing, were responsible for 69% and 59% of medium-sized transactions respectively, French issuers have largely avoided this segment. In 2010 and 2011 (ytd), the total volume here was EUR 1 bn in each case, which equates to a share of 2% or 3% respectively of the placed benchmark volume of the French market.

WHY GO SMALLER?

So, why has the sub-jumbo covered bond market emerged? And why is issuance so volatile? There are several drivers of this from the issuer's side:

> **Smaller issuers**. As the benefits of covered bonds as a funding source become more apparent, more issuers are attracted to the market. Whereas some of these new issuers are the 'High Street giants' of the European mortgage market, it is inevitable that more of them are likely to be the issuers whose assets and modest funding needs previously made covered bonds an uncompetitive source of funds. In many jurisdictions this crisis has caused an explosion of issuance from second and third tier issuers without the inclination or ability to raise jumbo quantities of cash.

With this motivation its no surprise that most of the sub-jumbo issuance for the last two years has come from Spain and Germany, the two countries with the most small and medium issuers.

> **Asset-liability matching**. One of the lessons of the financial crisis is that the refinancing of maturing covered bonds might not be as straightforward as we used to think. Rating agencies increasingly focus on the risk of lumpy bond maturities falling due when refinancing opportunities are limited by yet another bout of market volatility. To some extent 'internal' liquidity (cash being generated by the assets in the pool) and substitute assets can address this risk but the smaller the gaps in the issuer's amortisation profile, the less stressful the stress scenario that must be survived. Two bonds of EUR 500 mn maturing one year apart are simply a lower refinancing risk than one bond of EUR 1 bn.

> **Volatility**. As the old curse goes, 'may you live in interesting times'. Unfortunately we are doomed to live, and to have to issue bonds, in interesting times for the foreseeable future, so the ability to be flexible in the face of 'interesting' market conditions is vital. Sometimes issuers through no fault of their own, face a new issue book smaller than they had targeted and, therefore a dilemma, to issue a successful deal or to issue a jumbo deal? Issuers and investors alike want an issue to be successful but the pressure to issue jumbos for their own sake is often too great.

Again, its no surprise therefore that when the market is wide open for issuance - as it was in January 2011 for example - the percentage of deals that are sub-jumbo is far less than it is in more 'interesting' markets.

WHAT ARE THE DIFFERENCES/DOES EUR 1 BN CUT-OFF STILL MATTER?

For a long time, the jumbo format has stood for liquidity and speedy fungibility. These attributes suffered significantly in the course of the financial market crisis, which ultimately led to an end to market making on the covered bond markets. Even though liquidity is still far from reaching its pre-crisis levels, it has improved significantly recently. The suspension of market making has resulted in liquidity only being expressed through issuance volume today. Consequently, jumbo issues suggest greater fungibility vis-à-vis sub-jumbos even though this not necessarily the case. On the contrary, a broadly based sub-jumbo may be more liquid than a jumbo sold to end investors. Finnish bonds, which are, in some cases, difficult to obtain on the market, can be cited as an example here.

A key aspect for asset managers when deciding to make an investment is whether the proposed investment can be sold quickly, meaning that this group of investors mostly prefers jumbos.

Market making used to apply to EUR 1 bn bonds, but are there any other differences between a bond of EUR 999 m and one of EUR 1,000 m? The most important difference is that the latter bond is eligible for inclusion in many indices, most importantly the Iboxx covered bond index. Unlike senior and ABS bonds, where the eligibility criteria specify a EUR 500 m cut-off point, the covered bond rule is based on the old jumbo definition. After discussion at the ECBC's Market Issues Working Group it was decided that this cut off level was no longer defensible and that the ECBC should approach Iboxx to propose that they reduce it to EUR 500 m. At time of going to press the outcome of this discussion was still unclear.

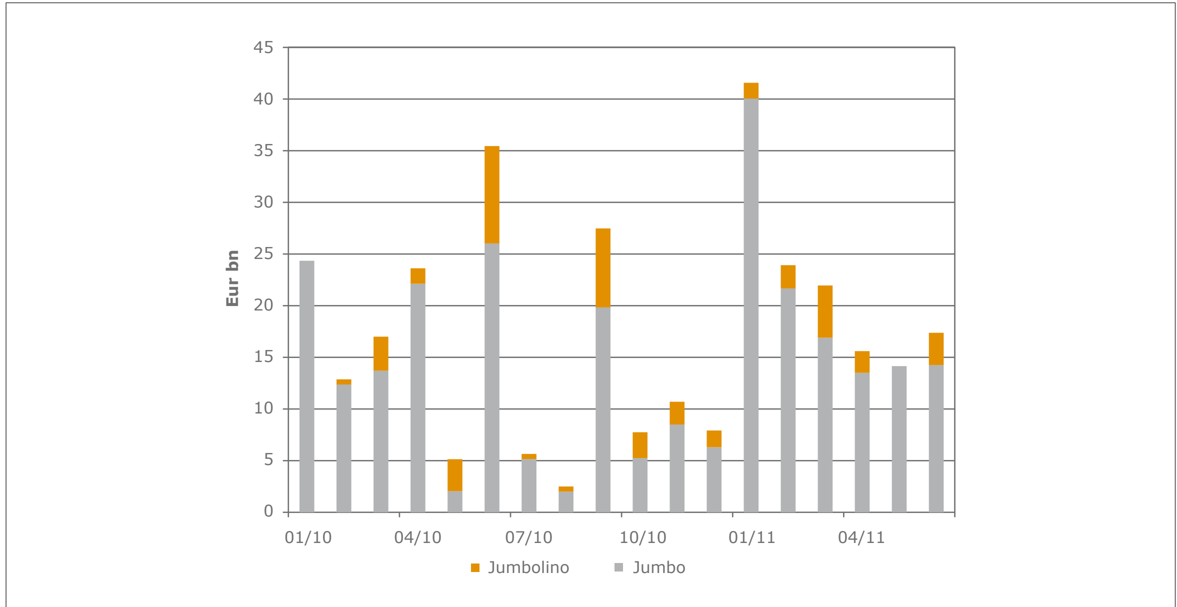
The other important difference is the eligibility criteria for some individual investors. Whereas all investors would prefer the greater liquidity of the larger trades (all other things being equal) some have an arbitrary EUR 1 bn cut-off point hard coded into their investment rule book. How easy it will be for these investors to change their rules as the market evolves is yet to be seen.

THE FUTURE OF THE SUB-JUMBO MARKET

Established issuers, which have large-scale cover funds, are decisive players in the jumbo covered bond market. On the other hand, medium-sized issuers and first-time issuers primarily fall back on sub-jumbos and, in the process, benefit from easier asset/liability management. Contrary to last year's expectations, when sub-jumbos were to some extent lauded as the trendsetting size on the covered bond market, primary market activities this year are not pointing to an increasing trend towards sub-jumbos.

Whereas jumbos will always be the dominant part of the covered bond market, sub-jumbos will remain an important niche in particular for the smaller and medium issuers and in volatile periods. Provided that primary market activities pick up once more following the summer break, we predict that the proportion of sub-jumbos in benchmark transactions should stand at between 10% and 20% once more this year.

> Figure 1: Sub-jumbo issuance: sometimes there, sometimes not.



> A word about nomenclature

Jumboliño [juhm-boh-lee-nyoh] - noun
1: covered bond similar to a jumbo in all ways except size
Colloquial, now considered obsolete in some circles.
Origin: Jumbo, originally the name of an elephant, from the Swahili 'Jambo' meaning 'Hello'. Subsequently used to describe covered bonds of at least EUR 1 bn. Also, the Brazilian-Portuguese diminutive suffix -liño, conveying smaller size and/or endearment.

The press started to use the term jumboliño in a semi-facetious way in early 2010 to refer to covered bonds that were structured and syndicated like jumbo deals but were below the traditional EUR 1 bn size threshold. Although the word is frequently used, the Market Issues Working Group of the ECBC recently decided that it conveyed an insufficiently serious demeanour for the covered bond market and recommended that it should be replaced by the word 'sub-jumbo'.

1.10 THE INVESTOR'S PERSPECTIVE

By Fritz Engelhard, Barclays Capital

I. INTRODUCTION

Over the past 12 months, covered bond investors have been forced to adapt to a rather challenging market environment, which has been characterized by significant swings in outright yield levels, high spread volatility in sovereign debt markets, big swings in primary market activity, multi-notch rating downgrades of sovereign, senior and covered bonds, a changing regulatory environment and central bank interventions in sovereign debt markets. The mix of these factors has made it difficult to keep focussed in order to grasp the many investment opportunities which evolved under these conditions. This article first highlights the various challenges covered bond investors were facing and then shows examples for relative value opportunities.

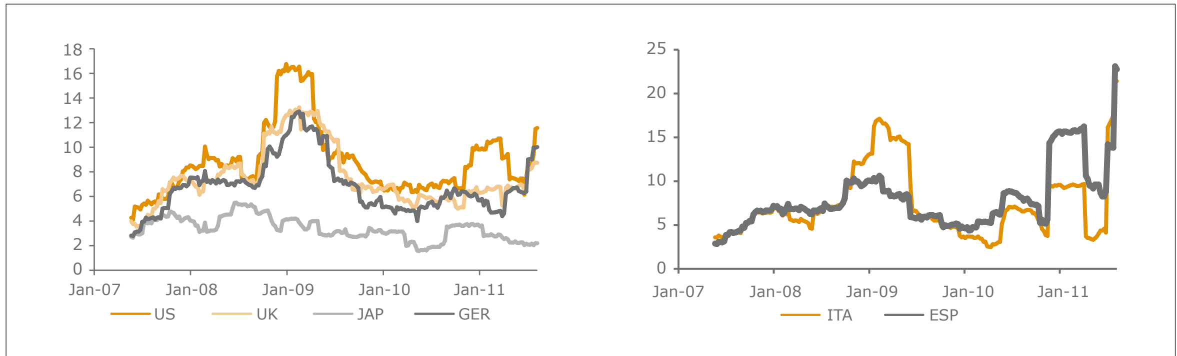
II. IN THE FRAY

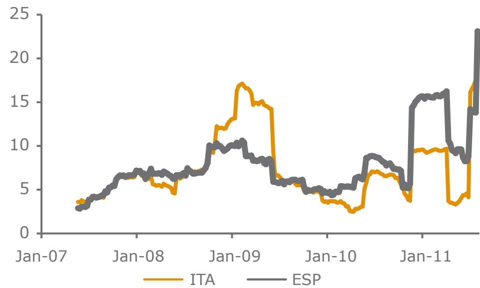
The destabilization of Euro area financial markets gained momentum over the past twelve months. This had a strong impact on the market approach of many investors. The interplay between increasing pressure on sovereigns in European peripheral countries and political attempts to address market concerns through support commitments, debt restructuring measures, fiscal policy announcements and direct market interventions has made it very difficult to assess medium term trends. In addition, the exit from exceptional support measures for the banking industry, the discussion surrounding addicted banks and the significant swings in economic growth expectations remained on the radar screens. Finally, the global environment has been also quite challenging, with the debt ceiling debate in the US, the catastrophe of Fukushima and rising political instability in the Middle East.

The mix of the above factors has led to exceptionally high volatility in major fixed income markets over the past twelve months. Between October 2010 and March 2011 ten year government bond yields in the US, the UK and Germany increased by 100-125bp. Following a brief period of stabilization, ten year yields decreased again by about 50bp until June and then dropped another 75bp in the short period between July and mid August. The rising volatility reflects in the development of the standard deviation of weekly yield changes over rolling 20 week periods. For Gilts and Bunds, the standard deviation doubled from 5bp in late 2010 to 10bp in mid 2011, close to the historically high levels of 13bp in early 2009 (Figure 1). Volatility in Italian and Spanish ten year government bonds exceeded the levels from 2009, reaching levels of close to 25bp, with outright yields partly changing by 100bp within less than a week (Figure 2).

> Figure 1: Standard deviation of weekly 10y government bond yield changes over rolling 20 week periods (US, UK, Japan, Germany)

Figure 2: Standard deviation of weekly 10y government bond yield changes over rolling 20 week periods (Italy, Spain)





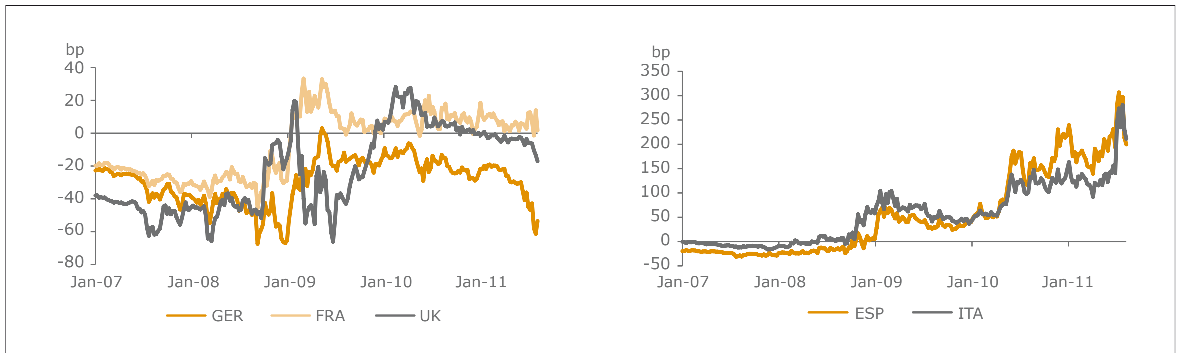
Source: Barclays Capital

The high volatility in outright yield levels was accompanied by strong shifts in the shape of the respective yield curves and also substantial changes in swap spreads. The two year / ten year yield differential in the US Treasury and German Bund curves steepened by 50-75bp in November/December 2010. On the back of raising short-term rates, the German curve flattened again by 90bp in the course of H1 2011. The US curve remained steep until mid July, when the curve flattened by about 50bp within a single month on the back of a more gloomy economic growth outlook as well as flight to quality flows.

The moves in swap spread have been also quite severe. Following a period of relative stability between mid 2009 and mid 2011, Bund swap spreads widened by 30bp between mid June and mid August. Within the same period the swap spreads of ten year Spanish and Italian government bonds reached new highs around mid swaps +300bp and the gap between ten year German and French government bond widened by 50bp, reaching a high at 90bp.

> Figure 3: 10yr government bond swap spreads (Germany, France, UK)

Figure 4: 10yr government bond swap spreads (Italy, Spain)

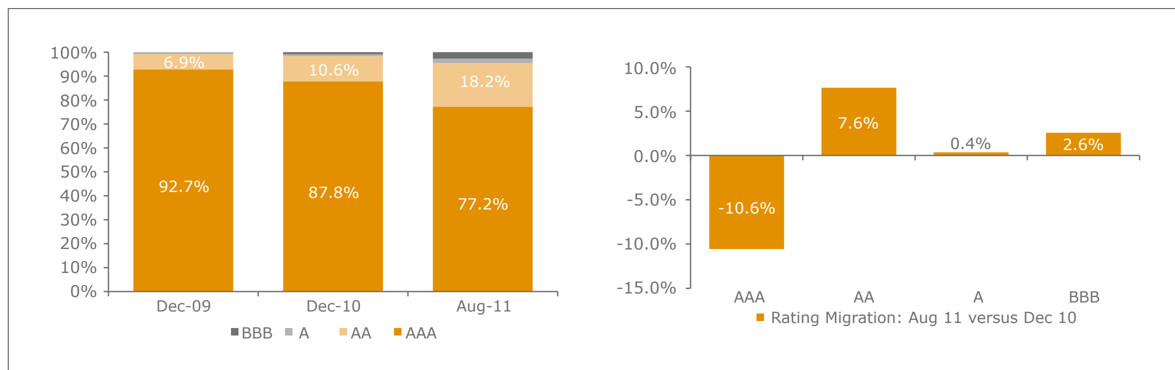


Source: Barclays Capital

The highly volatile market environment has been accompanied by a series of multi-notch downgrades of sovereign, bank senior and covered bond ratings. On the sovereign side, one of the most severe decisions has been the four notch downgrade of Portugal's long-term sovereign debt rating from Baa1 to Ba2 by Moody's on 5 July 2011. On the covered bond side, the downgrades of Spanish Multi Cédulas transactions by nine notches from AAA to BBB- on 1 August 2011 by S&P and the seven notch downgrade of some Spanish covered bonds by Moody's on 25 March 2011 have been record breaking. Between December 2010 and August 2011, the share of triple-A rated covered bonds included in the Barclays Capital Euro Aggregate Covered Index decreased by 10.6 percentage points whilst the share of double-A rated covered bond increased by 7.6 percentage points (Figures 5 and 6).

> Figure 5: Development of Rating Distribution within the Barclays Capital Euro Aggregate Covered Index

Figure 6: Rating Migration Aug. 11 versus Dec. 10 within the Barclays Capital Euro Aggregate Covered Index



Source: Barclays Capital

On the rating front, investors where not only exposed to rating migration triggered by the application of existing criteria, but also needed to gauge the impact of a change in underlying assumptions and a change in criteria. Secondary market liquidity for some collateral assets deteriorated and consequently rating agencies became more prudent with regards to their assumptions on monetizing cover pools. Furthermore, S&P and Fitch were reviewing their approaches to counterparty risk. Whilst Fitch published the final, covered bond specific, criteria in March 2011, S&P's decision to first include covered bonds in the roll out of the global counterparty criteria for structured finance products exposed many covered bonds to substantial downgrade risk in early 2011. On 13 January 2011, three days before the final roll out of the new criteria on 17 January 2011, a separate approach to covered bonds was announced. In August, the S&P analysts published a statement saying that they do not expect to publish the updated counterparty criteria for covered bonds before October 2011.

With regards to the regulatory environment, over the past twelve months, EU decisions surrounding capital requirements and liquidity management rules have been very much in the focus. On 20 July 2011, the European Commission finally adopted a new "legislative package". The proposed regulation may allow for the inclusion of covered bonds as so-called level 1 assets, in case authorities regard them as being compliant with the highest standards in terms of liquidity and quality. Under the new rules, authorities will also have the ability to take into account particular business models when applying

liquidity risk management and leverage rules. Whilst these decisions reflect the generally supportive stance of supervisory authorities and lawmakers vis-à-vis covered bonds, the fact that the European Banking Authority (EBA) has much power for making discretionary decisions and stipulate details makes it rather difficult for bank treasury managers to gauge what exactly qualifies as a liquid asset under the new rules over the next two years.

III. ABOVE THE FRAY

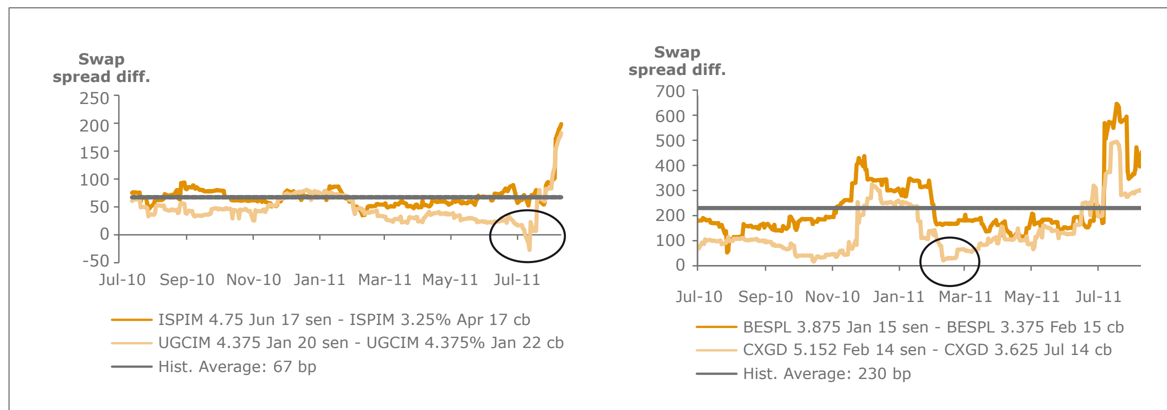
The volatility in global fixed income markets has led to unsteady liquidity conditions in covered bond markets. In times of rising market tensions, investors have been quite restricted to fulfill their mandates in managing risk positions. As a consequence, risk limits and leverage were generally reduced. However, those investors who managed to take into account potential changes in market conditions could also benefit from the opportunities arising from limited secondary market liquidity. Below we highlight two examples for strategies which were applied by investors in order to grasp those opportunities.

Example 1: Buy covered versus senior bonds with no give up

In the course of H1 2011 there have been a number of opportunities where senior bank debt was trading at similar spread levels as covered bonds issued or sponsored by the same institution. Fundamentally this implies that either the cover pool is basically worthless or that senior debt holders could be successful in claiming access to cover assets in an insolvency scenario. Both possibilities are basically unfounded. Such pricing distortions are generally related to varying investment restrictions and supply / demand dynamics in both asset classes. Consequently, for investors who have no restrictions on switching between the two asset classes these situations represent very good relative value opportunities. Figures 7 and 8 below highlight such opportunities in the Italian and the Portuguese market.

> FIGURE 7: ITALY – COVERED VERSUS SENIOR BONDS

FIGURE 8: SPAIN - COVERED VERSUS SENIOR BONDS



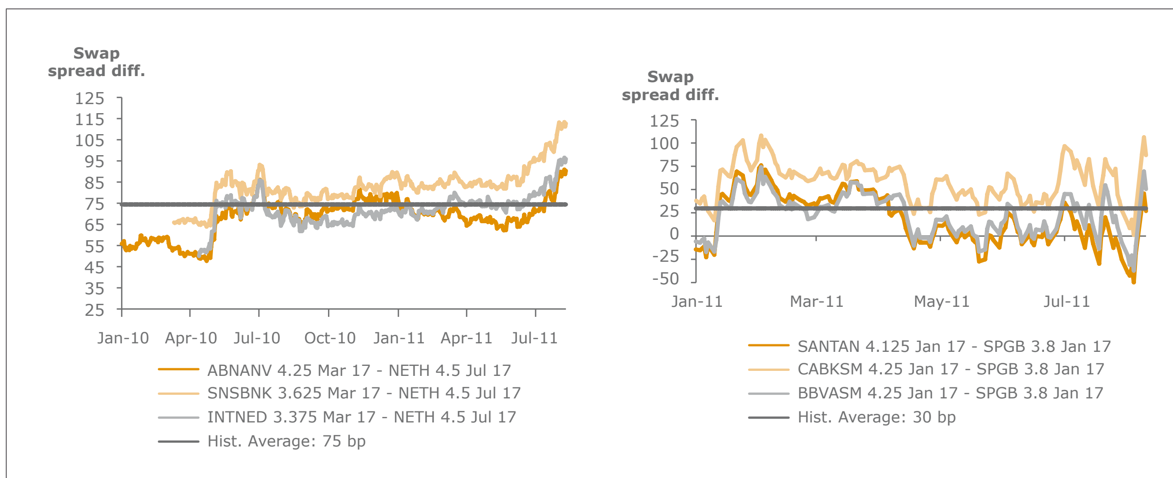
Source: Barclays Capital

Example 2: Switch from sovereign to covered bonds to enhance yield and reduce performance volatility

Covered bond investors needed to keep a close eye on developments in underlying sovereign markets. In European core countries, government bonds have become rather expensive in July and August 2011 on the back of flight to quality flows and the close correlation to underlying future contracts. Covered bonds generally lagged this development. In The Netherlands for example the yield gap between covered and government bonds increased from an average of 75bp to 95-110bp, thereby creating a very good opportunity to switch out of government into covered bonds (Figure 9). In peripheral European markets, swap spread correlations between covered and government bonds remained narrow. However, covered bond spreads have been generally much less volatile compared to government bonds and many of them benefit from a better rating compared to the underlying sovereign. The ECB interventions in Italian and Spanish government bond markets in early August have made covered bonds more attractive gain. In Spain for example, the swap spread differential between covered and government bonds moved from -50bp to +30bp within a less than a week (Figure 10).

> FIGURE 9: THE NETHERLANDS – COVERED VERSUS GOVERNMENT BONDS

FIGURE 10: SPAIN - COVERED VERSUS GOVERNMENT BONDS



Source: Barclays Capital

ANNEX: THE COVERED BOND INVESTOR COUNCIL

By Nathalie Aubry-Stacey, International Capital Market Association

The ICMA Covered Bond Investor Council ('CBIC') has noticed that better transparency is essential to strengthening the covered bond market and in the end will benefit issuers and their customers by lowering funding cost. 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 information requirements list is a template that is part of a process to achieve high transparency standards throughout Europe in the long run but not a 'all or nothing' list in the short-term.

The CBIC launched a consultation in the form of a qualitative and quantitative information template to meet 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.

Better transparency will result in easier access to information for all investors, big and small. By standardising information requests from investors, the transparency standards would harmonise their requirements thereby providing issuers with clarity when designing their IT and systems specifications.

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.

The CBIC transparency initiative was announced at the ECBC plenary meeting in Stockholm on March 31. A public consultation was opened between April 14 and the end of June. The CBIC 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).

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 submission from the UK authorities focused on these institutions' belief that the CBIC's transparency template should extend to require loan-level data in addition to the stratification tables it has already proposed.

National issuers and issuer association listed several ways in which they felt the CBIC's template could be improved, for example by better defining or describing certain requirements referred to in the proposed standards.

The CBIC intends to review all comments received over the summer, and establish working groups according to the themes that came up during the consultation period. The CBIC noted the ECBC's response which mentions that transparency will form a key element of the label. The CBIC will be publishing a reviewed template in September/October and look forward to working with the ECBC and national associations.

1.11 THE NON-BENCHMARK SIDE OF THE COVERED BOND MARKET

By Leef H. Dierks, Morgan Stanley

Despite becoming increasingly important funding instruments in periods of elevated market turmoil, private placements still tend to be sidelined when compared with benchmark covered bonds. Yet, in light of their smaller issuance sizes and the absence of a syndicate, private placements enable issuers to flexibly access the (term-) funding market at short notice and often are tailor-made responses to reverse inquiries. Even though private placements cannot be regarded as an alternative to benchmark covered bonds we reason that going forward, the relevance of private placements within the issuers' funding strategy will further mount.

Ever since the Eurosystem's EUR 60 bn covered bond purchase programme (CBPP), which began its operations in July 2009, increased the markets' awareness of covered bonds as a refinancing instrument, the latter have played an increasingly prominent role among investors, issuers, and a broader capital market audience. Despite this being a doubtlessly welcome development, public attention still is mostly geared towards the rather prominent *jumbo* (or benchmark) segment[1]. The non-benchmark side of the covered bond market, in contrast, often tends to be overlooked. This lack of attention, in principle, is not justified, as the primary market for non-benchmark papers was among the first to re-open in the woes of the financial markets' crisis in 2008 and 2009.

Non-benchmark covered bonds, which, among other instruments, comprise private placements, typically have an issuance volume of in between EUR 10 m and EUR 250 m with some deals amounting to as much as EUR 500 m. Year-to-date, with data being notoriously unreliable due to the private and thus less transparent nature of the instrument, aggregate, EUR-equivalent private placement issuance amounted to EUR 31.7 bn with an average term-to-maturity of six years and an average deal size of circa EUR 118 m[2]. Most deals, i.e. roughly 71%, were EUR-denominated (Figure 1). In light of these relatively moderate volumes (compared to benchmark covered bonds where gross supply amounted to EUR 130 bn at the time of writing) a common feature among private placements is that they typically are being launched by the issuer directly or by a sole lead manager instead.

Even though private placements are usually being issued by 'traditional' covered bond issuers, i.e. market participants who also rely upon the issuance of benchmark papers, they should generally not be regarded as an alternative to the issuance of benchmark covered bonds. Instead, despite normally being issued out of the same programme as benchmark covered bonds, private placements enable issuers to flexibly access the (term-) funding market at short notice and often are tailor-made responses to reverse inquiries. What is more, from an issuer's perspective, private placements can often be issued at more advantageous conditions than benchmark covered bonds[3].

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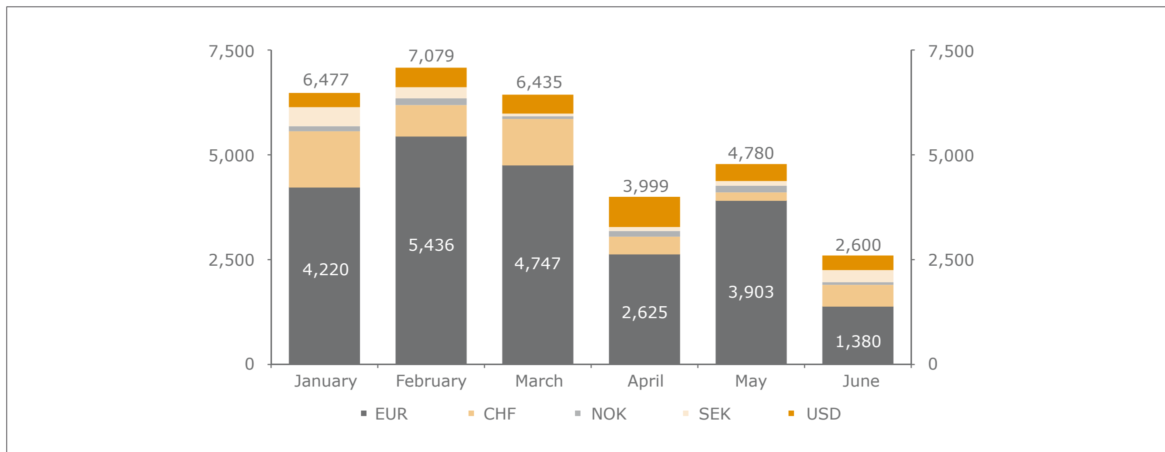
1 According to the original wording of the Association of German Pfandbriefbanks (vdp), "the minimum issue size of a Jumbo Pfandbrief is EUR 1 bn. The volume of the initial issue must be at least EUR 750 m. The issuer is obligated to increase the outstanding volume of the issue to at least 1bn within 180 calendar days after the initial offering. This has meanwhile been changed to "a minimum issue size of EUR 1 bn". Source: Association of German Pfandbriefbanks.

2 Note: as per July 20, 2010. The median was EUR 75 m. Source: Dealogic, Morgan Stanley.

3 Note: The term private placements in the above context should not be confounded with the "SEC Rule 144A" private placements. The latter are a means for non-US covered bond issuers to gain access to the US market where an issuer can obtain an exemption from the SEC to place its covered bonds with so-called "qualified institutional buyers" directly, i.e. without going through the usual legal process required for publicly traded securities.

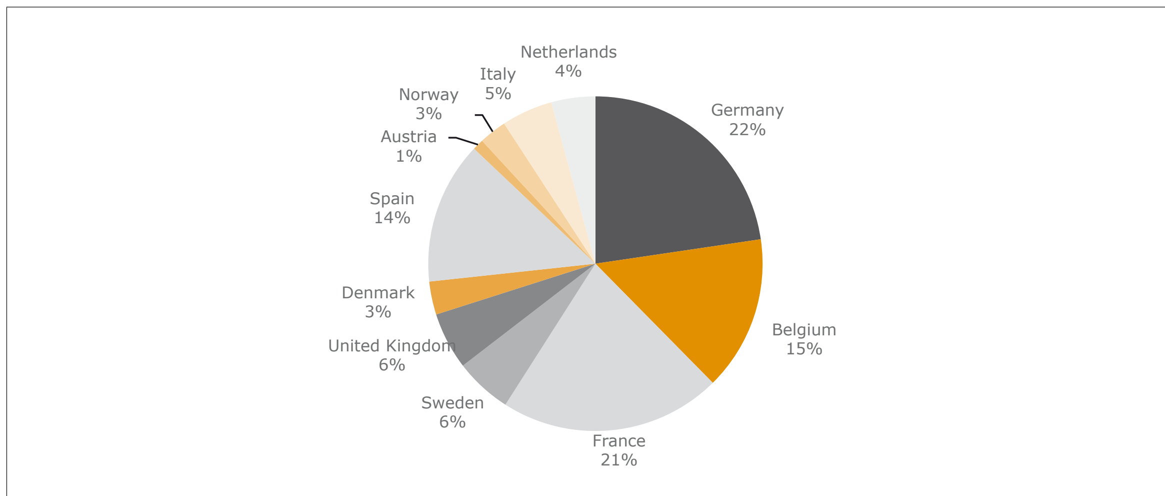
> Figure 1: Gross Monthly Private Placement Issuance (in EUR-equivalent), 2011



Source: Dealogic, Morgan Stanley

From a regulatory perspective, private placements issued out of an EMTN-programme typically are subject to a mark-to-market valuation which potentially requires investors to regularly adjust the value of their exposure. Yet, according to IAS 39.9, private placements which an investor holds as available-for-sale assets (AFS) have to be measured at fair value in the balance sheet. Private placements with a fixed maturity, however, which are not being held as an AFS position and which an investor intends to and can hold to maturity, are considered to be hold-to-maturity investments – and are valued at amortised cost, effectively shielding their investment's book value from volatility. Needless to say: for several traditional investors such as (German or French) insurance companies, among others, this feature considerably increases the appeal of private placements. This is endorsed by the fact that in H1 2011 nearly half (43%) of all private placements issued came from German or French entities (Figure 2).

> Figure 2: Regional Distribution of Private Placements Priced in H1 2011



Source: : Dealogic, Morgan Stanley

The instrument's mounting attractiveness is also reflected in more recent developments. In the course of the last year, private placements have experienced a noticeable increase in the number of so-called *club* deals. These refer to a transaction in which a single issuer confidentially soft-sounds only a handful of potential investors in an attempt to later issue a private placement. Club deals tend to have a larger issuance size and thus feature a potentially higher liquidity than typical private placements – which makes them an adequate compromise between the traditional liquid benchmark covered bonds and smaller-sized, illiquid private placements. Consequently, the issuance of club deals is poised to further increase.

Attributed to the ongoing peripheral European sovereign debt woes, the typical investor base has shown little appetite to increase its private placement holdings as of late. In light of a mark-to-market evaluation and a largely inactive secondary market, which ultimately impedes a timely exit, this behaviour is comprehensible and has seen the investor base experience a (temporary) decline. This is also reflected in the aggregate issuance, which, also influenced by the seasonal pattern, with a EUR-equivalent of only EUR 2.6 bn, fell to its lowest level year-to-date in June 2011. Going forward, however, and assuming that a sustainable solution to contain the sovereign debt crisis will eventually be found, the issuance of private placements will swiftly recover – as their relevance as a funding instrument has steadily mounted.

CHAPTER 2 - GENERIC SECTION

2.1 OVERVIEW OF COVERED BONDS

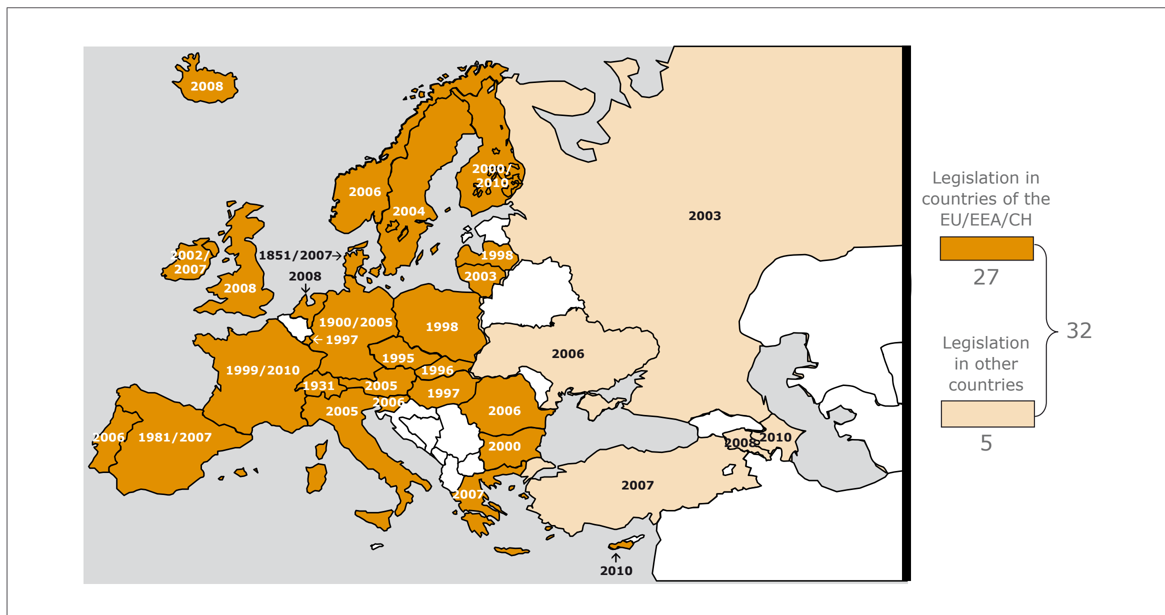
By Ralf Burmeister, LBBW, Ralf Grossmann, SG CIB
and Otmar Stöcker, Association of German Pfandbrief Banks

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 2010 amounting to EUR 2.5 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 they provide 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 Belgium, Romania, Australia, Canada, Japan, South Korea, New Zealand and US)

> Chart 1 – Covered Bond Legislation in Europe (as of June 2011)



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 consequence of this is that today we again find covered bond systems in nearly all European countries.

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:

First of all, covered bonds offer cheap funding in absolute and relative terms and secondly -due to the high credit quality of covered bonds- also offer longer term funding for the issuer compared to other funding sources banks usually have at hand. One major experience motivating the introduction of such

a high quality funding tool like covered bonds is the fact, that it has always been difficult to measure the creditworthiness of a bank, which is still true today. 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 bond 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.

Another aspect of the use of covered bonds is that investors tend to invest larger volumes into bonds, which on the back of a legally sound mechanism are perceived as safe, offering higher recoveries and more transparency compared to a senior unsecured bank bond. The regulation around covered bonds (e.g. UCITS and / or Solvency II) does reflect exactly this safety of covered bonds and in turn encourages institutional investors to engage themselves on a larger scale in this highly regulated market.

Especially the financial crisis highlighted in 2008/09 another major advantage of using covered bonds from an issuer's perspective: market accessibility. Although covered bonds clearly have suffered as with many other capital market products, but there has been a tremendous comeback in terms of spreads, issuance volume as well as investors' confidence. 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 in case the latter gets under stress.

However, from an issuer's perspective, covered bonds are only one wholesale funding instrument among others. Looking at the past competition between Covered Bonds and securitisation products, at least for the moment the on-balance instrument of Covered Bond seems to have the edge. The ECB clearly states that covered bonds are a valuable alternative to the US mortgage backed security model as it mitigates the moral hazard problems surrounding MBS products (see e.g. the ECB's Financial Integration Report, April 2010).

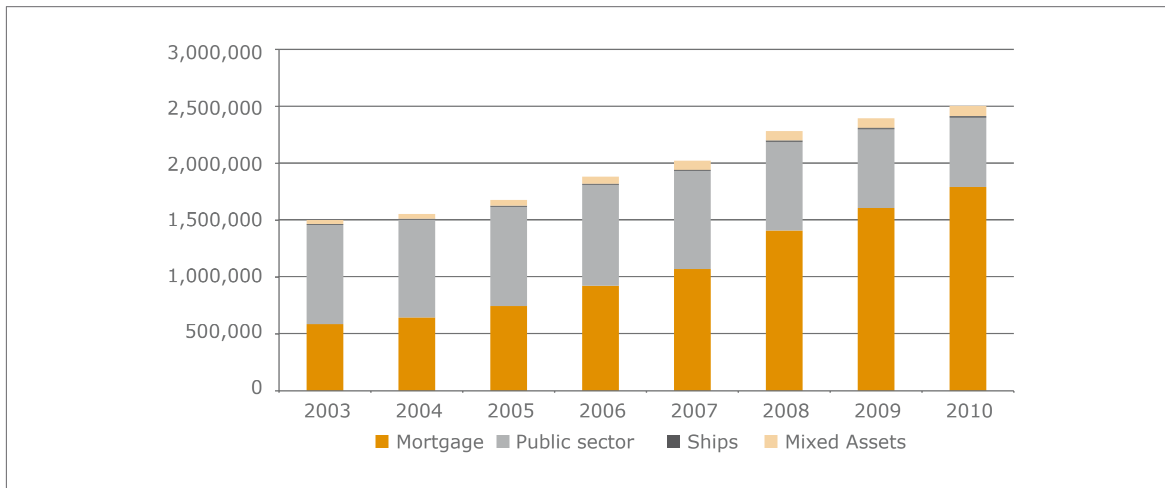
On the other hand, pure reliance on senior unsecured funding and interbank markets as sole wholesale funding sources did prove to make a bank more susceptible to market turmoil. The ECB has acknowledged the prominent role of covered bonds and stated in January 2011:"A smoothly functioning covered bond 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 therefore 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.

2.1.4 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 only 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.

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.

> CHART 2: TOTAL OUTSTANDING COVERED BONDS BY UNDERLYING ASSETS, 2003 TO 2010



Source: EMF/ECBC - Covered bonds outstanding at the end of 2009

2.1.5 LEGAL FRAMEWORK

UCITS AND CRD

1) UCITS

The special character of covered bonds has been enshrined in Article 52(4) of the Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). This Directive replaced the previous Council Directive 85/611/EEC on 1 July 2011 and Article 22(4) was renumbered to Article 52(4)[2].

Article 52(4) does not mention the name "Covered Bond", but its criteria constitute the eldest and most important regulation in EU-law to set a minimum standard for bonds, which are secured by assets, without saying, which ones. The criteria of Article 52(4) were taken over in other EU-directives so that they can be regarded as the core regulations of "Covered Bonds" (in UCITS called "certain bonds") before the CRD.

Article 52(4) of this Directive defines the minimum requirements that provide the basis for privileged treatment of so-called "certain bonds" in different areas of European financial market regulation. Article 52(4) allows a special treatment, when these "certain" bonds are issued by a **credit institution** which has its registered office in a Member State and:

> is subject by **law** to special public **supervision** designed to protect bondholders;

> in particular, sums deriving from the issue of these bonds must be invested in conformity with the **law** in **assets** which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds; and

2 In this Article, the new Directive will be referred to, therefore, the references will be to Article 52 (4).

> 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 the accrued interest.

Covered bonds that comply with Article 52(4) UCITS directive are considered to have an lower risk profile, which justify the easing of prudential investment limits. Therefore, investment funds (UCITS) can invest up to 25% (instead of max. 5%) of their assets in covered bonds of a single issuer that meet the criteria of Article 52(4).

All 27 EU Member States have sent UCITS notifications to the Commission, with 24 Member States notifying that they have authorised issues fulfilling the UCITS criteria of Article 52(4). The three countries not having transposed Article 52(4) into national law are Bulgaria, Malta and Slovenia. Two Member States, Estonia and Belgium, notified that they do not have a covered bond legislation in place, whilst two further Member States notified that they have a covered bond legislation but no issues yet (Lithuania and Romania). All notifications are published on the website of the EU Commission:

http://ec.europa.eu/internal_market/investment/legal_texts/instruments_en.htm

2) CRD

Another cornerstone of covered bond regulation at EU level is the Capital Requirements Directive (CRD)[3]. The CRD is based on a proposal from the Basel Committee on Banking Supervision to revise the supervisory regulations governing the capital adequacy of internationally active banks. The CRD rules apply to all credit institutions and investment service providers in the EU.

The European Council formally adopted the CRD on 7 June 2006 and the Directive was published in the Official Journal (OJ) of the European Union on 30 June 2006 (L177). A special article on the CRD can be found in Section 2.3 of this Chapter.

Under Basel II and III, covered bonds are not explicitly addressed as a specific asset class justifying lower risk weights, and therefore they are treated like unsecured bank bonds for credit risk weighting calculations. However, as covered bonds play an important role in EU financial markets, the European Union has decided to establish a privileged treatment for covered bonds under the CRD, Annex VI, paragraphs 68 to 71.

According to the CRD, covered bonds benefit from privileged credit risk weightings only if they fulfil the following requirements:

(i.) Compliance with the standards of Article 52(4) of Directive 2009/65/EC (UCITS)

(ii.) The asset pools that back the covered bonds must be constituted only of assets of specifically-defined types and credit quality.

(iii.) New quantitative restrictions on certain types of cover assets were established (e.g. max 15% exposure to credit institutions).

(iv.) The issuers of Covered Bonds backed by mortgage loans must meet certain minimum requirements regarding mortgage property valuation and monitoring.

Directive 2010/76/EU (CRD III), published on 14 December 2010 provides two amendments to Directives 2006/48/EC and 2006/49/EC concerning covered bonds. Firstly, the Loss Given Default (LGD) value

3 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).

for covered bonds in the standardised approach is set at 11.25%. Secondly, the waiver for MBS was extended by three years to December 2013, with a review to be undertaken by the European Banking Committee (i.e. using the Comitology procedures) by December 2012, with a view to either extending the waiver or converting it to a general rule. Under the new MBS waiver, MBS of credit quality Step 1 will be permitted up to a lower level of 10% of the cover pool, whilst MBS of credit quality Step 1 will be allowed above 10% provided that it is 'own group' issuance and that the MBS is subject to the same supervision requirements as envisaged in UCITS 52(4).

The Commission is currently preparing a draft Proposal to further modify the CRD, known as CRD IV. The main element of this Proposal, which is expected to be published during summer 2011, is to transpose the Basel III Agreement into the CRD. Basel III recognised covered bonds as high quality liquid assets under the 'Level 2' category of the new Liquidity Coverage Ratio. Please refer to the Key Themes article on Basel III for more information.

3) Solvency II

Solvency II is an updated set of requirements for insurance firms. It is expected to enter into force in early 2013. At the time of writing, the Commission was preparing the final technical requirements for Solvency II. These requirements could include preferential treatment for covered bonds in the concentration risk and spread risk sub-modules. Please refer to the Key Themes article on Solvency II for more information.

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 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

European covered bond systems are similar in this area. 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 all 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 2010 amounted to EUR 2.5 trillion (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 2010 were Denmark, Germany, Sweden, France, and Spain 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.

> Chart 3 – Volume outstanding CB end of 2010 in EUR million

	Public Sector	Mortgage	Ships	Mixed Assets	Total
Austria	19,555	7,645	0	0	27,200
Canada	0	18,003	0	0	18,003
Czech Republic	0	8,242	0	0	8,242
Denmark	0	332,505	6,722	0	339,227
Finland	0	10,125	0	0	10,125
France	75,548	156,239	0	88,693	320,480
Germany	412,090	219,947	7,805	0	639,842
Greece	0	19,750	0	0	19,750
Hungary	0	6,323	0	0	6,323
Ireland	36,550	29,037	0	0	65,587
Italy	10,092	26,925	0	0	37,017
Latvia	0	63	0	0	63
Luxembourg	28,889	0	0	0	28,889
Netherlands	0	40,764	0	0	40,764
Norway	1,837	70,178	0	0	72,015
Poland	126	511	0	0	637
Portugal	1,400	27,730	0	0	29,130
Slovakia	0	3,442	0	0	3,442
Spain	18,350	343,401	0	0	361,751
Sweden	0	188,750	0	0	188,750
Switzerland	0	62,046	0	0	62,046
United Kingdom	3,548	205,370	0	0	208,918
United States	0	11,497	0	0	11,497
EU-27	**606,148**	**1,626,768**	**14,527**	**88,693**	**2,336,136**
Total	**607,984**	**1,789,739**	**14,527**	**88,693**	**2,500,943**
%	24%	72%	1%	4%	100%

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.

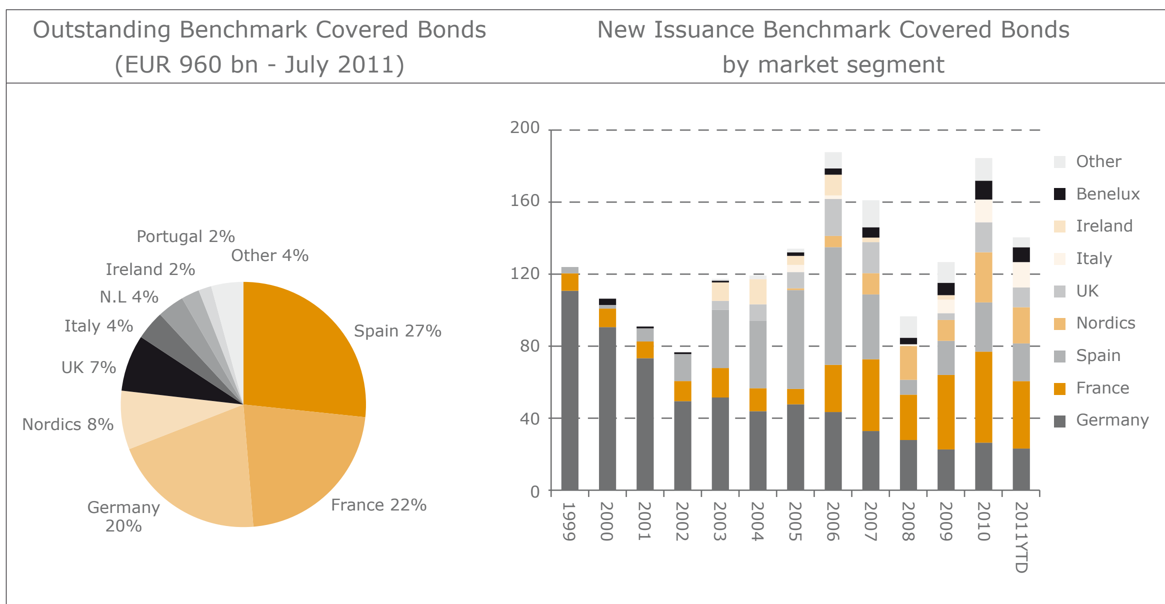
In **Spain**, the data on the table only includes the volume of issuances/outstanding listed in the national market through AIAF. Covered Bonds listed outside AIAF (e.g. US, London, Luxemburg, etc.) are not included in the statistics.

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 (in most cases EUR 1 bn). 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 2011 year-to-date, Benchmark covered bonds with maturities of 10Y account for 21% (11% in 2010) and maturities over 10Y represent 7% of total supply (6% in 2010). The current total outstanding volume of the benchmark Covered Bond market is approximately EUR 960 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.

> Chart 4 – Benchmark Covered Bond Supply



Source: Market data, SG CIB

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

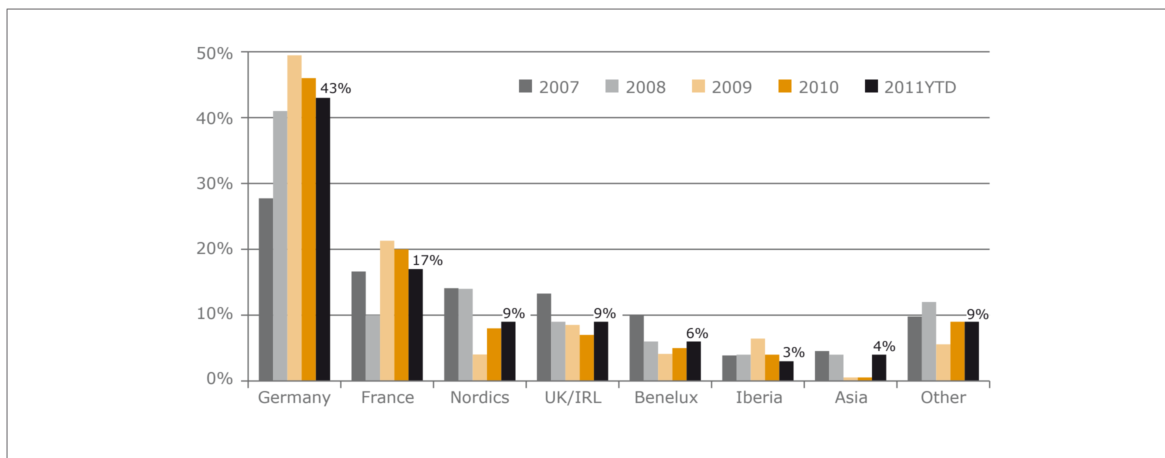
2.1.9 WHO INVESTS IN COVERED BONDS?

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.

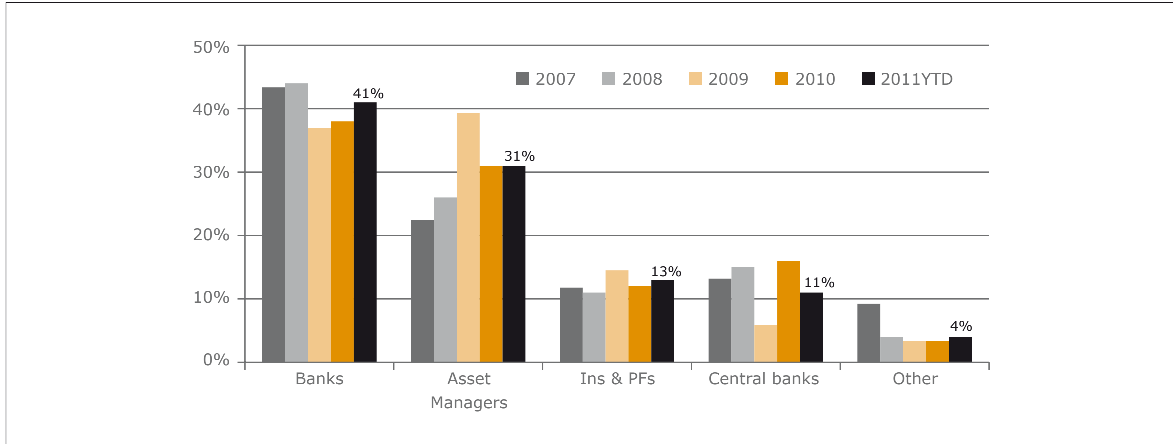
The investors of covered bonds range from small private investors to large institutional investors, the latter dominating the Benchmark covered bond market. The main groups of institutional covered bond investors are credit institutions, investment funds, pension funds, insurance companies and central 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.

> Chart 5 – Benchmark Covered Bond Primary Market placement by country / geographical area



Source: ECBC, SG CIB

> Chart 6 – Benchmark Covered Bond Primary market Placement by type of investor



Source: ECBC, SG CIB

2.2 RMBS VS. COVERED BONDS

By Bernd Volk, Deutsche Bank

Pre-crisis convergence of Covered Bonds and MBS

MBS are eligible as collateral for covered bonds in some jurisdictions (e.g. France, Italy, Ireland and Luxembourg) and the boundaries between covered bonds and MBS were in certain instances starting to become blurred before the crisis. Covered bonds were used as collateral in synthetic securitization transactions (e.g. several Geldilux SME CLOs). In countries without specific legal framework for covered bonds, so-called structured (or general law based) covered bonds were structured with the help of securitization techniques to replicate the dual claim characteristic for covered Bonds.

Covered Bonds are an on-balance sheet funding tool

In contrast to securitizations, the assets remain on the balance sheet of the issuers of covered bonds. 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 specialized Covered Bond bank. The specialized 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

Although 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 becomes static. As long as the issuer is solvent, the issuer manages the cover pool and can bring in new cover assets.

MBS have typically a static pool and credit enhancement by tranching

Covered bonds typically have a fixed rate bullet structure. This can lead to higher market risk in the cover pool compared to triple A-rated 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, overcollateralization requirements by rating agencies regarding covered bonds are typically much bigger than subordination requirements for senior tranches of RMBS.

Covered Bond holders have recourse against a bank

A crucial difference between covered bonds and MBS is that Covered Bond holders 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.

Moreover, regulatory changes relating to liquidity buffers, leverage limits, reserve requirements and valuations 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. 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.

Maturity extension as main risk of RMBS

One of the main risks of highly rated MBS is sharp maturity extensions. MBS (p)repayment 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. Falling prepayment rates along with the lack of fully functioning debt capital markets has meant 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 overcollateralization as they would in a Covered Bond. However, overcollateralization 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, RMBS 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).

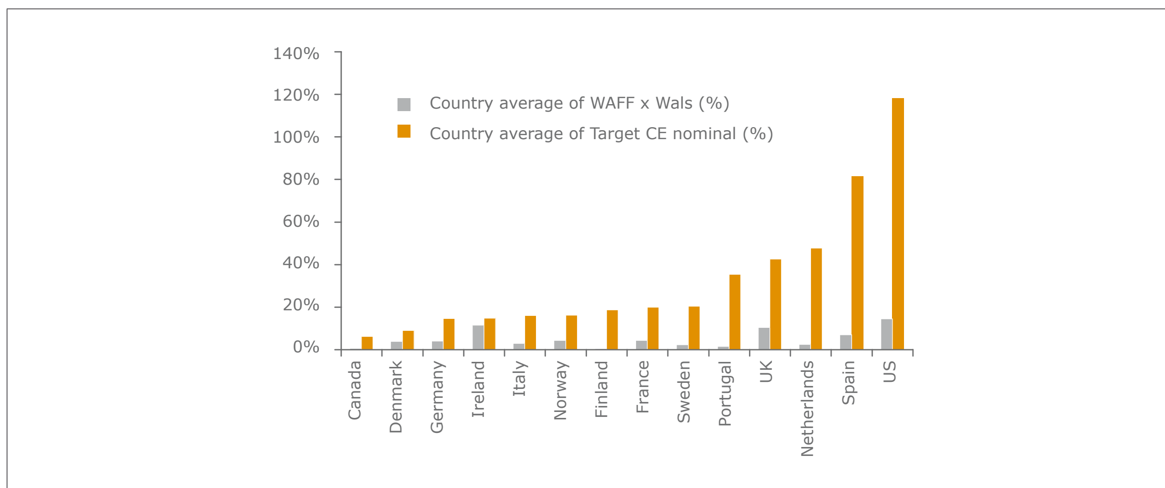
In case of covered bonds, increasing non-performing loans in the cover pool are a negative indicator regarding issuer credit quality. The issuer typically takes out non-performing loans (i.e. keeps the pool clean). In most countries, issuers are obliged to do so by law. When non-performing loans in the 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 of over 20% to keep current ratings. At the same time, numerous Spanish RMBS have credit enhancements of

only 6-10%. In this respect, the latest S&P statistics, comparing expected cover pool losses (credit risk) and OC requirements (credit risk and market risk) of S&P rated covered bonds in respective countries, seems very interesting, again showing that OC requirements are driven mainly by market risk.

> Weighted Average Frequency of Foreclosure Times Weighted Average Loss Severity (expected loss) versus total credit enhancement



Source: S&P

Covered Bonds are excluded from direct burden-sharing measures in case of bank restructuring

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. Northern Rock, Bradford and Bingley, Hypo Real Estate). One can argue that while that has occurred to date, given sovereign pressures, a risk is the 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 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 was suggested in the EU discussion paper regarding bank resolution regimes.

Regulatory support for Covered Bonds, regulatory restrictions for RMBS

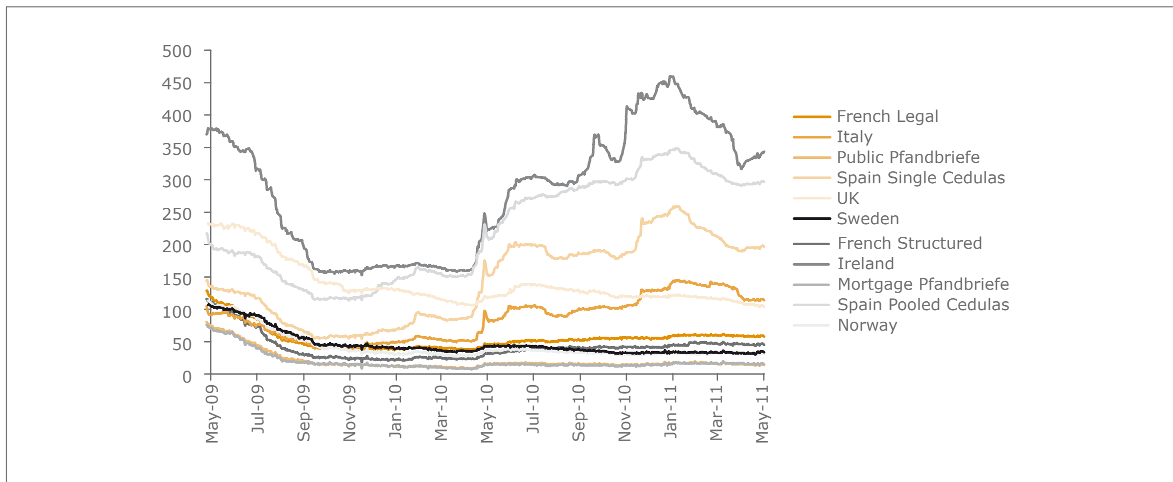
Generally, particularly compared to pre-crisis, MBS face increasing legal and regulatory restrictions. On the other hand, legislators and regulators increasingly support covered bonds. For instance, CRD II - 5% retention and greater disclosure requirements for MBS, CRD III – more onerous capital requirements for securitisations held in trading books, CRD IV - more onerous liquidity requirements, Solvency II – capital requirements for insurance companies and credit rating agency legislation, ECB collateral requirements – 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 greater restrictions surrounding securitisation vis-à-vis covered bonds.

Spread pick-up of RMBS versus Covered Bonds differs between countries

Spreads of covered bonds remained extremely heterogeneous in H2 2010 and Q1 2011. Spreads of Irish and Portuguese covered bonds have been most volatile and traded extremely wide compared to their respective levels a year back. Also Spanish covered bonds widened significantly in the past 12 month (as of May 2011). UK covered bonds were the cheapest covered bonds out of a triple A country. German Pfandbriefe, French and Nordic covered bonds continue to trade tightest.

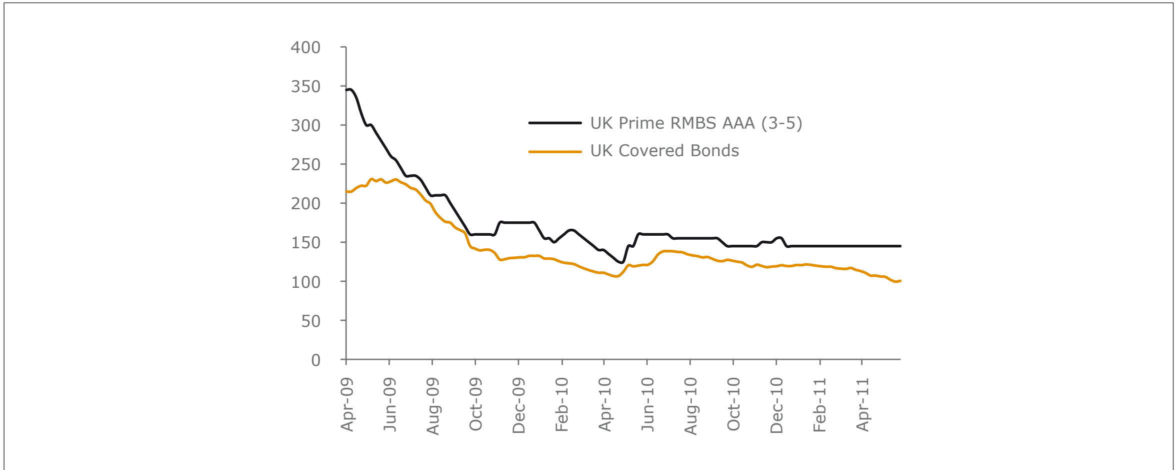
Given that holders of covered bonds have a claim against an issuing bank and a pool of mortgage (or public sector) loans, spreads of covered bonds are typically tighter than senior bank bonds and mortgage backed securities (MBS). However, the spread difference between covered bonds and residential mortgage backed securities (RMBS) differs between countries and issuers. For instance, the pick-up of Dutch RMBS versus Dutch covered bonds is higher than UK RMBS versus UK covered bonds. The higher senior CDS and senior unsecured funding costs of UK banks versus Dutch banks was probably a reason for this pricing difference. Interestingly, in H1 2011, the front end of the RMBS curve seemed cheap, e.g. 2 year Dutch RMBS traded 20 bp inside comparable 4.7 year Dutch RMBS and provided a pick-up of over 60 bp versus Dutch covered bonds (as of May 2011).

> Spreads of Covered Bonds diverged significantly in H2 2010



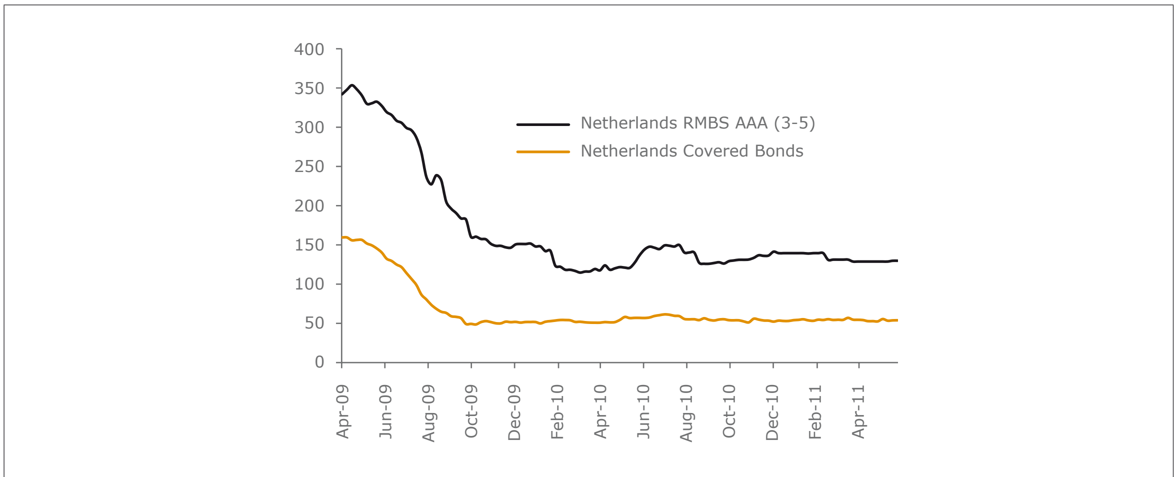
Source: iBoxx, Deutsche Bank

> UK RMBS trading close to UK covered bonds*



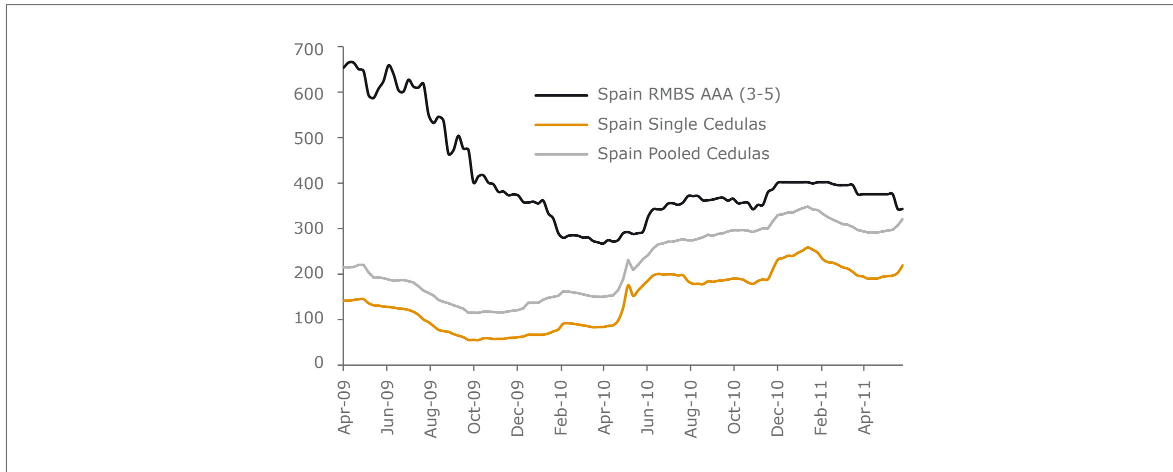
*spreads as of 31 May 2011, Source: Markit, Deutsche Bank

> Dutch RMBS trade with a higher pick-up versus Dutch covered bonds than UK RMBS versus UK covered bonds*



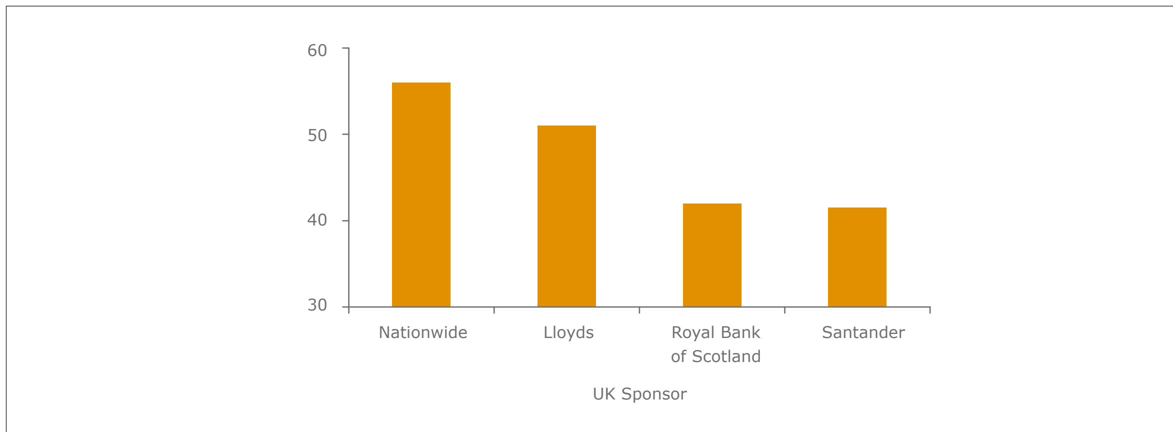
*spreads as of 31 May 2011, Source: Markit, Deutsche Bank

> Spanish RMBS trade with a pick-up to Multi-Cédulas



*spreads as of 31 May 2011, Source: Deutsche Bank

> Spread pick-up of RMBS versus Covered Bonds in bp*



*spreads as of 31 May 2011, Source: Deutsche Bank

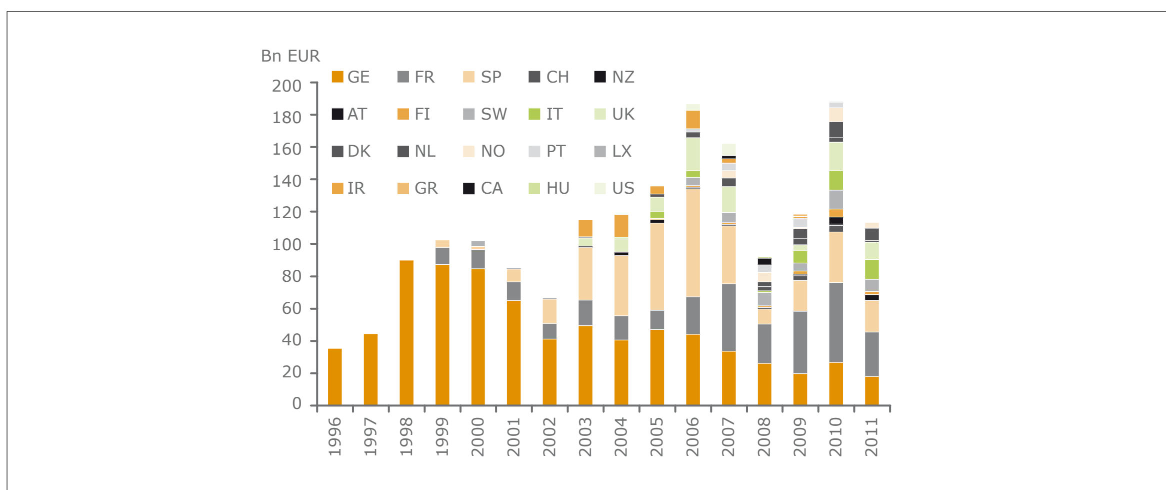
Recovery of new issuance of EUR benchmark Covered Bonds in Q2 2009 and new issuance record since then

The RMBS market was completely closed during the start of the financial market crisis. Issuance of EUR benchmark covered bonds was also mainly substituted by the issuance of state guaranteed benchmark bonds. In Q2 2009, the primary market for publicly issued RMBS was still almost completely shut (given the loss of key investors such as SIVs, conduits, money market funds and some bank treasuries). However, Q2 2009 showed a significant recovery of new issuance of EUR benchmark covered bonds (also driven by the ECB announcement to buy covered bonds). FY 2010 showed almost a new record volume of EUR benchmark Covered Bond issuance. In Q1 2011, a clear new issuance record of almost EUR 100 bn was achieved. As of 10 June 2011, year-to-date issuance of EUR benchmark covered bonds even amounted to EUR 132 bn, compared to EUR 99 bn year-to-date as of 10 June 2010. Given lack of

market access, retained issuance remained also important in case of (and mainly limited to) peripheral Covered Bond countries.

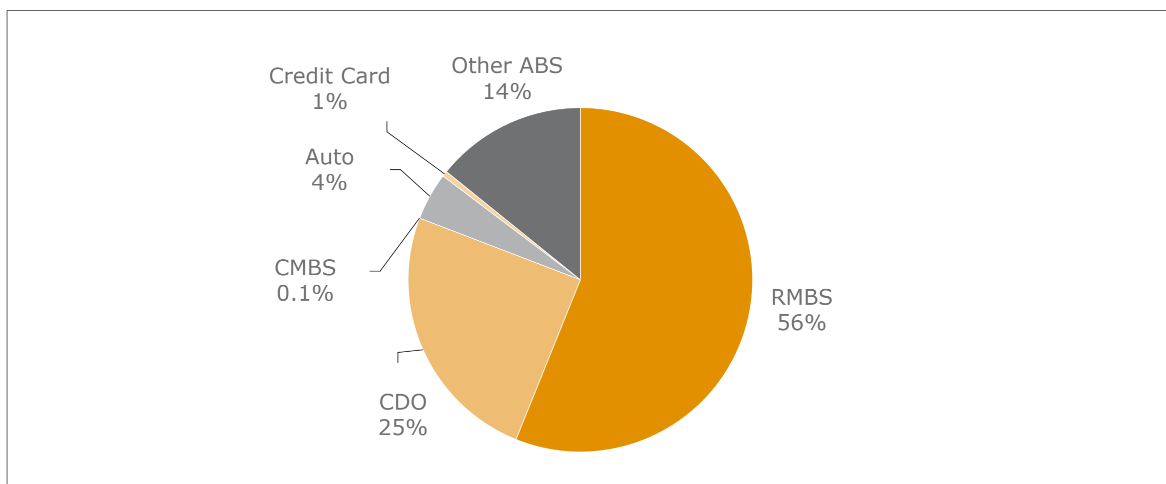
In contrast to this, while issuance of European ABS/MBS also recovered in 2010 and Q1 2011, retained deals still account for the majority of supply. Issuance was still dominated by banks' securitize-and-repo exercises. As of May 2011 in total EUR 11.2 bn of Portuguese RMBS were placed and EUR 27.6 bn of Portuguese RMBS were retained. EUR 11.6 bn of Irish RMBS were placed and EUR 55.9 bn of Irish RMBS were retained. Q1 2011 issuance of ABS/MBS reached EUR 110 bn, of which around EUR 60 bn were RMBS.

> Already FY 2010 issuance of EUR benchmark Covered Bonds close at new record



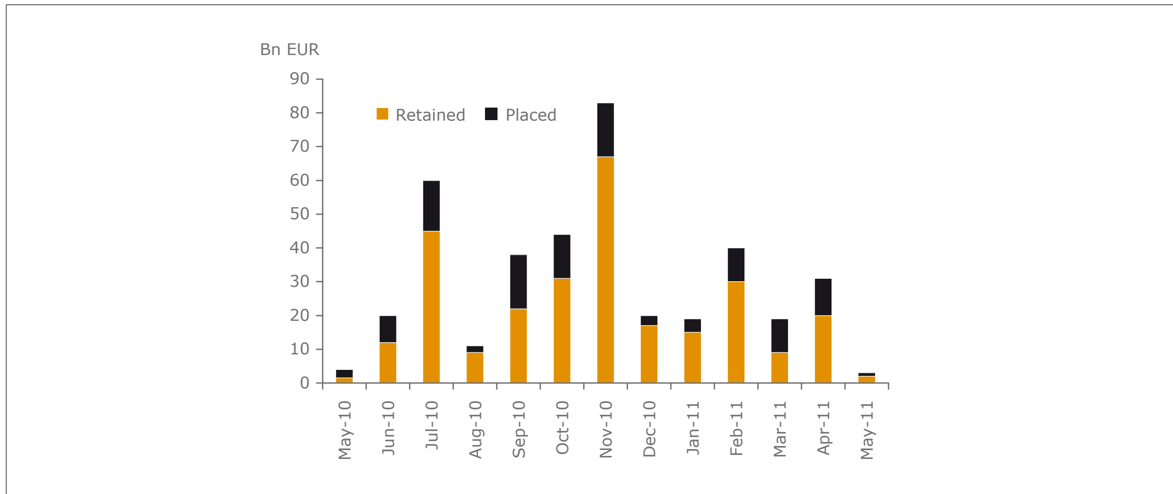
Source: Deutsche Bank

> Investor placed asset securitisations class breakdown (as of 17 May 2011)



Source: Deutsche Bank

> Retained versus placed issuance of European ABS



Source: Deutsche Bank

Conclusion

While public issuance of MBS recovered in the past two years, issuance levels are still far from historical highs. In case of Covered Bond on the other hand, issuance levels were at historically high levels in H2 2010 and Q1 2011.

Despite convergence of covered bonds and MBS pre-crisis, there are crucial differences between the two products. MBS investors are exposed to the risk of underperformance of the cover pool and maturity extension. During the financial crisis, high non-performing loans and lower pre-payments were drivers of cover pool under performance and maturity extensions of MBS. Covered bonds are bank bonds and holders of covered bonds 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 Bond holders 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 strong 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 increasing investor protection.

Overall, also driven by regulatory (and central bank support), covered bonds are likely to remain a very important funding tool for banks in the post-crisis financial market architecture.

2.3 COVERED BONDS AND REPO

By Frank Will and Michael Michaelides, RBS

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 (QE) have been extensively used by the Federal Reserve and the Bank of England, whilst the ECB's preferred response was its EUR 60 bn covered bond purchase programme initiated in mid-2009. Nonetheless a crucial pillar of the responses of all central banks has been through their monetary policy operations, either increasing the number or nature of their long and short term repo operations, or widening the pool of 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)	EUR	Up to BBB-	Best Rating	EUR 1 bn 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	GBP 1 bn or EUR 1 bn (depending on issuance currency)	No
	Discount Window	Yes			A-/A3		none	Yes
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)	

Central Bank	Operation	Covered Bonds eligible?	Eligible Covered Bonds	Currency	Minimum Rating	Rating Treatment	Minimum Size	Own-name
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) Foreign Bonds: None but BBB- for favourable liquidity category (II not III)	Best Rating	None	Yes
Reserve Bank of Australia (RBA)	Repo Operations	Yes	Any covered bond fulfilling the eligible security criteria	AUD	AAA	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

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 three 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. 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. Notably for example, the Greek banks between them have seven programmes used for repo purposes, National Bank of Greece, Eurobank and Piraeus Bank even have two programmes each, yet there is only one outstanding Greek jumbo covered bond.

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 75% in amounts posted since 2008 (second in terms of growth only to ABS and non-marketable assets) and almost three times the increase in total collateral posted for repo operations (27%). See section below for more detailed discourse on covered bonds used in the ECB operations and the ECB classification of a 'covered bank bond'.

1.1 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

1 Protocol on the Statute of the European System of Central Banks and of the ECB, Article 18.1

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.

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 uncovered bank bonds (since 1 Feb 2009):The value assigned to uncovered bank bonds issued by an issuer or entity with close links must be less than a share of 10% in the value of the collateral pool of a counterparty, unless the market value of these assets is not higher than EUR 50 m
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) > 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'
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 A- (S&P) / A3 (Moody's) / A- (Fitch) / AL (DBRS). In deviation of its best rating approach at least two ratings must meet the criteria.
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 guarantor must be established in the EEA
Currency of Denomination	EUR

In January 2011 the ECB implemented its new 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, except for assets in liquidity category V (i.e. ABS) which remained at the higher A- threshold. Notably the minimum rating threshold has been lifted for Greek Irish and Portuguese sovereign paper, since May 2010, April 2011 and July 2011 respectively.

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).

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% haircuts 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** (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	

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** (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		5.5	5.5	6	6	8	8	15	15
1-3		6.5	6.5	10.5	11.5	18	19.5	27.5	29.5
3-5		7.5	8	15.5	17	25.5	28	36.5	39.5
5-7		8	8.5	18	20.5	28	31.5	38.5	43
7-10		9	9.5	19.5	22.5	29	33.5	39	44.5
>10		10.5	13.5	20	29	29.5	38	39.5	46

Source: ECB (*Assets in that liquidity category that are given a theoretical value will be subject to an additional 5% haircut)

1.2 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 as of 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% 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.

1.3 Covered Bonds and 'Close Link' Exemption

'Covered bank bonds' also benefit from certain preferential treatments compared with non-UCITS compliant covered bonds and 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 now 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. Apart from the fact that swap counterparties and liquidity providers to a transaction may now also be precluded from using these ABS as eligible collateral, originators of ABS (which have historically been able to use their retained ABS as eligible collateral) are no longer be able to do so if they provide a currency swap or liquidity above the 20% threshold.

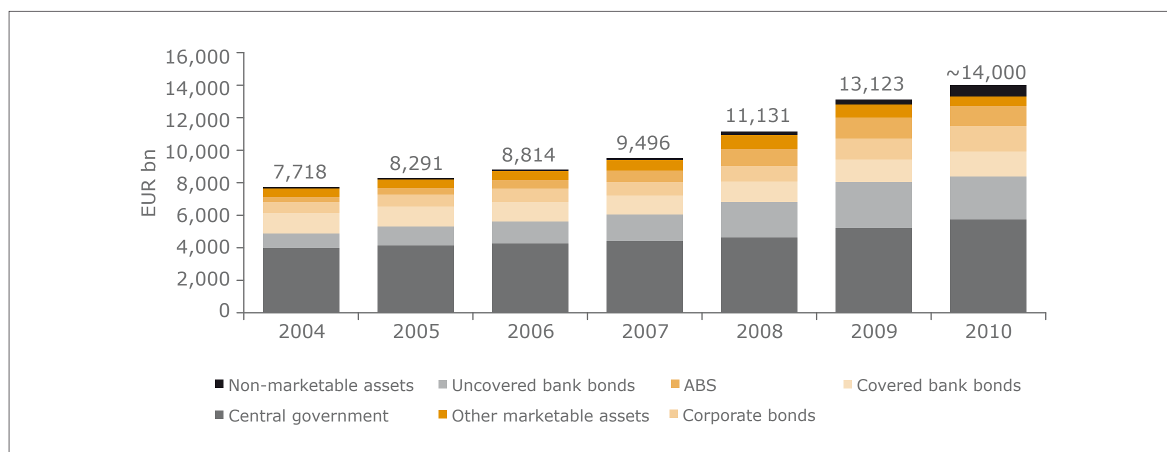
2 'Close links' means the counterparty is linked to an issuer/debtor/guarantor of eligible assets by one of the following forms: (i) the counterparty owns directly, or indirectly, through one or more other undertakings, 20 % or more of the capital of the issuer/debtor/guarantor; or (ii) the issuer/debtor/guarantor 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]

The main exemptions from the 'close links' rule remain 'covered bank bonds'. Self-issued UCITS compliant covered bonds can be used by counterparties as collateral, i.e. an issuer can use its own covered bonds and there are no close links prohibitions. This has been one of the drivers of the strong increase in new covered bond programmes since 2008.

1.4 Use of Covered Bonds as Collateral in Eurosystem Operations

The overall volume of marketable assets which had become eligible for repo operations has increased over 80% from EUR 7.7 bn in 2004 to EUR 14.0 bn at year end 2010. Of this increase EUR 1.3 bn, has resulted from the temporary measures introduced in 2008, many of which expired at year-end 2010. At end-2010 this meant central government debt accounted for the largest share (41%) followed by uncovered bank bonds (19%), covered bank bonds (11%), corporate bank bonds (11%), ABS (9%) and other bonds, such as supranationals (4%).[3]

> Chart 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 to 13%

Although the use of covered bank bonds (which includes only UCITS compliant covered bonds) jumped by around 57% from 2008 to 2009, almost double the rate as total collateral use (29%), their share in the repo operations has dropped from 26% in 2004 to 13% in 2010.

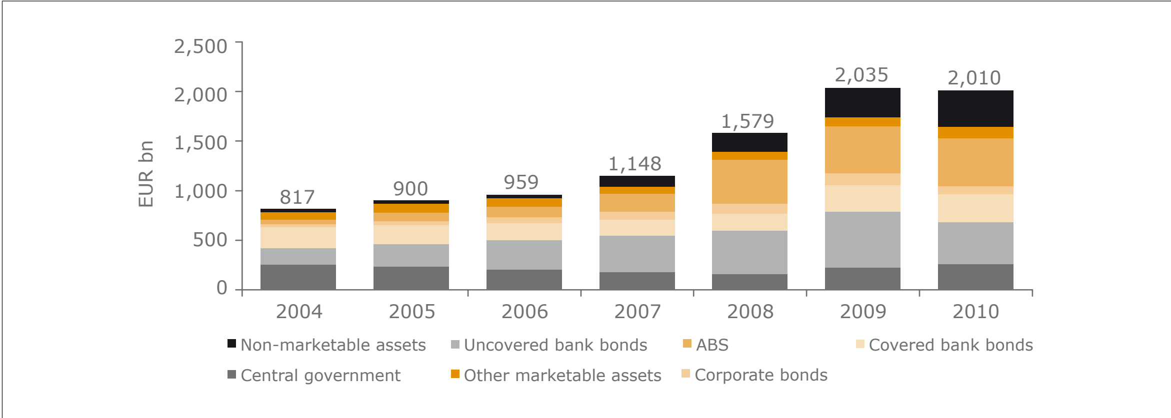
Since 2004, the share of uncovered bank bonds (which included general law based covered bonds) has significantly increased from 20% to 28% having peaked at 32% in 2007.

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.

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. This no doubt played some role in the ECB's decision to exclude ABS from the lower minimum rating threshold for eligible collateral for repo operations. The share of non-marketable securities continued to rise, representing 18% in 2010, compared to 14% in 2009 and only 9% in 2008, whilst the temporarily-available asset classes (such as foreign-currency assets) represented only 1% of total marketable collateral put forward in 2010.

Chart 2 also indicates 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 more recently has shown a decline to a total usage.

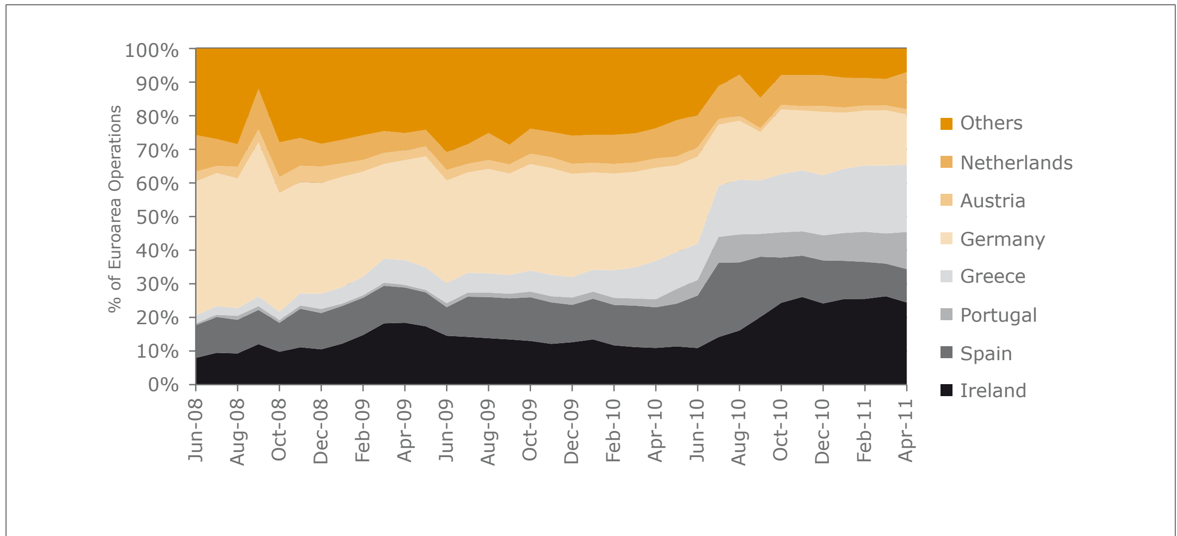
> Chart 2: Actual use of collateral by asset type



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. The usage by German banks has dropped since July 2010 reflecting the stabilisation in the German market. TheEUR Spanish credit institutions have also significantly lowered their usage of the ECB facilities compared with the peak in August 2010, partly driven by better access to the wholesale market but also by the higher usage of clearing houses for liquidity purposes.

> Chart 3: Composition of total Eurosystem lending including fine tuning by NCBs



Source: ECB, 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 and also 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 the announcement of a supplementary 6m LTRO. 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.

1.5 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, though perhaps equally important it maintains its positive stance 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]

Moreover, a key second justification is regarding the absence of effective risk transfer and the desirable incentives this creates for the originating banks. As 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. 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:

>Table: 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 Covered Bonds	EEA
Minimum Rating	AAA rated	A3/A- provided that AAA rated at time of issuance
Minimum Size	At least £1bn or EUR 1 bn (depending on issue currency)	n/a
Own Name Covered Bonds	No	Yes
Underlying assets	Residential Mortgages, social housing loans or public sector debt	

4 European Central Bank, "Covered Bonds in the EU Financial System", December 2008

5 Keynote address by Jean-Claude Trichet, Munich, 13 July 2009

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 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, presumably for liquidity reasons. Meanwhile under the current guidelines, even for most of the UK banks, only their Euro covered bonds would be eligible, given that most of the Sterling covered bonds currently 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.

On 1 July 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 will no longer be eligible for short term repo operations. Thus even some AAA countries such as Norway, Denmark, Finland or Austria, 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

2.1. 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 usually set 25bp below the Bank of England rate. Thus the Operating Standing Facilities are designed to establish a (symmetric) corridor around the Bank rate[6]. 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.

6 As of July 2011, the bank is remunerating all reserves at the bank rate, so there is no need for the deposit facility to be used (though it remains set at 25bp below that bank rate).

2.2. 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.

2.3. 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 quarter; 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[7]. 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 are 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).

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.[8] 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

7 There is no maximum number of bids, only a maximum total value of bids from a single participant.

8 The rationale here is to avoid participants basing their bids on assumptions about others' behaviour.

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.

2.4. The Discount Window

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 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 illiquid securitised loans and mortgages (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 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

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).

2.5. Additional Disclosure Requirements for Residential Mortgage Covered Bonds

The Bank of England is in the process of imposing additional disclosure and transparency requirements for RMBS and covered bonds backed by residential mortgages. The BoE requires anonymised loan level information for securities from these two asset classes. 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.

10 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 implementation period for the loan level data has already begun and will last until 30 November 2011. During this period, securities not complying with the new transparency requirements will continue to be accepted without penalty, until the end of the implementation period. At the end of the implementation period, there will be an additional one 'transitional' year period during which securities not meeting the new requirements may remain eligible but will be subject to increasing haircuts, of 5% at the beginning of the period 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 ultimately need to be provided.

These additional transparency requirements do not apply to public sector covered bonds.

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.

3.1. 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.

10 With the exception of covered bonds already pledged within the Special Liquidity Scheme

11 Fannie Mae, Freddie Mac and Federal Home Loan Bank.

"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 Obligation Foncières or any of the various Nordic covered bonds have not been included.

		% 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
Operational Standing Facilities	USD Denominated Bills/Notes/ Bonds	2.0	4.0	5.0
	USD Denominated Zero Coupon	3.0	10.0	9.0
	Foreign Denominated Bills/Notes/ Bonds	8.0	10.0	11.0
GSEs	USD Denominated- AAA rated	2.0	4.0	5.0
	USD Denominated- AA-BBB rated	3.0	5.0	6.0
	Foreign Denominated	8.0	10.0	11.0
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	6.0
	USD Denominated-	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

		% of Market Value (by Maturity)		
Asset Class	**Asset Type**	**0-5 yrs**	**>5-10 yrs**	**>10 yrs**
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	4.0	18.0
	CDOs- AAA rated	8.0	9.0	10.0
	CMBS- AAA rated	3.0	7.0	8.0
Agency Backed Mortgages	Pass through	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

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.

4. SWITZERLAND: ELIGIBILITY CRITERIA FOR SWISS NATIONAL BANK (SNB) OPERATIONS

4.1. 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 at 9:00 am 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 several 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. Coun-

terparties 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).

4.2. 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.

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:

- 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).
- have a fixed principal amount with an unconditional redemption
- have a fixed rate, floating rate or zero coupon
- 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.
- 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:

12 Guidelines of Swiss National Bank (SNB) on Monetary Policy Instruments.

	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.

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 billion 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."

4.3. 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.

5. NORWAY: ELIGIBILITY CRITERIA FOR NORGES BANK OPERATIONS

5.1 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[13], whilst the overnight lending rate charged to banks for overnight loans (for "D-Loans", see

13 As of the second half of 2011, each bank will be assigned a quota for deposits that will bear interest at Norges Bank key rate, the sight deposit rate. Sight deposits in excess of the quota will bear interest at a lower rate, the reserve rate, which will be set 100bp below the deposit rate. This moves the system closer to an ECB-style 'corridor' system than the current 'floor system'.

below) is the other (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).

5.2. 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 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. Issuance from Norwegian banks and mortgage companies are generally exempt here, though Norwegian covered bonds are not. For securities issued by Norwegian entities a credit rating of the issuer is sufficient.

14 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.

- 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[14]

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 million, whilst securities in a foreign currency must have a minimum volume equivalent to EUR 100 million.
- 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.

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.

Under the current arrangements covered bonds would fall within liquidity category II, as a form of 'bank debt'. Thus haircuts would be modest, but much higher than government debt. A five year (rated) covered bond would therefore receive a 6% haircut on its market value when being considered as collateral. Furthermore, there is an additional 3% haircut for debt denominated in foreign currencies. Finally, zero coupon bonds with a residual maturity of more than seven years are not eligible for repo operations.

The haircuts applied to the market value of a security are set out by category below:

> Norges Bank Haircuts by Category and Residual Maturity

Liquidity Category	Liquidity Category I	Liquidity Category II	Liquidity Category III	Liquidity Category IV
Eligible Collateral	> Norwegian Government Bonds > Foreign government or govern. guaranteed bonds, min. rating A/A2	> Bank or Corporate Bonds min rating: A/A2 > Norwegian municipalities, municipality guaranteed, or state-owned enterprise bonds, > VPS-registered Bond Funds**	> Norwegian Bank and Corporate Bonds min rating: BBB-/Baa3 > Unlisted/unrated Norwegian covered bonds, > Unlisted/unrated power or infrastructure company bonds	> Unrated/ unlisted Norwegian Corporates*
0-1 year	1	2	8	25
1-3 years	2.5	3.5	10	28
3-7 years	3	6	12	31
7+ years	4	8	14	n/a

Source: RBS, Norges Bank

(Securities in foreign currencies are subject to a further 3% haircut)
* except debt of power or infrastructure companies (in Category III).
** In the case of funds, duration will be used to determine the haircut instead of the period to the next interest rate adjustment, and collateral registered in VPS must be NOK.

5.3. 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 230bn. The maturity of the swaps was originally three years but was subsequently extended to five years.

Bank quota & Reversal of Temporary Arrangements

An interesting feature amongst the Norwegian repo framework is the 'bank quota'. This is the maximum share of a bank's borrowing facility which can consist of securities issued by banks. This is currently capped at 35% of a bank's borrowing from Norges Bank and includes securities from Norwegian, as well as foreign banks. As of 15 February 2012, the temporary measures put in place in autumn of 2008

to provide liquidity to the banking sector will be reversed and the bank quota will fall to 0%. As such, bank securities, other than covered bonds, will no longer be eligible for loans from the Norges Bank. The approval of new securities which would only qualify as collateral under the previous regime has already ceased.

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.

6.1 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

> **Structured bonds**: Highly structured securities or those with embedded derivatives are not eligible.

> **Own 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[15]. This 'related party exemption' also applies to covered bonds and as such "own name covered bonds" are not eligible for RBA repo operations.

15 An exception applies in extraordinary circumstances when the RBA may accept related party RMBS or ABCP

6.2. 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.

	Minimum Rating	Minimum Number of Issuer Ratings	Minimum Number of Issue Ratings
General Collateral			
Commonwealth Government Securities	n/a	n/a	n/a
Semi-governments Securities	n/a	n/a	n/a
A$ Domestic Issues by Supranationals and Foreign Governments	AAA*	2	1
A$ Securities with an Australian Government Guarantee	n/a	n/a	n/a
A$ Securities with a Foreign Sovereign Government Guarantee	AAA*	2	2
Private Securities			
Short-term securities			
Bills and CDs	n/a	n/a	n/a
CP	A-1	n/a	1
Asset Backed CP (ABCP)	A-1	n/a	1
Long-term securities			
ADI Issued Debt Securities	A-	2 (either)	
RMBS and CMBS	AAA	n/a	1
Other AAA Securities	AAA	n/a	1

* In the case of securities guaranteed by the New Zealand government AA+ is the minimum rating.

This provides a potential leeway for repo eligibility for covered bonds denominated in AUD and issued in the Kangaroo market (i.e. onshore) to be eligible for Repo transactions with the RBA. As of end of July 2011, the only eligible covered bonds are those issued by Canadian Imperial Bank of Commerce (CIBC) in AUD. 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 CDO or other such structures.

7. NEW ZEALAND: ELIGIBILITY CRITERIA FOR RESERVE BANK OF NEW ZEALAND (RBNZ) OPERATIONS

7.1. 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 any of 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.

7.2. 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[16] (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.

16 As of end-July 2011, only three covered bonds were eligible: the Bank of New Zealand 6.0% June-2015 and Bank of New Zealand 6.425% June-2017 covered bonds.

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 AAA 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 the eligible covered bonds receive highly favourable treatment.

Eligible Security	**Minimum Rating**	**Haircut**	
		< 3 years	**≥ 3 years**
NZ Government & RBNZ			
Treasury Bills	AAA	1%	3%
Bonds			
Inflation-linked Bonds			
RBNZ Bills			
Acceptable Kauri issues	AAA	3%	5%
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
Securities guaranteed by NZ government			
NZD Denominated	AAA	6%	8%
	A-1+		
Non-NZD Denominated	AA+	11%	13%
	A-1+		
Securities issued/guaranteed by Foreign governments			
NZD Denominated	AA+	6%	8%
	A-1+		
Securities issued/guaranteed by Foreign governments (NZD)			
Bonds	AA+	6%	8%
CP			
RMBS (NZD- on a single name basis)			
Bonds	AAA	10%	15%
CP			n/a
RMBS (NZD- on a two name basis)			
Bonds	AAA	19%	
CP			
Covered Bonds (NZD			
Bonds	AAA	5%	8%

8. COVERED BONDS AND REPOS: CONCLUSION

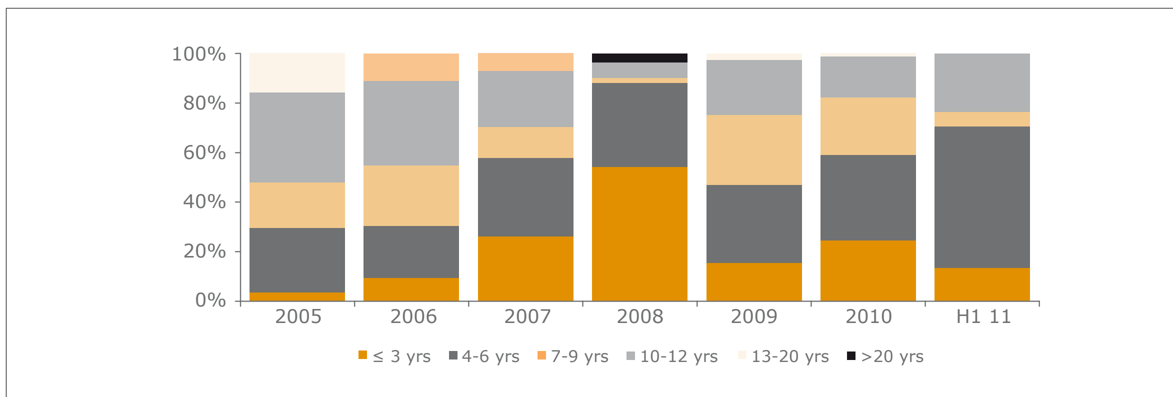
The comparison of the various treatments of covered bonds by some of the major central banks underlines the special status of covered bonds. This is driven in our opinion by the macro-economic benefits of covered bonds through the provision of cheap residential (and commercial) mortgages (see separate article in this publication by Frank Will & Jan King for more details) and by given banks 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 BEYOND BANK FUNDING: THE MACRO-ECONOMIC DIMENSION OF COVERED BONDS

By Frank Will, RBS and Jan King, LBBW

Usually, the benefits of covered bonds are demonstrated at issuer level, highlighting that covered bonds offer comparatively cheap and reliable funding to issuers whilst also helping to broaden the investor base. Providing issuers access to long term funding, for example, has been well demonstrated throughout 2011 when looking at the average tenor of publicly placed covered bond issues.

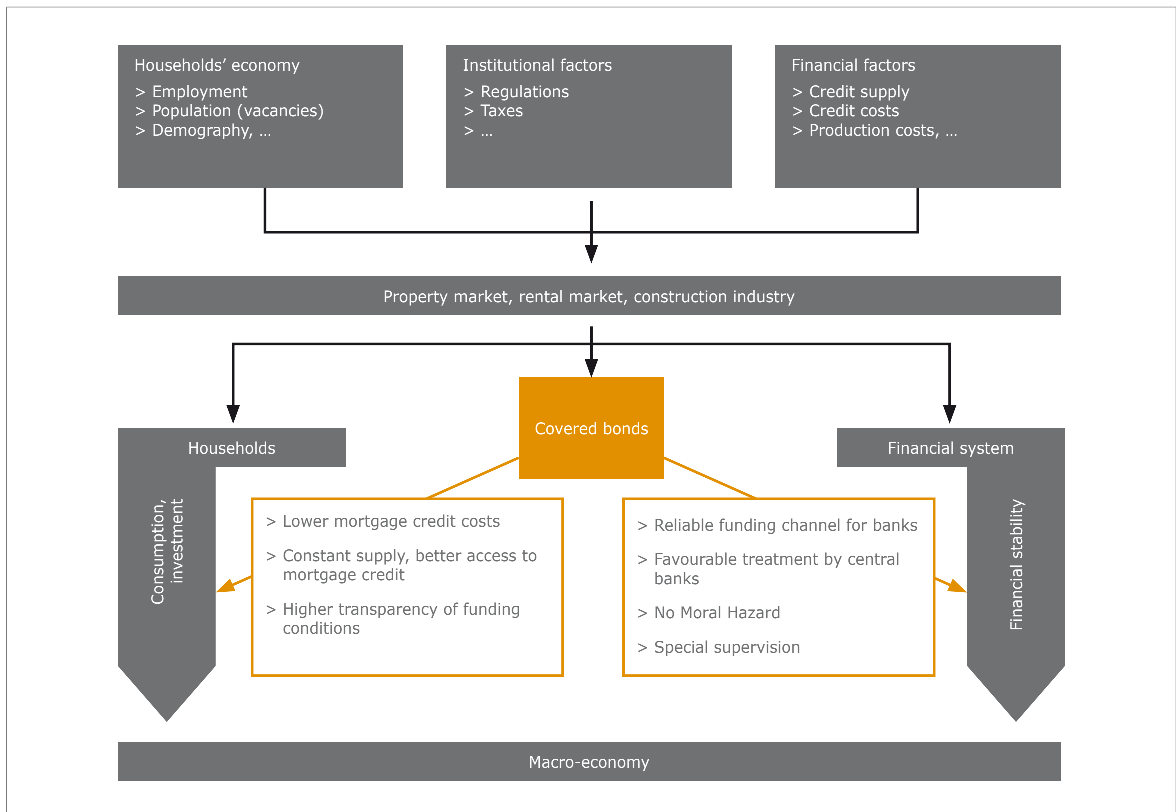
> CHART 1: ANNUAL EUR BENCHMARK COVERED BOND SUPPLY BY MATURITY



Source: RBS

Also, the benefits of covered bonds for investors, such as homogeneity within the same legal framework, special supervision or comparatively good rating stability even in an environment of strong rating pressure on sovereigns, are quite frequently displayed. The intention of this article is to shed some light on a third aspect of covered bonds: the macro-economic benefits and financial stability through the use of covered bonds. In order to demonstrate this aspect, we would like to present the arguments at two different levels, firstly, the importance of covered bonds in mortgage financing, and secondly, their importance for financial stability. The following figure illustrates the impact of these two channels on the macro-economy and how covered bonds influence these.

CHART 2: COVERED BONDS' INFLUENCE ON THE PROPERTY MARKET AND THE MACRO-ECONOMY

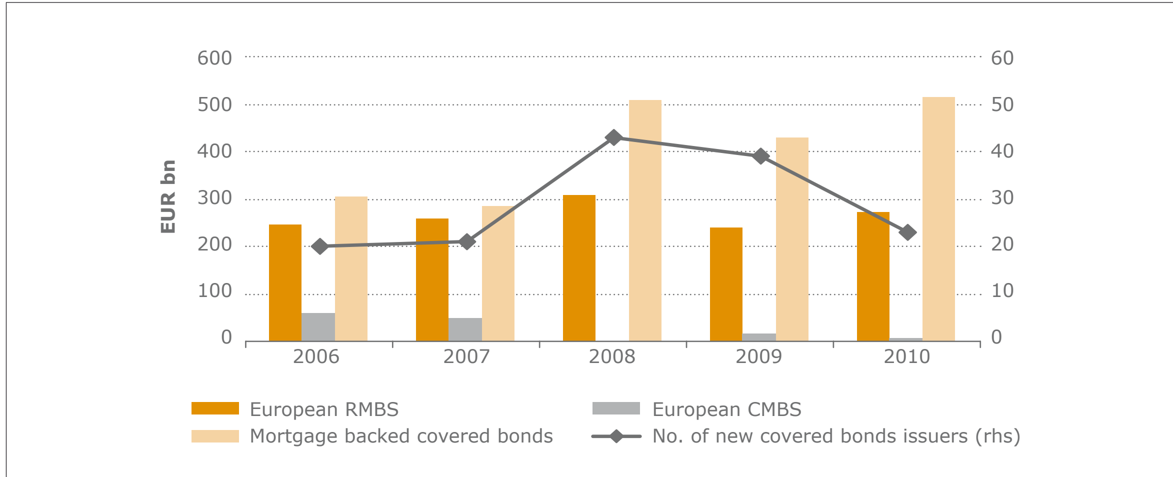


Sources: Sveriges Riksbank, LBBW

IMPACT OF COVERED BONDS ON MORTGAGE AND PROPERTY MARKETS

Covered bonds have become an important tool in providing funding for mortgage lending in many countries – although to varying degrees. Without discussing the basic features of how important property markets (residential as well as commercial) are for the state of an economy, it is fair to state that the purchase of a property is usually the largest purchase a typical household will make in their life. Conditions in the property market as well as in the mortgage credit markets therefore have important long-term effects on consumption and investment behaviour. Vice versa, historical evidence shows that a banking crisis in connection with a real estate crisis tends to have the longest drag on growth, consumption and finally employment in a country (see e.g. IMF 2007). The current crisis is no exception in this regard despite the massive and highly welcomed interventions and growth stimuli taken by government, as well as conventional and unconventional monetary policy measures taken by central banks worldwide. Therefore, any measure or instrument bringing safety, reliable credit supply and continuously low credit spreads for borrowers to the mortgage markets are to be welcomed per se.

> CHART 3: YEARLY ISSUANCE VOLUMES OF RMBS, CMBS AND MORTGAGE BACKED COVERED BONDS, EUR BN AND NO. OF NEW COVERED BOND ISSUERS

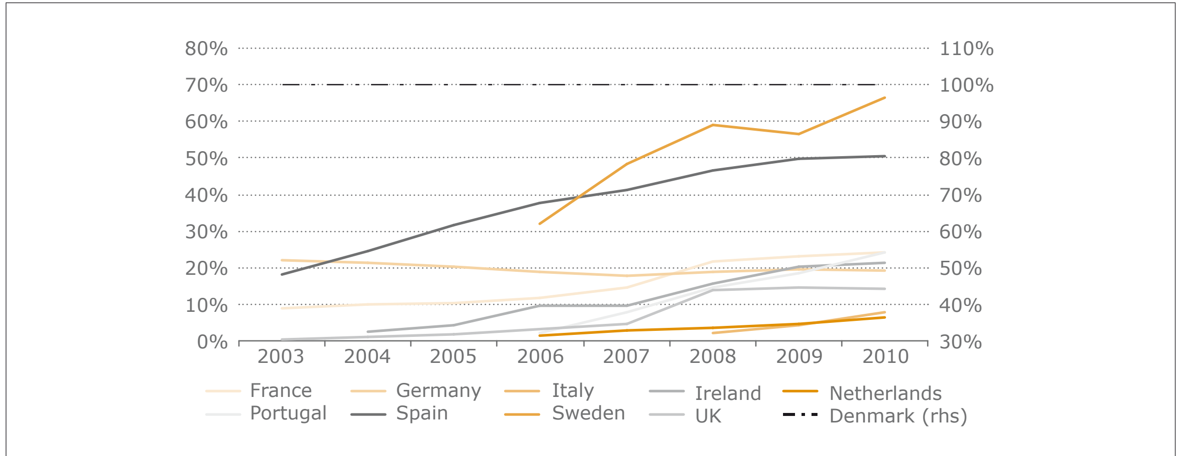


Sources: EMF, ECBC, LBBW

The advantage for investors of homogeneity within the same legal framework has already been mentioned. However such homogeneity is also beneficial for the property market in general. Homogenous funding instruments for banks lead to higher information efficiency increasing transparency as regards the pricing of mortgage loans. Consequently, it will be easier for market participants to predict their cost of capital on which investment decisions are based, or to determine the cost of housing as a calculation basis for the rent. The best example is Denmark where mortgage loan interest rates and prepayment conditions can be easily monitored on a daily basis through the price development of the mortgage bonds funding the loan.

To state the obvious, the positive effects of covered bonds outlined in this article are clearly dependent on the extent of use of covered bonds within a particular country compared to the size of the domestic mortgage market, GDP 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).

> Chart 4: Mortgage backed covered bonds as % of residential mortgage loans



Sources: EMF, ECBC, LBBW

Besides, the argument of macro-economic advantages in our view is also valid for public sector covered bonds, assuming that providing capital market access to public sector is per se a positive feature. The general assumption behind this statement is of course that funding of any public sector body is a positive feature as these public entities spend their money sensibly in accordance with the needs and requirements of society. The ECBC Fact Book surely is not the place to discuss public indebtedness and whether the society is always best served by public bodies, we will not pursue this discussion, instead we restrict our arguments to mortgage backed covered bonds. Nonetheless, public sector covered bonds have undoubtedly reduced the funding costs of public sector borrowers. The bundling of public sector assets has resulted in (1) an increase of diversification allowing borrowers to achieve higher ratings above their individual credit standing, (2) funding benefits through benchmark transactions and (3) a significant broadening of the investor base. All this has contributed to a considerable reduction of the funding costs of public sector borrowers.

	Mortgage Backed Covered Bonds Outstanding, EUR bn								Covered Bonds Outstanding, EUR bn								Mortgage Backed CBs as % of Residential Mortgage Loans							
	2003	2004	2005	2006	2007	2008	2009	2010	2003	2004	2005	2006	2007	2008	2009	2010	2003	2004	2005	2006	2007	2008	2009	2010
Austria	4.0	4.0	4.0	3.9	4.1	5.0	5.3	9.6	10.8	10.8	17	19.5	19.3	22.3	24.9	30.8	10.1	8.3	7.4	6.4	6.3	7.0	7.3	12.0
Czech R.	1.6	2.0	4.5	5.5	8.2	8.1	8.2	8.2	1.6	2.0	4.5	5.5	8.2	8.1	8.2	8.2	67.2	53.1	74.0	68.8	65.9	50.6	48.2	34.0
Denmark	204.7	216.1	246.4	260.4	244.7	255.1	319.4	332.5	211.6	222.5	253.3	267	252.6	262.3	326.8	339.2	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Finland	0.0	0.3	1.5	3.0	4.5	5.8	7.6	10.1	0.0	0.3	1.5	3.0	4.5	5.8	7.6	10.1	0.0	0.7	3.1	5.4	7.2	8.6	10.6	13.2
France	38.3	47.5	57.2	74.0	103.6	159.4	176.0	193.5	86.9	105.8	124.8	154.6	200.1	264.5	289.2	320.5	9.9	11.0	11.3	12.8	15.9	22.5	23.9	24.2
Germany	256.0	246.6	237.5	223.3	206.5	217.4	225.1	219.9	1056.7	1010.1	975.9	948.8	888.6	805.6	719.5	639.8	22.1	21.3	20.4	18.9	17.9	19.0	19.6	19.1
Greece	0.0	0.0	0.0	0.0	0.0	5.0	6.5	19.75	0.0	0.0	0.0	0.0	0.0	5.0	6.5	19.8	0.0	0.0	0.0	0.0	0.0	6.4	8.1	24.6
Hungary	3.6	5.0	5.1	5.9	6.0	7.1	7.1	6.2	3.6	5.0	5.1	5.9	6.0	7.1	7.1	6.2	60.5	62.5	54.5	56.0	45.9	45.5	31.65	24.9
Ireland	0.0	2	4.1	11.9	13.6	23.1	29.7	29.0	12.4	29.2	45.1	61.8	64.8	75.7	80.7	65.6	0.0	2.6	4.2	9.7	9.7	15.6	20.1	21.4
Italy	0.0	0.0	0.0	0.0	0.0	6.5	14.0	26.9	0.0	0.0	4.0	8.1	8.1	14.6	23.1	37.0	0.0	0.0	0.0	0.0	0.0	2.1	4.2	7.6
Latvia	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	4.8	4.1	2.4	1.3	1.3	1.3	1.2	1.0
Luxembourg	0.0	0.0	0.0	0.2	0.2	0.2	0.0	0.0	16.9	19.6	25.0	28.5	33.9	35.6	31.6	28.9	0.0	0.0	0.0	1.3	1.1	1.0	0.0	0.0
Netherlands	0.0	0.0	2.0	7.5	15.7	21.0	28.4	40.8	0.0	0.0	2.0	7.5	15.7	21.0	28.4	40.8	0.0	0.0	0.4	1.4	2.8	3.6	4.7	6.5
Norway	0.0	0.0	0.0	0.2	6.4	21.9	51.3	69.9	0.0	0.0	0.0	0.0	6.4	21.9	52.3	71.7	0.0	0.0	0.0	0.0	3.6	12.8	26.3	31.9
Poland	0.2	0.2	0.6	0.5	0.7	0.6	0.6	0.5	0.2	0.2	0.6	0.5	0.8	0.7	0.7	0.6	1.8	2.3	3.8	2.0	1.9	1.0	1.0	1.0
Portugal	0.0	0.0	0.0	2.0	7.9	15.3	20.3	27.7	0.0	0.0	0.0	2.0	7.9	15.4	21.4	29.1	0.0	0.0	0.0	2.2	7.8	14.5	18.3	24.2
Slovakia	0.5	1.1	1.6	2.2	2.7	3.6	3.6	3.4	0.5	1.1	1.6	2.2	2.7	3.6	3.6	3.4	36	47.9	51.4	52.6	41.9	41.9	39.1	31.9
Spain	57.1	94.7	150.2	214.8	267	315.1	336.7	343.4	62.0	101.9	159.9	226.4	283.3	332.1	352.8	361.8	18.3	24.6	31.6	37.6	41.3	46.7	49.6	50.5
Sweden	0.0	0.0	0.0	55.3	92.3	117.6	133.9	188.8	0.0	0.0	0.0	55.3	92.3	117.6	133.9	188.8	0.0	0.0	0.0	27.2	41.7	53.7	56.7	66.5
UK	5.0	15.0	26.8	50.5	82	204.3	201.1	205.4	5.0	15.0	26.8	50.5	82.0	204.3	204.5	208.9	0.5	1.2	1.9	3.2	4.7	14.0	14.7	14.2
US	0.0	0.0	0.0	4.0	12.9	12.9	12.9	11.5	0.0	0.0	0.0	4.0	12.9	12.9	12.9	11.5	0.0	0.0	0.0	0.0	0.2	0.1	0.2	0.2

Source: EMF, ECBC, LBBW. Data for 2010 as of July 2011

Note: Covered bonds backed by mortgages include both residential and commercial mortgages, however, data on total commercial mortgage loans outstanding is not available for all countries. By including all mortgage backed covered bonds, this will tend to overstate the percentages in the second section of this table in those countries where more significant use of commercial mortgages is made in the cover pool.

IMPACT OF COVERED BONDS ON FINANCIAL STABILITY

The second argument underpinning the significance of covered bonds for the overall banking sector and, ultimately toward their contribution to enhancing financial stability, is their favourable treatment by central banks and the role of covered bonds in the current crisis. An obvious example of the relationship between covered bonds and central banks was the Eurosystem's EUR 60 bn Covered Bond Purchase Programme in 2009/2010.However, a more detailed investigation into this topic, quickly reveals more interesting facts about covered bonds and financial stability:

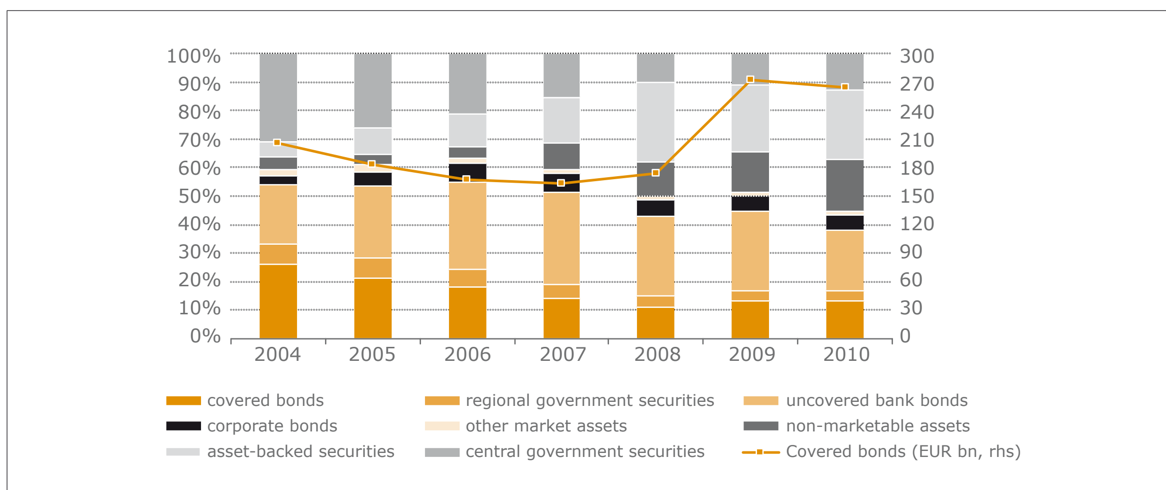
> **The moral hazard problem of ABS is solved by using covered bonds as the issuer still retains the credit risk of the underlying loans.**

"[...] the EU covered bonds model is a valuable alternative to the US mortgage backed securities model because it is a form of securitisation that mitigates the perverse effects arising from the lengthening of intermediation chains." Source: ECB, Financial Integration in Europe, April 2010.

> **The widespread use of covered bonds as collateral in central bank repo transactions.**

According to statements from the ECB, more than EUR 260 bn of covered bonds were used on average as collateral in the course of 2010. This should be compared to the overall outstanding volume of covered bonds of EUR 2,504 bn. The Bank of England, as well as Norges Bank, had also broadened the eligibility criteria of their market operations allowing the use of covered bonds in order to support their domestic bank funding and counteract a mortgage credit crunch.

> Chart 5: Composition of collateral deposited in the Eurosystem as % and absolute amount of deposited covered bonds, EUR bn



Sources: ECB, LBBW

Since the subprime crisis erupted in 2007, with corresponding effects on the securitisation market, government bonds and covered bonds have partly been replaced by ABS as collateral for repo transactions with the Eurosystem. For example, as at the peak of the banking crisis it was no longer possible to refinance property loans through MBS in the market as in the past, these loans were then deposited with the central bank in form of retrained securitisation transactions. Of the marketable collateral, government bonds - thanks to their comparatively high liquidity –and covered bonds – thanks to their

higher marketability - can be better used to obtain liquidity elsewhere and are therefore substituted by way of preference.

> **The haircuts for the use of covered bonds in central bank repos are considerably lower than those for ABS.**

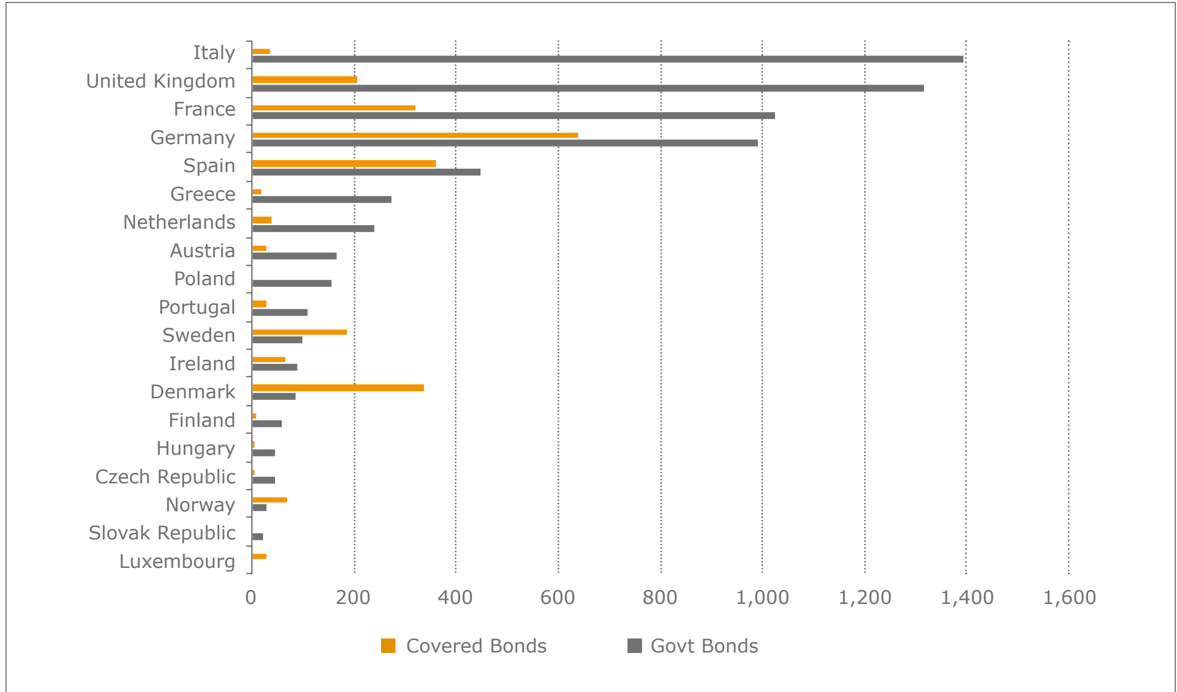
> Even before the ECB Covered Bond Purchasing Programme, central banks had already been well established and sophisticated investors in covered bonds prior to the crisis. Further, one would expect central banks to eventually return to the type of investment behaviour seen before 2007 once the current environment, characterised by turbulence in peripheral European government bond markets and the search for higher financial market stability, has subdued.

> The attractiveness of the product is also underlined by the significant increase in issuers over the last few years (see the chart in the previous section) thereby diversifying the funding channels of banks, improving the availability and accessibility of credit and helping to stabilise an even larger proportion of the banking sector.

Looking at the latest international trends, South Korean regulators have established guidelines to provide a framework for covered bond issuance, Canada has recently launched a consultation paper on covered bond legislations well as Australia, New Zealand and Belgium having set up draft laws. The UK Regulated Covered Bond regime is being reviewed whilst the United States has taken steps towards the passing of the the US Covered Bond Act. Furthermore, the inaugural covered bond out of New Zealand was issued last year.

When looking at the pure size of today's covered bond market globally, it is also fair to state that the existence of covered bonds provide an investment alternative to government bonds or bank deposits. Even though the current sovereign debt crisis has shown that covered bonds and government bonds tend to be closely correlated in times of severe stress at the sovereign level, their beta factor is well below one. Providing an opportunity to diversify a portfolio beyond government bonds should also be seen as beneficial to investors and should be seen as a mitigating and therefore stabilising factor in capital markets when shocks hit other market segments. This is highlighted by the situation in the stressed periphery countries: many covered bonds out of these countries trade inside of their respective government debt reflecting the market perception of higher expected recovery values of covered bonds.

> CHART 6: OUTSTANDING VOLUME OF SELECTED GOVERNMENT BOND AND COVERED BOND MARKETS (INCLUDING PUBLIC SECTOR COVERED BONDS), END 2010, EUR BN



Source: OECD, ECBC, LBBW

Looking at the role covered bonds have taken particularly within European economies, we think it is important and to the benefit of the overall economy as well as to financial stability, to carefully examine the impact of the ongoing banking regulation and any potential changes in central bank policy on covered bond funding. The current regulatory initiatives regarding for example regulating bank's asset liability matching, liquidity position or lending behaviour, are all areas of crucial importance for covered bond from the issuer's perspective – but they will be dealt with under banking rather than covered bond regulation. Given the aforementioned macro-economic importance of covered bonds and their crucial role in bank refinancing, any serious setbacks for covered bonds should definitely be avoided.

	Covered Bonds Outstanding, EUR bn								Covered Bonds as a % of GDP								Covered Bonds as % of Government Bonds							
	2003	2004	2005	2006	2007	2008	2009	2010	2003	2004	2005	2006	2007	2008	2009	2010	2003	2004	2005	2006	2007	2008	2009	2010
Austria	10.8	10.8	17.0	19.5	19.3	22.3	24.9	30.8	4.8	4.6	7.0	7.6	7.1	7.9	9.0	10.8	7.1	6.2	10.9	10.7	9.2	11.0	17.5	18.4
Czech Republic	1.6	2.0	4.5	5.5	8.2	8.1	8.2	8.2	2.0	2.2	4.4	4.9	6.5	5.5	6.1	5.7	13.2	9.8	19.3	17.2	19.3	17.9	25.9	17.8
Denmark	211.6	222.5	253.3	267	252.6	262.3	326.8	339.2	112.3	112.9	122.2	122.1	111.3	112.6	146.6	144.9	200.9	196.2	292.8	307.8	284.3	276.0	391.6	382.5
Finland	0.0	0.3	1.5	3.0	4.5	5.8	7.6	10.1	0.0	0.2	1.0	1.8	2.5	3.1	4.5	5.6	0.0	0.4	2.4	4.5	6.4	9.0	17.1	16.7
France	86.9	105.8	124.8	154.6	200.1	264.5	289.2	320.5	5.5	6.4	7.2	8.6	10.6	13.6	14.9	16.6	10.1	10.6	13.5	14.5	16.1	21.6	33.8	31.3
Germany	1056.7	1010.1	975.9	948.8	888.6	805.6	719.5	639.8	48.8	45.7	43.5	40.8	36.6	32.3	29.9	25.6	115.1	94.9	99.6	82.2	67.6	64.2	82	64.4
Greece	0.0	0.0	0.0	0.0	0.0	5.0	6.5	19.8	0.0	0.0	0.0	0.0	0.0	2.1	2.7	8.6	0.0	0.0	0.0	0.0	0.0	1.5	2.8	7.1
Hungary	3.6	5.0	5.1	5.9	6.0	7.1	7.1	6.2	4.9	6	5.7	6.6	5.9	6.7	7.6	6.3	10.3	10.4	10.9	10.2	8.4	10.1	14.4	13.4
Ireland	12.4	29.2	45.1	61.8	64.8	75.7	80.7	65.6	8.8	19.6	27.8	35	34.1	41.6	49.3	42.6	33.7	67.3	119.7	147.5	139.9	128.5	195.9	72.3
Italy	0.0	0.0	4.0	8.1	8.1	14.6	23.1	37	0.0	0.0	0.3	0.5	0.5	0.9	1.5	2.4	0.0	0.0	0.3	0.5	0.5	0.9	2.0	2.7
Latvia	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.5	0.5	0.4	0.4	0.4	0.5	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	n/a
Luxembourg	16.9	19.6	25.0	28.5	33.9	35.6	31.6	28.9	65.3	71.5	82.5	83.5	90.5	90.5	83.8	69.5	3406.6	3674.9	8513.6	22907.5	n.a.	1279.6	1625.8	722.2
Netherlands	0.0	0.0	2.0	7.5	15.7	21.0	28.4	40.8	0.0	0.0	0.4	1.4	2.8	3.5	5.0	6.9	0.0	0.0	0.8	2.9	5.6	7.6	14.7	17
Norway	0.0	0.0	0.0	0.0	6.4	21.9	52.3	71.7	0.0	0.0	0.0	0.0	2.2	7.1	19.0	23.0	0.0	0.0	0.0	0.0	18.6	72.0	245.7	236.3
Poland	0.2	0.2	0.6	0.5	0.8	0.7	0.7	0.6	0.1	0.1	0.2	0.2	0.3	0.2	0.2	0.2	0.3	0.2	0.5	0.3	0.4	0.4	0.6	0.4
Portugal	0.0	0.0	0.0	2.0	7.9	15.4	21.4	29.1	0.0	0.0	0.0	1.3	4.8	9.3	13.1	16.9	0.0	0.0	0.0	2.0	6.7	13.4	26.7	26.7
Slovakia	0.5	1.1	1.6	2.2	2.7	3.6	3.6	3.4	1.7	3.1	4.1	5.0	5.0	5.5	5.7	5.2	4.9	7.5	12.4	13.3	12.9	16	23.1	14.6
Spain	62	101.9	159.9	226.4	283.3	332.1	352.8	361.8	7.9	12.1	17.6	23.0	26.9	30.5	33.6	34.0	18.5	27.4	48.2	61.8	70.8	78.8	119.8	80.8
Sweden	0.0	0.0	0.0	55.3	92.3	117.6	133.9	188.8	0.0	0.0	0.0	17.6	27.9	35.9	46.5	54.5	0.0	0.0	0.0	40.7	68.5	110.8	180.3	185.7
UK	5.0	15.0	26.8	50.5	82.0	204.3	204.5	208.9	0.3	0.8	1.5	2.6	4.0	11.2	13.1	12.3	0.8	2.1	3.4	5.4	8.0	19.8	28.4	15.8
US	0.0	0.0	0.0	4.0	12.9	12.9	12.9	11.5	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.1	0.4	0.3	0.5	0.2

Source: EMF, ECBC, LBBW. Data for 2010 as of July 2011

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 expected to pass Parliament toward the end of 2011 (August predictions are for a November 2011 enactment). Given legislation has yet to pass Parliament, the below summary is based on the most recent draft legislation.

The four 'Major' Australian banks, made up of Commonwealth Bank (Aa2, AA, AA), Westpac Banking Corporation (Aa2, AA, AA), ANZ (Aa2, AA, AA-), and National Australia Bank (Aa2, AA, AA), are all poised to be the main covered bond issuers, with estimates of inaugural deals coming to market Q1 2012. Based on the 8% issuance cap, as at May 2011, the total for all potential issuers (seven in total) is AUD 167 bn[1].

Two of the four Major Australian banks have been issuing covered bonds during the past twelve months out of their New Zealand subsidiaries. This issuance has given both management and systems experience ahead of issuing out of the Australian parents.

Others banks with both the balance sheet size and credit rating to issue AAA covered bonds include Macquarie Group Ltd (A2, A-, A), Citigroup Pty Ltd (A2, A+, NR), Suncorp (A2, NR, A), Bendigo & Adelaide Bank (A2, BBB+, A-), and ING Bank (Australia) Limited (A1, A, A), which is the 5th largest retail bank in Australia.

AUSTRALIAN COVERED BONDS

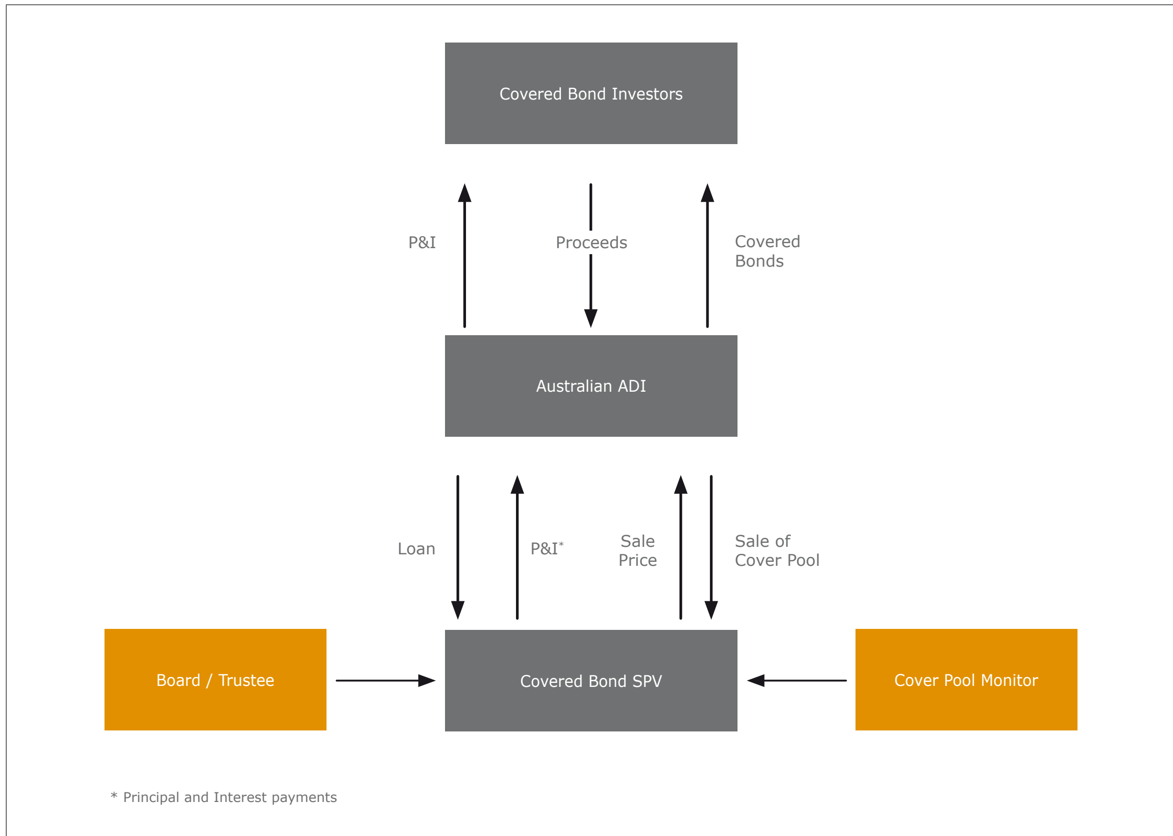
Australian Covered Bond programs follow similar structures as the UK, Canada and New Zealand, given the similarity of the legal systems. Australian Covered Bonds will be direct, unconditional obligations of the Issuer. In the event of Issuer insolvency or default, investors have a claim over the pool of cover assets and a claim on the issuer ranking subordinate to 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 is likely to be structured as a company or a trust (not an LLP, like the UK, on account of tax ramifications). A 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 likely to only be permitted to sell the cover assets up to the contractual maximum; not any voluntary OC, which is held in the form of a senior claim by the Issuer, becoming a part of the Issuer's senior unsecured obligations to which covered bond holders rank pari passu - but behind depositors.

See Figure 1 for how the Australian Government's draft legislation[2] illustrates an Australian covered bond.

1 Equivalent in foreign currencies: EUR 126 bn, US$ 181 bn, GBP 111 bn at 26th July 2011.

2 p.25, *Exposure Draft – Banking Amendment (Covered Bonds) Bill 2011*.

> Figure 1: Generic Australian covered bond programme structure



Banks issuing covered bonds: ADIs[3] 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 (including contractual and voluntary over-collateralisation) is set at 8% of an ADI's 'Assets in Australia.' This cap prevents covered bondholders having 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. 'Assets in Australia' is to be defined by the prudential regulator but it is not expected to be controversial or material however so defined. (N.B. There are two 8% tests in the legislation; the first test is a point-in-time only test for issuance purposes, which if failed results in a prohibition on issuance under legislation; the second test is a prudential test, which is a continuous reporting test that, if breached, may result in a deduction from regulatory capital equivalent to the excess over the 8% cap.)

3 *Authorised Deposit-taking Institutions* ("**ADIs**"), as they are known locally, are the equivalent of an EEA credit institution.

Ring-fencing the cover pool of assets: The cover pool of assets providing security to covered bond-holders and service providers needs to be held by a covered bond special purpose vehicle separate from the ADI issuing the covered bonds, or by a *Covered Bond Credit Institution* if the arrangement involves several ADIs. The covered bond special purpose vehicle or *Covered Bond Credit Institution* 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).

Australian Prudential Regulation Authority'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 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).

Maintenance of the cover pool: The ADI is required 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. This may involve the ADI transferring additional assets to the cover pool and replenishing assets in the cover pool. APRA has the power to prevent an ADI maintaining the cover pool in particular circumstances, however.

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:

> auditing 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 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 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.

I. FRAMEWORK

The Australian covered bond regime emulates the UK RCB in most respects. The issuance is from the bank rather than a 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 (or, in the case of the yet to be confirmed CBCI aggregated structure). See Figure 1.

Australian 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 legislation requires all cover 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):

- cash;
- 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;
- 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.

The LTV limit for mortgages must not vary across different programmes (80% for residential mortgages; 60% for commercial mortgages).

It is important to note that mortgages above one of the 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 the contractual Asset Coverage Test (see Section V below).

V. ASSET-LIABILITY MANAGEMENT

The legislation prescribes a minimum level of overcollateralisation (OC) of 3% and requires the cover pool to be capable of covering all claims attaching to the bonds at all relevant times.

It is predicted that, contractually, issuers are likely to perform a dynamic Asset Coverage Test (ACT) most likely on a monthly basis to ensure minimum 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 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. COVER POOL MONITOR AND BANKING SUPERVISION

An issuer under the legislation must be an ADI (unless it is a CBCI or aggregation SPE for the sole purpose of aggregated issuance).

The issuer is responsible for monthly cover pool monitoring; however, the ACT calculation is likely to be independently verified by an *Approved Auditor* or an *AFSL* holder.

The legislation only deals with the legislative tests – further obligations regarding ACT calculations will likely stem from the contracts.

APRA has the power to order the issuer to cease transferring additional assets to its cover pool if it believes in doing so the issuer threatens its broader solvency (especially its ability to meet the claims of depositors).

VII. HOW ARE SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS REGULATED?

Broadly-speaking the covered bond legislation requires cover pool assets to be beneficially-owned by a special purpose vehicle, not by the ADI. If the ADI is in default, its statutory manager (or APRA) still cannot touch the cover pool assets unless they constituted part of the voluntary over-collateralisation.

VIII. 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 other [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.

The Australian central bank, The Reserve Bank of Australia, has indicated that it is likely to add Australian covered bonds to the list of open market operations' ("OMO") eligible collateral[4]. It already accepts so-called 'Kangaroo' covered bonds from Canadian, French and Danish AUD issuers of covered bonds. Entry on to the OMO list is seen as crucial because the collateral is mirrored in the recently announced central bank Secured Committed Liquidity Facility, which is Australia's Basel liquidity LCR solution, required because of the dearth of Level 1 securities locally (and nil Level 2 securities). This, then, creates a captive investor base in the form of local bank balance sheets and in turn encourages real money investors, thereby promoting liquidity and depth further. But this will take time, and much hinges on its development because once it is liquid in the prudential regulator's eyes it will likely become eligible as a Level 2 liquid asset. This is significant because the central bank facility, in contrast, attracts a disincentive fee to encourage only necessary reliance upon it.

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.

IX. DEVELOPMENT OF THE MARKET

The volume of outstanding Australia regulated covered bonds could amount to about $145.5bn, based on the 'Assets in Australia' of the most likely issuers. Clearly, it will take time for issuers to reach their 8% limits.

4 See: http://www.rba.gov.au/mkt-operations/xls/eligible-securities.xls

> Figure 2: Overview – Australian covered bond programmes*

	CBA	WBC	ANZ	NAB	ING (AUS)	SUN	BAB	CITI (AUS)	MQG
Programme volume in (MAX)	Statutory 8% (including OC) of 'assets in Australia' issuance limit								
AUD (bn)	43.0	43.8	29.5	34.3	3.8	4.6	3.4	1.5	4.3
EUR (bn)[5]	31.6	33.0	22.2	25.8	2.9	3.5	2.6	1.1	3.2
USD (bn)[6]	45.5	47.4	31.9	37.1	4.1	5.0	3.7	1.6	4.7
LTV cap	Mortgages: 80% Residential 60% Commercial								
House price index	n/a								
Maximum asset percentage applied in ACT	No statutory ACT								
Minimum over-collateralisation	103%								
Current asset percentage applied in ACT	n/a								
Current over-collateralisation	n/a								
In arrears accounting	Not defined (likely to be contractually defined as either of missed payments or scheduled balance methodology)								
Hard bullet	n/a								
Asset monitor	No issuance yet. Only *Approved Auditors* and AFSL holders permitted.								

Source: Australian Securitisation Forum
Data: based on 8% Resident Assets, May 2011, Australian Prudential Regulation Authority
Note: *No issuance yet – all figures are illustrative based on 8% assets in Australia statutory encumbrance limit at May 2011 and the exchange rate at 25 July 2011.

5 Equivalent, estimated using exchange rate AUD1.00:EUR0.752 at 25 July 2011.

6 Equivalent, estimated using exchange rate AUD1.00:USD1.083 at 25 July 2011.

3.2 AUSTRIA

By Bernhard Freudenthaler, Hypothekenverband (Austrian Pfandbrief-Forum Secretary)
Martin Schweitzer, Erste Group Bank (Austrian Pfandbrief-Forum Speaker)

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 in during 2010 with the aim of further harmonizing/unifying Austrian Pfandbrief legislation.

II. STRUCTURE OF THE ISSUER

The Mortgage Banking Act does stipulate 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, to Switzerland;

USA, Canada and Japan are not eligible. For EEA 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" 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 overcollateralisation level of 2% is in place, which must be held in highly liquid substitute cover assets.

As well as these rules, banks can 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. 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. For FBS if the government commissioner is concerned that the rights of the Covered Bond holders are being infringed then he can apply to the courts to appoint a joint special representative of the creditors.

VII. 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' and are earmarked for the claims of the Covered Bond holders. Any voluntary overcollateralisation is also bankruptcy-remote but cover assets that are 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 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. 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. As long as the separate legal estate has sufficient liquidity, 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.

Only in the case of over-indebtedness or insolvency of the cover assets may trigger an acceleration of Covered Bonds.

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 can, 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 voluntary overcollateralisation that is not necessary to cover the claims of the Covered Bond holders can be transferred back to the insolvency estate.

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.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

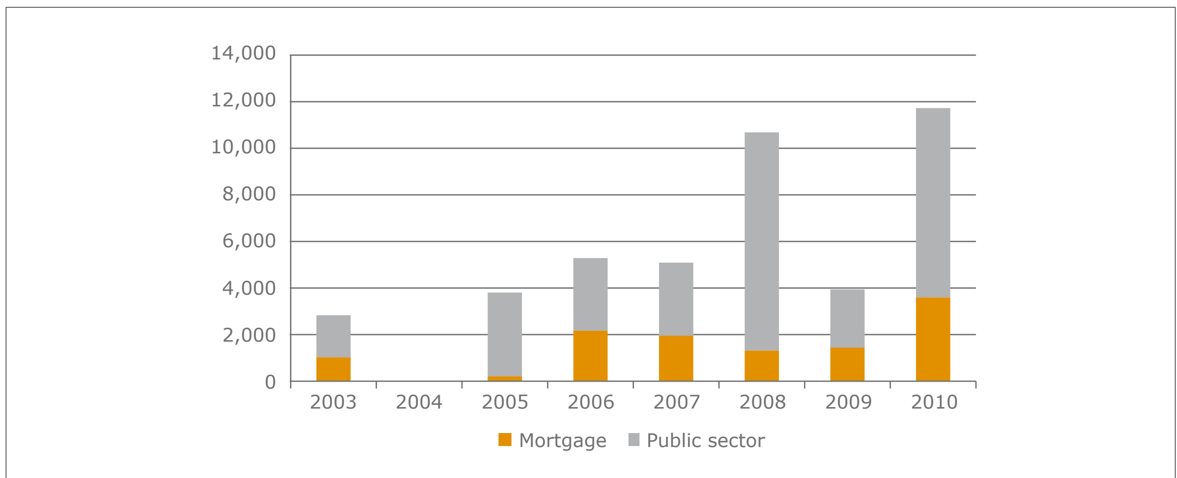
Austrian Pfandbriefe as well as Austrian Covered Bonds (FBS) fulfil the criteria of the UCITS 52(4) directive, as well as those of the CRD Directive, Annex VI, Part I, Paragraph 68 a) to f). This results in a 10% risk weighting in Austria and other European jurisdictions where a 10% risk weighting is allowed.

Austrian Covered Bonds are eligible in repo transactions with the national central bank.

> Figure 1: Covered Bonds Outstanding, 2003-2010, EUR m

Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2010, EUR m



Source: EMF/ECBC

3.3 BELGIUM

By Carol Wandels[1], Dexia Bank Belgium

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[2]. It is expected that Belgium will join the dedicated legal framework countries by the end of 2011.

The description of the forthcoming Belgian covered bond framework in the following sections is based on the draft legislation as it currently stands but might still be subject to changes going forward.

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[3] established in Belgium. However such institutions will first need to be licensed by the NBB as covered bond issuer and also the covered bond program itself will need to get approval from the NBB. For both licenses, an extensive file detailing several aspects (f.ex. strategy, solvability, risk management, etc) needs to be submitted. 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. At program level a further distinction is made between CRD-compliant covered bonds, i.e. "Belgian pandbrieven/lettres de gage", and non CRD-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. 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.

Consultation of the NBB's website will hence give an overview of:

> Belgian credit institutions issuing covered bonds

> Belgian pandbrieven programs and its specific issuances

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 special") on the other hand. The general estate will comprise those assets of the issuing bank to which all its creditors have a direct recourse.

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1 Special thanks to my Dexia colleagues and the colleagues of Stibbe & BNP Paribas Fortis for reviewing the text!

2 Allen & Overy (Brussels), Stibbe (Brussels)

3 Existing credit institutions could decide to issue themselves or to issue from a newly created credit institution. The latter would be a subsidiary or an affiliate of the mother company.

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 specifically related to that program. 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.

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. Only following repayment of all Belgian pandbrieven will any amounts left in the special estate return to the insolvent general estate.

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
- category 5: derivatives

These five general categories are subject to further eligibility criteria:

- geographical scope: OECD, except for category 1 and 2 that are further restricted to EEA;
- 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 ABS/MBS 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 in default (>90days 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[4]]
- 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.

4 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.

- 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, no value can be given anymore.

When it comes to property valuation (applicable to cat 1 and cat 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 that the valuation is based on the report of an accredited third party appraiser.

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.

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.

Other safeguard mechanism that will be foreseen:

- Issuer will have the possibility to retain its own Belgian pandbrieven for liquidity purposes
- Commingling risk:
  - 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
  - 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'
- Set-off and claw back risk: separate legislation in progress to legally solve this

> Following the bankruptcy of the issuer, the separate legal estate will maintain a (limited and extinguishing) banking license

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 for a period of [x] years subject to prior approval from the NBB (however, such appointment should be able to be revoked by the NBB in case of objective reasons);

> neither the certified/statutory auditor of the issuer, nor the certified/statutory auditor of any company controlling the issuer can be chosen.

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 is also allowed to perform audits (independent from the cover pool monitor) at its discretion.

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).

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Belgian pandbrieven will comply with the requirements of Art. 52 par. 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.

3.4 BULGARIA

By Yolanda Hristova, UniCredit Bulbank
and Franz Rudolf, UniCredit Research

I. FRAMEWORK

In Bulgaria, the legal basis for covered bond issuance is the Mortgage-backed Bonds Law issued by 38th National Assembly on 27th September 2000, published in the State Gazette (*Darzhaven vestnik*) issue 83 of 10 October 2000, 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.

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 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:

1. housing units, including leased out;
2. villas, seasonal and holiday housing;
3. commercial and administrative office spaces, hotels, restaurants and other similar real estate; and
4. 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;
- 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 – MORTGAGE APPRAISER OF A PROPERTY

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 the purposes of the mortgage appraiser of a property under the law, the comparative method, the revenue method and the cost-to-make method shall be used.

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.

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. SEGREGATION OF COVER ASSETS

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.

VII. 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:

1. 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;
2. 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:
   - the size of the outstanding principal at the time of extending the loan and by the end of the most recent full quarter;
   - loan life at the time of extending the loan and the remaining term to maturity;
   - interest rates, fees and commissions on the loan;
   - 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;
   - 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;
3. characteristics of the mortgage loan portfolio on the basis of which the issue is made, including a distribution of loans by:
   - the size of the outstanding principal;
   - the residual term to the final repayment of the loan;
   - interest rate level;

- their risk classification by the end of the most recent full quarter;
- 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.

VIII. REDEMPTION OF MORTGAGE-BACKED BONDS IN THE EVENT OF BANKRUPTCY OF THE ISSUING BANK

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 para2, 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.

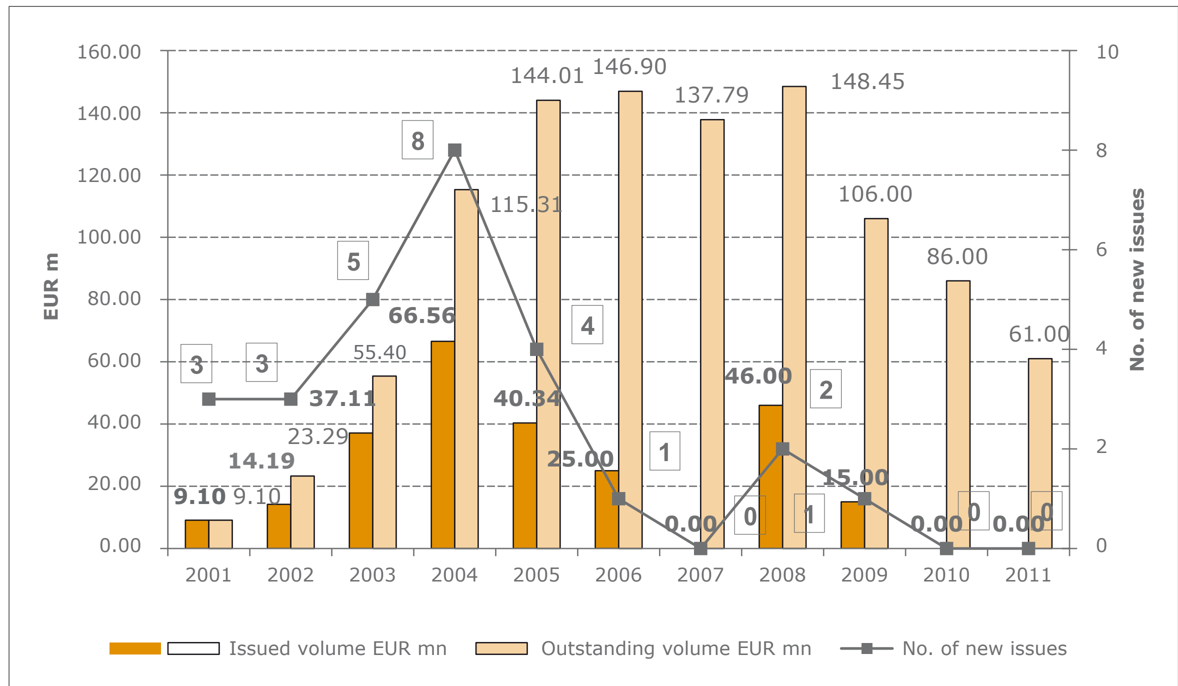
IX. COMPLIANCE WITH EUROPEAN LEGISLATION

Mortgage-backed Bonds Law complies with the requirements of Art.22 par.4 UCITS Directive as well as with those of the CRD Directive, Annex VI, Part 1, Paragraph 68.

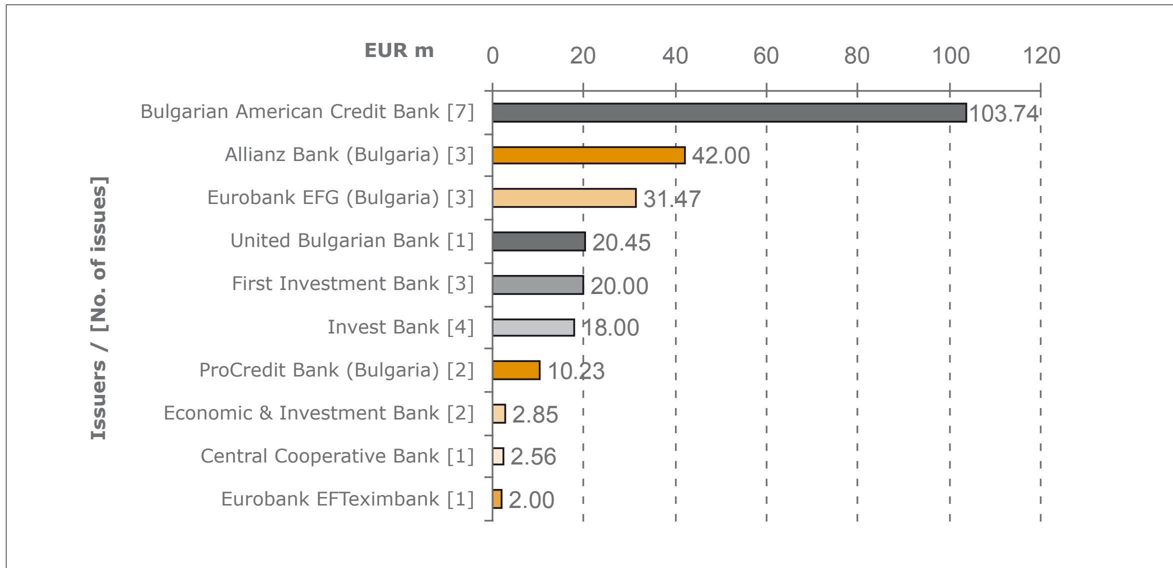
X. BULGARIAN MORTGAGE BOND MARKET INFORMATION

Since the adoption of the Bulgarian Law on Mortgage-backed Bonds in 2000 the Mortgage Bond Issues in Bulgaria total 27. There were no new issues in 2010 and until the end of April 2011. The volume of issued mortgage-backed bonds is EUR 253.3 mn originated by 10 issuing banks. As of the end of April 2011 the outstanding Mortgage Bonds amount to EUR 61 mn.

> Figure 1: Mortgage Bond Issues in Bulgaria



> Figure 2: Mortgage Bond Issuers in Bulgaria (2001 - Apr 2011)



3.5 CANADA

By Hiren Lalloo, RBC Capital Markets

I. FRAMEWORK

There is currently no dedicated legislation for the issuance of Covered Bonds in Canada. As such, Canadian Covered Bonds are based on contractual agreements structured to comply with Canada's existing legal framework. Following the federal government budget announcement in March 2010 to introduce Canadian covered bond legislation, the Department of Finance released a Covered Bonds Consultation Paper on May 11, 2011 outlining the key elements of the proposed Canadian covered bond legislative framework which will apply to covered bonds issued by Canadian Federally Regulated Financial Institutions ("FRFIs"). For the most part, the proposed framework aims to codify the terms within the existing Canadian covered bond programs. Some of the key elements noted in the Consultation Paper are as follows:

> Structure – The framework proposes adopting an SPV model whereby asset segregation occurs via legal sale to a bankruptcy remote special purpose vehicle ("SPV"). This is in line with the existing Canadian structures

> Priority of Claim – The proposed framework will provide clarity that in the event of an Issuer insolvency, the covered bondholders have a priority claim on assets held by the SPV

> Eligibility Criteria – The proposal under the framework is to limit eligible assets to residential mortgage loans located in Canada

> Collateral Valuation and Asset Coverage Test – The proposal aims 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. This will reflect the existing programs which currently all have similar tests

> Record Keeping – The proposal will require sellers to keep records on which assets have been transferred to the SPV and provide the SPV with sufficient information to perfect its claim over the cover assets

> Maximum Overcollateralisation – The proposal aims to set the maximum level of overcollateralisation at ten percent

> Registration – The proposal is to adopt the concept of a centralised Registrar who sets out the process for registration under the Covered Bond Act. The legislation will only benefit registered programs established by registered Issuers. The Registrar would certify that a particular covered bond program meets the legislative requirements and adequate public disclosure is provided. The Registrar would also have the ability to suspend/sanction Issuers. Existing covered bond programs could become registered programs upon successful registration of the Issuer and confirmation that the program meets the requirements

> Demand Loan – Under the proposal the size of the Demand Loan will be the value of the excess collateral within the Guarantor that is not required as collateral for the outstanding covered bonds (see the description of the Demand Loan in Section II). The Demand Loan should be callable at any time but must be called following a breach of certain triggers and default of the Issuer. In addition, the proposal is that the value of the Demand Loan to be repaid will be the higher of the value determined on the date the Issuer defaults and the date the Demand Loan is repaid

- Substitute Assets – The proposal aims to set minimum standards and a maximum percentage of substitute assets that can be included in the cover pool which will reflect the terms of the existing programs
- Registrar – The proposal outlines two alternative roles that can be played by the Registrar and requests feedback on the functions, expertise and characteristics of an effective Registrar
- Penalties – Under the proposal, the Registrar will have the power apply penalties including suspending an Issuer from issuing covered bonds within the framework
- Counterparties – Under the proposed framework, Issuers will be permitted to act as swap counterparty and service provider (account bank, cash manager, etc.) within their programs. Issuers will be required to put in place back-up swap counterparties and service providers if they breach certain triggers. This is in line with the existing Canadian programs where the triggers are based on credit ratings. The Consultation paper requests comments on whether alternate triggers can be considered. The proposal also suggests the Registrar have the authority to set minimum standards for the types of assets that can be used as collateral for swaps
- Reporting and Disclosure – The proposal aims to set minimum disclosure requirements based on what is currently being provided by the Canadian Issuers and to standardise the type and frequency of such disclosure
- Cover Pool Audit – The proposal aims to standardise the content and frequency of the cover pool audit performed by an independent audit firm on a sample of the cover pool

Comments were due to the Department of Finance on the proposals within the Consultation Paper on June 10, 2011.

II. STRUCTURE OF THE ISSUER

Canadian financial institutions are regulated by the Office of the Superintendent of Financial Institutions ("OSFI"). In June 2007, OSFI issued a statement permitting Canadian financial institutions to issue Covered Bonds up to a maximum of 4% of their total assets. 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.

The Canadian Covered Bond programs are all based on a similar structure that was derived from the UK structure, given the similarity between the legal systems (Canadian common law is derived from English common law). Canadian Covered Bonds are direct, unconditional obligations of the Issuer. In the event of the insolvency or default by the Issuer, 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 an unconditional and irrevocable guarantee on the Issuer's obligations under the Covered Bonds. In Canadian Covered Bond programs, 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.

The cover assets are segregated from the Issuer through a legal true sale between the Issuer and the Guarantor. Whether structured as a limited liability partnership or a trust, the Guarantor is bankruptcy remote from the Issuer. 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 and the security interest in the mortgages is perfected.

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. The structure of the Canadian Covered Bond programs incorporates a unique feature related to the inter-company loan, which enables the Guarantor to hold surplus assets in anticipation of an issuance. The loan 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. To meet regulatory requirements, the Demand Loan ensures that Covered Bonds investors only have access to the assets that are required as collateral for the Covered Bonds. Maintaining surplus assets within the Guarantor provides Canadian Issuers the flexibility to access the market quickly as the cover pool is continuously analyzed and monitored by the rating agencies.

III. COVER ASSETS

The cover assets within the existing covered bond programs comprise amortising residential mortgages (RBC, BMO, BNS, CIBC, NBC, CCD), National Housing Association mortgage backed securities (NHA MBS) within the CIBC program and home equity lines of credit ("HELOCs") within the TD program. The residential mortgages within the RBC program are uninsured (otherwise known as prime or conventional mortgages with a maximum loan to value ("LTV") of 80% and full documentation). The other programs are backed by insured mortgages, NHA MBS or insured HELOCs. 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.

Under the Canadian Bank Act, mortgage insurance is required for any mortgage with an LTV in excess of 80% originated by a regulated financial institution. Alternatively, originators can bulk insure pools of conventional mortgages for funding or capital purposes. This insurance is provided by the CMHC and other approved third party insurers, including Genworth Financial. However, the collateral within the Canadian Covered Bond programs (except RBC) only includes mortgages insured by CMHC. On January 17, 2011 the Department of Finance announced that CMHC will no longer be providing insurance on HELOCs effective April 18, 2011. Insurance on the existing HELOCs that were insured prior to that date has been grandfathered.

The structure of Canadian mortgages differs from those in the US and the UK. The term of Canadian mortgages is typically one to five years (based on an amortisation term of up to thirty years), after which the borrower is required to renew or refinance the mortgage. In most cases, the mortgage is renewed

with the same lender if the borrower is current and has met the required payments under the mortgage. The lender does have the option not to refinance the mortgage.

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.

Certain Canadian mortgage products are structured to provide the borrower with flexibility. This enables the borrower to split their 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 borrower determined during the underwriting process. For the RBC program, only the amortising mortgage tranches have been included as collateral within the cover pool whereas with the TD program, the collateral is made up of both the amortising and non-amortising tranches. The cover assets in the large Canadian bank programs are geographically diversified across Canada, with larger concentrations in the urban centres. The mortgage pools within the NBC and CCD programs are concentrated in Quebec.

Substitute assets can be included in the cover pool provided their aggregate value at any time does not exceed 10% of the Canadian dollar equivalent of the outstanding principal balance of Covered Bonds. In all cases, substitute assets are limited to Canadian dollar denominated RMBS (subject to receipt of Rating Agency Confirmation) and exposures to institutions that qualify for a ten to twenty percent risk weighting under the Basel II Standardised Approach. These investments are subject to stipulated ratings, concentration limits, rating agency limits and consent of the interest rate swap counterparty in certain cases.

IV. HEDGING AND ASSET - LIABILITY MANAGEMENT

In the existing Canadian Covered Bond programs, interest rate risk, basis risk and exchange rate risk have been hedged.

The Guarantor enters into an interest rate swap at closing to swap interest cash flows from the collateral (including GIC Accounts and substitute assets) into a Canadian floating rate. Under all the programs except the TD, NBC and CCD programs, cash flows are exchanged under this swap from closing. The floating rate received is typically used by the Guarantor to meet the interest payments due on the inter-company loan. Under the TD, NBC and CCD programs, the interest rate swap is forward starting and cash flows under this swap are only exchanged following the activation of the Covered Bond guarantee. The notional balance of this swap is typically the outstanding balance of the entire collateral pool (performing mortgages / NHA MBS / HELOCs, GIC Accounts and substitute assets).

The Guarantor also enters into a forward starting exchange rate / basis swap at closing to swap the Canadian floating rate into the interest rate basis and currency the covered bonds are denominated in. Cash flows under this swap are only exchanged following the activation of the Covered Bond guarantee. The notional balance of this swap is typically the outstanding balance of the applicable series of Covered Bonds issued.

Given their current ratings, all the existing Canadian Issuers act as the swap counterparty with the Guarantor for both swaps. Triggers are in place to ensure that the Issuer (as swap counterparty) posts collateral against its obligations under the swap following downgrade. The Issuer will be replaced as the swap counterparty following further downgrade.

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 overcollateralisation 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. 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. This amount 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.

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. During the extension period, interest will continue to be paid monthly on the outstanding Covered Bonds at an equivalent floating rate. In addition, principal amounts outstanding can be repaid on the monthly payment dates to the extent funds are available. This minimises the risk of the Covered Bonds defaulting following an Issuer Event of Default and gives the Guarantor reasonable time to dispose of any collateral in an orderly manner (through whole loan sales / securitisation) to the extent required. Given the typically short remaining term of the amortising mortgages within the Canadian cover pools, large amounts of principal will be received by the Guarantor through scheduled amortisation.

Most programs do permit issuance of hard-bullet covered bonds. This structure incorporates a Pre-Maturity Test that is aimed at ensuring adequate liquidity is available to meet upcoming Covered Bond maturities. Under the test, if the Issuer's rating falls below stipulated levels, an amount at least equal to the maturing Covered Bond is required to be deposited in a Pre-maturity Liquidity Ledger either six or twelve months before the maturity date, depending on the Issuer's rating. Failure to deposit the required amount will constitute an Issuer Event of Default and service of a Notice to Pay on the Guarantor.

Similar to the other structured covered bond programs, a dynamic ACT is performed on a monthly basis. This test ensures that there are always sufficient assets available within the cover pool as collateral for the outstanding Covered Bonds. Under the test, the balance of the asset pool is determined, factoring in the required level of overcollateralisation (based on the asset percentage), LTV caps and non-performing mortgages and adjusting for potential negative carry. The asset percentage is confirmed by the rating agencies and depends on numerous factors including the credit quality and historic performance of the pool and the ability of the Guarantor to dispose of the assets in a stressed environment. The asset percentage for the Canadian Covered Bond programs currently ranges between 91.8% and 95%, depending on the type of collateral. All the Issuers have voluntarily incorporated a minimum level of overcollateralisation within their programs, by capping the asset percentage at 97.0%.

When calculating the asset balance for the ACT two calculations are run. Firstly, an LTV cap of 80% for uninsured mortgages and 90% for insured mortgages / HELOCs (subject to a stipulated CMHC ratings

level) is multiplied by the latest valuation of each mortgage. This amount is compared to the outstanding balance on the mortgage and the lower of the two amounts is noted. Secondly, the latest valuation of each mortgage / HELOC is multiplied by a factor which depends on whether the mortgage / HELOC is performing or non-performing (greater than ninety days delinquent). For performing mortgages / HELOCs, the factor is 1, while for non-performing mortgages the factor is 0.9 if insured and CMHC is rated above a stipulated level or zero if CMHC is rated below the stipulated level or the mortgage is uninsured. This amount is then compared to the outstanding balance on the mortgage and the lower of the two amounts is then multiplied by the Asset Percentage. The lower of the aggregate amount for the total pool determined under each of the two calculations above equals the Adjusted Aggregate Loan Amount. This is required to be at least equal to the aggregate outstanding balance of Covered Bonds under the program to pass the ACT.

If the ACT is breached and not cured on the next calculation date, an ACT Breach Notice is served to the Issuer. 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:

- Default by the Issuer on Covered Bond interest or principal that has not been cured within a stipulated period
- Failure of the Issuer to perform or observe any obligations under the Covered Bond documents (excluding the Dealer Agreement or subscription agreement) except related to failures under the ACT noted above, and such failure continues for a period of 30 days
- Liquidation, insolvency, winding up, etc. of the Issuer
- Failure to rectify any breach of the Pre-maturity Test (only applicable to hard bullet covered bond issuance)

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 Bonds.

Similar to the UK programs, 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. Under the test, the aggregate asset amount is calculated, factoring in the mortgage balance and LTV and adjusting for potential negative carry. If the Aggregate Asset Amount is less than the outstanding balance of the Covered Bonds, the AT is failed resulting in a Guarantor Event of Default. Other events that result in a Guarantor Event of Default include:

- Default by the Guarantor on any guaranteed amounts
- Default by the Guarantor in the performance or observance of any obligation, condition or provision under the Covered Bond documents
- An order is made or an effective resolution passed for the liquidation or winding up of the Guarantor
- The Guarantor ceases or threatens to cease to carry on its business or substantially the whole of its business
- The Guarantor stops payment or is unable, or admits inability, to pay its debts generally as they fall due or is adjudicated or found bankrupt or insolvent

- Proceedings are initiated against the Guarantor related to liquidation, insolvency, winding up, etc. of the Guarantor
- The Covered Bond guarantee is not or is claimed not to be in full force and effect by the Guarantor

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 practical to meet the Covered Bond payments.

In addition to the downgrade triggers for the swap counterparties, the ACT, the maturity extension rules and the AT all aim to ensure the Guarantor has sufficient collateral to meet the Covered Bond liabilities, when and if required. If the proceeds derived from the collateral are insufficient to meet the Covered Bond obligations in full, investors still have an unsecured claim against the Issuer for the shortfall.

Similar to the UK programs, several other safeguards have been incorporated into the Canadian Covered Bond programs. These include minimum ratings requirements for the various third parties that support the program, including the servicer, the swap counterparties, the GIC providers, the account bank and the cash manager. In addition, independent audits will be performed by the asset monitor on a regular basis to verify the accuracy of the calculation of the ACT. A cover pool audit is also typically performed by an independent audit firm on a sample of the cover pool.

V. VALUATION AND LTV CRITERIA

In Canada, every property is typically valued as part of the underwriting process. The valuation is either performed by an accredited, third party property appraiser or through an automated valuation tool based on the recent sale price of a similar property in a comparable area. As an appropriate Canadian property price index is currently not available, indexation has not been incorporated into the ACT. Properties are not typically reappraised when the mortgage is renewed, unless the borrower requests an increase to the approved LTV and additional debt or there is reason to believe the property value may have decreased.

VI. 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. In addition, the ratings of the outstanding Covered Bonds are reaffirmed by the rating agencies prior to each new issuance under the program.

An independent audit firm (the Asset Monitor) will test 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 will test the calculation on a monthly basis, until the situation is resolved. In addition, if the test reveals an error in the ACT calculation, the Asset Monitor will test the calculation monthly for a period of six months.

VII. HOW ARE SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS REGULATED?

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.

Although there is no specific asset register, the 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 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.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

For capital purposes, Canadian Covered Bonds are generally treated as senior unsecured debt issued by a financial institution.

IX. THE CANADIAN ECONOMY AND MORTGAGE MARKET

The Canadian economy continues to remain strong relative to its peers, with the lowest net debt to GDP ratio among the G7 nations. Over the last decade, Canada has been highly ranked for economic strength and employment growth and has also achieved the highest real GDP growth within the G7. Prior to the crisis, Canada prospered and enjoyed fiscal surpluses for eleven consecutive years. The Canadian regulators proactively responded to the crisis through strong fiscal stimulus, targeting credit, housing and labor markets, along with implementing effective monetary policy. Canada's banking infrastructure, which was ranked #1 for soundness for the third consecutive year in September 2010 by the World Economic Forum, continues to remain stable as Canada's banks are vigilantly regulated and conservative by nature.

Canada has a diversified, export oriented economy and is rich in natural resources. This provides a sound foundation for ongoing and future economic recovery. Unemployment in Canada remains below the long term average, with job reductions focused on the automotive and manufacturing sectors. Given Canada's strong recovery compared to the US, the unemployment rate at 7.4% is now below that of the US for the first time in nearly three decades.[1] The economic environment has exceeded expectations through Q1 of 2011, with strong recovery in certain sectors and a 3.9% annualised growth in GDP.[2] In a recent publication, the IMF praised the Canadian regulatory and financial system for its stability and strong recovery, highlighting liquidity requirements and supervisory agency co-operation.[3]

The mortgage and consumer fundamentals in Canada are strongly supported to a certain extent by the current low interest rate environment. Canadian mortgage products remain conservative (typically a one to five year term with up to a thirty year amortisation period, with very limited teaser rate or hybrid products). In addition, high prepayment penalties discourage refinancing booms. Sub-prime mortgages

1 "Current Trends Update - Canada," *Royal Bank of Canada*, accessed July 5, 2011, http://www.rbc.com/economics/market/pdf/ecotrend.pdf

2 "Current Trends Update - Canada"

3 "Regional Economic Outlook: Western Hemisphere – Watching Out For Overheating," *International Monetary Fund*, accessed July 5, 2011, http://www.imf.org/external/pubs/ft/reo/2011/whd/eng/pdf/wreo0411.pdf

continue to make up a very small and declining component of the Canadian mortgage market. The market is dominated by the big five Canadian Chartered banks (over 60% of the market), who retain a majority of the mortgages on their balance sheets. This encourages strong underwriting discipline based on high credit and documentation standards. A key difference between the Canadian and US mortgage market is that mortgage interest in Canada is not deductible for tax purposes. As such, Canadian borrowers have little incentive to carry mortgage balances and in general are less leveraged than their American counterparts. Canadian households have twenty cents of debt per dollar of net worth, whilst American households have thirty five cents of debt. The Canadian ratio is close to its historical average while the American ratio is well above its average. Despite the conservative mortgage market, home ownership in Canada is comparable to that of the US at approximately 68%.

Housing affordability has remained stable in Canada and is well below recent cyclical levels reached in early 2008 and record levels reached in 1990. There has been speculation that as a result of the likely increase in interest rates, housing affordability will decrease and have a detrimental impact on the Canadian market. However, recent research conducted by the Canadian Association of Accredited Mortgage Professionals (CAAMP) showed that housing and mortgage markets continue to remain in good shape and posses the ability to withstand an estimated interest rate increase to five percent (currently the Prime rate is three percent).[4] This is the result of the continued conservative approach by both lenders and borrowers which, combined with the strong economic and consumer fundamentals, have resulted in stable mortgage delinquency rates (90+ days) compared to the US. Furthermore, there has been a recent trend by borrowers to voluntarily increase their principal payments.[5]

Housing price trends in Canada have remained steady and according to the IMF in March 2009 the Canadian home market was the least over-valued leading up to the crisis. Between 2001 and 2007 Canadian housing values increased at an average rate of 10.2% per year and continued that upward trend at a yearly rate of 4.8% from 2008 to present.[6] While some speculate that the Canadian housing market may be subject to a bubble similar to the one experienced in the US, industry participants believe the increase in value has tangible determinants, including the limited availability of developed land around the key urban centres and the recent introduction of the Harmonised Sales Tax (HST) which has raised the cost of new construction.[7] In addition, homeowners' equity in Canada is high and has remained stable relative to that in the US.

4 "Stability In The Canadian Mortgage Market," *Canadian Association of Accredited Mortgage Professionals*, accessed July 5, 2011, http://www.caamp.org/meloncms/media/Spring%20Survey%20Reportweb.pdf

5 "Stability In The Canadian Mortgage Market"

6 "Stability In The Canadian Mortgage Market"

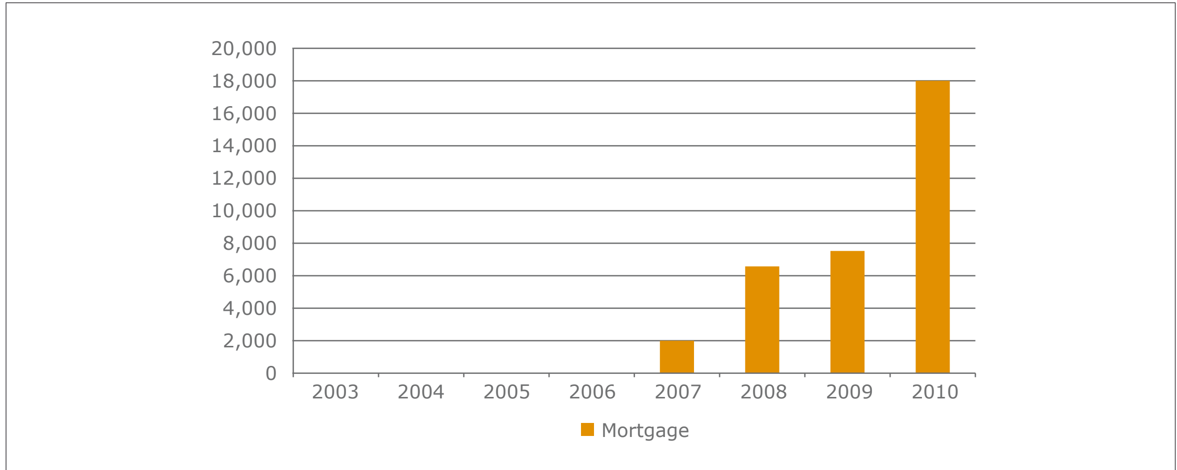
7 "Stability In The Canadian Mortgage Market"

Figure 1: Overview – Canadian Covered Bond programmes

	RBC	BMO	CIBC	BNS	TD	NBC	CCDJ
Programme Size	EUR 15 bn	EUR 7 bn	EUR 10 bn	US$ 15 bn	EUR 10 bn	US$ 5 bn	EUR 5 bn
Outstanding Covered Bonds	EUR 2.00 bn due Nov12 EUR 1.25 bn due Jan18 C$ 750 mm due Nov14 C$850 mm due Mar15 US$ 1.5 bn due Apr15 C$1.1 bn due Mar18 CHF425m due Apr21	US$ 2 bn due Jun15 EUR 1 bn due Jan13 US$ 1.5 bn due Jan16	CHF 375 m due Jan15 CHF 300 m due Dec11 CHF 500 m due Jun17 US$ 2.4 bn due Feb13 US$ 1.85 bn due Jul15 A$ 750 mm due Dec13 US$ 2 bn due Jan16 A$ 700 m due Mar16	US$ 2.5 bn due Jul13 US$ 2.5 bn due Oct15 A$ 1 bn due Jan14 US$ 2.0 bn due Aug16	US$ 2 bn due Jul15	US$ 1 bn due Jan14	US$ 1 bn due Mar16
LTV cap (performing loans)	80%	90%, subject to a CMHC rating of at least AA (low), otherwise 80%	90%, subject to a CMHC rating of at least AA (low), otherwise 80%	90%, subject to a CMHC rating of at least AA (low), otherwise 80%	90%, subject to a CMHC rating of at least AA (low), otherwise 80%	90%, subject to a CMHC rating of at least AA (low), otherwise 80%	90%, subject to a CMHC rating of at least AA (low), otherwise 80%
Asset percentage applied in ACT	91.8%	95%	93%	95%	95%	93.5%	93.5%
Overcollateralisation	107.5%	105.3%	104.2%	105.3%	105.3%	105.3%	105.3%
Non performing mortgages	No recognition for the ACT	Multiplied by a factor of 0.9, subject to a CMHC rating of at least AA (low), otherwise no recognition	Multiplied by a factor of 0.9, subject to a CMHC rating of at least AA (low), otherwise no recognition	Multiplied by a factor of 0.9, subject to a CMHC rating of at least AA (low), otherwise no recognition	Multiplied by a factor of 0.9, subject to a CMHC rating of at least AA (low), otherwise no recognition	Multiplied by a factor of 0.9, subject to a CMHC rating of at least AA (low), otherwise no recognition	Multiplied by a factor of 0.9, subject to a CMHC rating of at least AA (low), otherwise no recognition
Soft / Hard Bullet	Soft	Soft / Hard Bullet	Hard Bullet	Soft / Hard Bullet	Soft / Hard Bullet	Soft / Hard Bullet	Soft / Hard Bullet
Asset monitor	Deloitte	KPMG	Ernst & Young LLP	KPMG	Ernst & Young LLP	Samson Belair / Deloitte	PwC LLP
Asset Type	Conventional Prime Mortgages	CMHC Insured Mortgages	CMHC Insured Mortgages and NHA MBS	CMHC Insured Mortgages	CMHC Insured Home Equity Lines of Credit	CMHC Insured Mortgages	CMHC Insured Mortgages

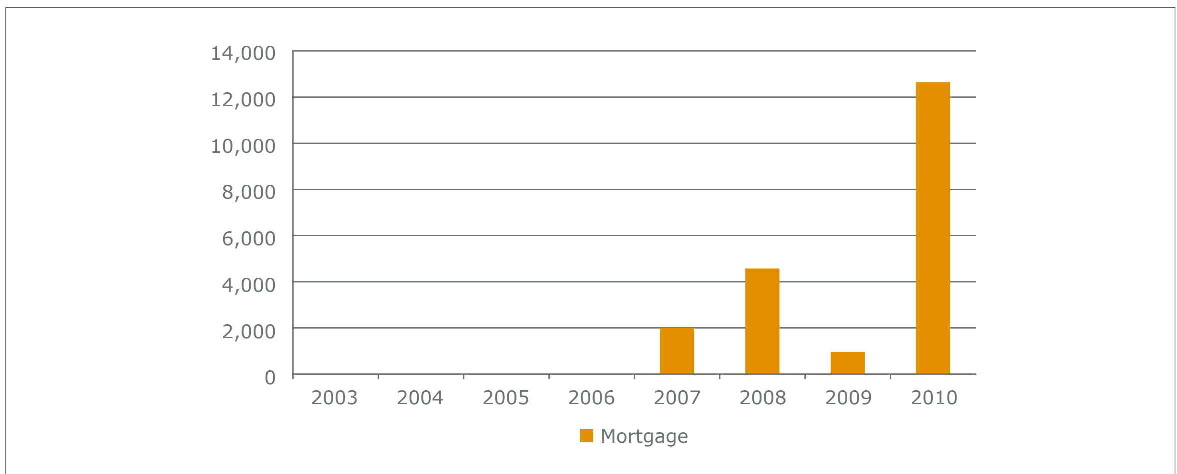
Source: RBC Capital Markets

> Figure 2: Covered Bonds Outstanding, 2003-2010, EUR m



Source: EMF/ECBC

> Figure 3: Covered Bonds Issuance, 2003-2010, EUR m



Source: EMF/ECBC

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.

3.6 CYPRUS

By Doros Theodorou and Dimitrios Spathakis, Marfin 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 Bonds 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. DIRECT AND INDIRECT ISSUANCE OF COVERED BONDS

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*)

> the Housing Finance Corporation (*established under the Housing Finance Corporation Laws*).

III. PREREQUISITES FOR THE ISSUANCE OF COVERED BONDS

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 EUR50 million 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
- 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/CBREGISTERMAY11EN.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.

IV. 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
- 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

> 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.).

V. 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:

(i) they do not exceed 25% of the value of the covered bonds secured by the Cover Pool, and

(ii) 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:

(i) they do not exceed 25% of the value of the covered bonds secured by the Cover Pool, and

(ii) 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:

(i) they do not exceed 25% of the value of the covered bonds secured by the Cover Pool, and

(ii) 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:

A. 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

   c. In situations where the market is subject to significant changes in conditions, a more frequent review of the property value is required

B. 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

C. Also when the balance of the financing exceeds EUR 3 m 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.

VI. STATUTORY TESTS

The Directive provides for the following statutory tests:

(a) **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.

(b) **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:

- Parallel interest rate shift of +200 and -200 basis points
- Interest rate shifts determined by a 99% 6-month confidence interval using daily changes for the last 365 days
- Exchange rate changes:
  - Euro and member-state currencies: 10%
  - Currencies of the United States, Canada, Japan, Switzerland, Australia: 15%
  - Other currencies: 25%
- Exchange rate shifts determined by a 99% 6-month confidence interval using daily changes for the last 365 days

(c) **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

(d) **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.

(e) **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:

> 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

> 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).

VII. PROTECTION OF DEPOSITORS

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.

VIII. 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:

1. overseeing the compliance of the Issuer with its obligations under the Cypriot Covered Bond Legislation;
2. 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
3. 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;
4. 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

IX. 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.

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.

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

X. EXERCISE OF THE CLAIMS OF COVERED BONDHOLDERS AGAINST THE REMAINING ASSETS OF THE CREDIT INSTITUTION

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 (the "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, including relevant requirements under a contractual OC, any assets which are not required to meet such assessment, 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*)

XI. IMPACT OF INSOLVENCY PROCEEDINGS ON COVERED BONDS

Where a Covered Bond Issuer is subject to dissolution proceedings, the Law does not provide for an automatic acceleration of the Covered Bonds.

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.

XII. SET-OFF

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.

XIII. 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).

3.7 CZECH REPUBLIC

By Pavel Kuhn, Ceska Sporitelna a.s.

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.

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.

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.

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

1) 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.
2) 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

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).

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 estates 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.

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.

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.

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.

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.

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.

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 are so far exempt from the income tax that are covered by the issuer with the receivables from the MC for housing investments.

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.

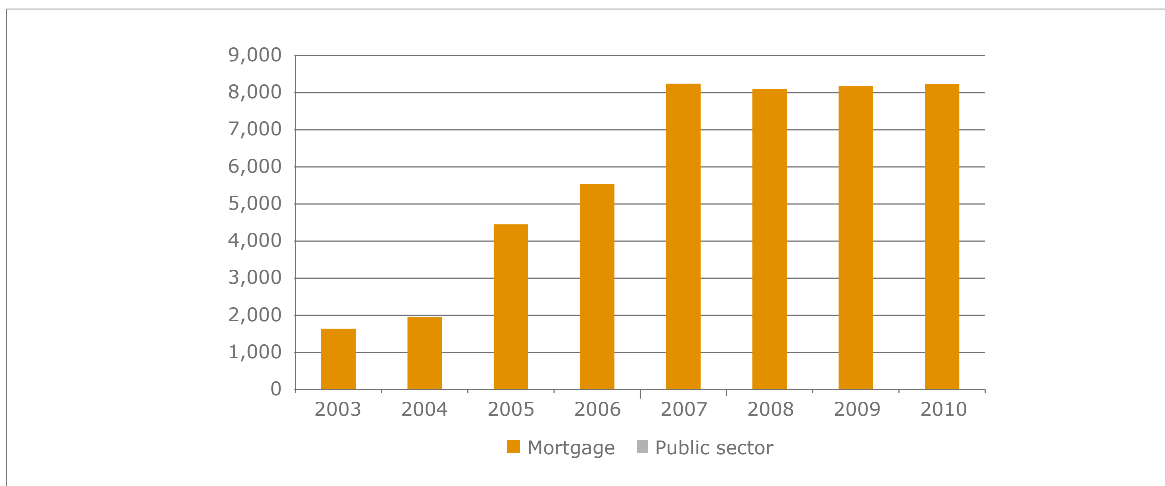
The CNB also supervises the issuer activities from the position of a Government supervisory body over the capital market. Each issuer having its MCBs in circulation is obligated to send to the CNB the reports showing its economic results and its financial situations in the determined intervals and to 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.

COMPLIANCE WITH EUROPEAN LEGISLATION

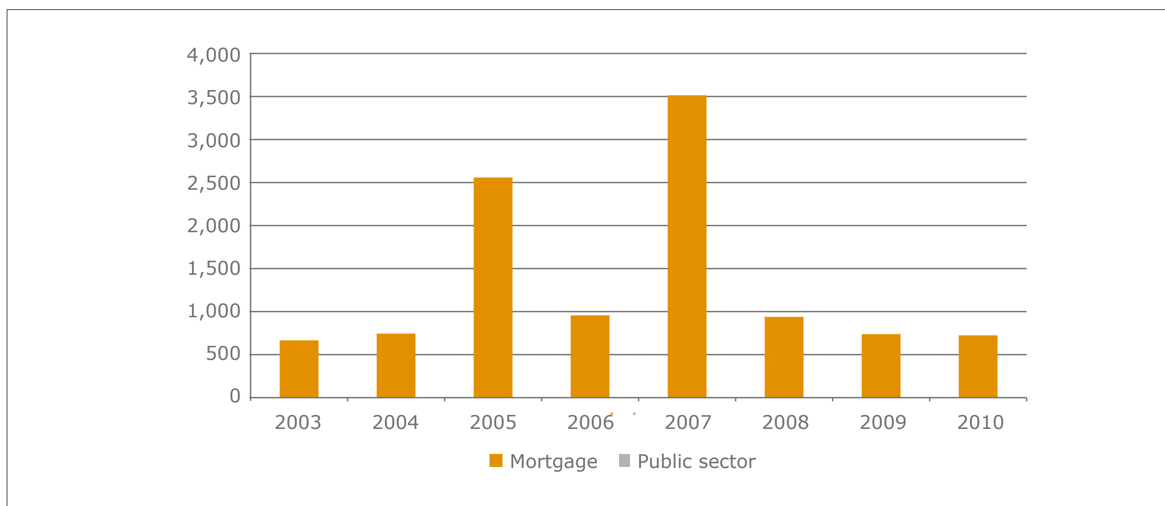
The Czech MCB legislation complies with the requirements of Art. 52 par. IV UCITS Directive.

> Figure 1: Covered Bonds Outstanding, 2003-2010, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2010, EUR m



Source: EMF/ECBC

Issuers: Czech issuers at the end of 2010 were 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
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I. FRAMEWORK

The Danish Act on covered bonds (SDOs) came into force on 1 July 2007. It was passed to implement the SDO rules of the EU capital adequacy rules (CRD). At the same time, it met the politi-cal 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 realk-reditlån og re-alkreditobligationer 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 commercial banks have also able to issue covered bonds to fund mortgage loans. However, mortgage banks still have the exclusive right to issue covered mortgage bonds.

This leads to the existence of three types of Danish mortgage bonds:

> the (traditional) mortgage bonds (Realkreditobligationer, ROs) issued by mortgage banks. ROs are UCITS compliant (article 52(4)).

> the (new) covered mortgage bonds (Særligt Dækkede Realkreditobligationer, SDROs) issued 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 commercial or mortgage banks (Særligt Dækkede Obli-gationer, 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 accord-ance 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.

Danish mortgage banks operate subject to a specialist banking principle in accordance with Danish legis-lation, 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 cen-tres 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 proceed-ings, 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 con-stitute 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 maxi-mum 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 invest-ments 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 as-signed 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 will lose their status as SDOs or SDROs. Where the LTV limit of 75% for owner-occupied dwellings etc is exceeded, supplementary security will be required when the LTV exceeds 80%.

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 percent/100 percent 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 pct. 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 percent 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 percent 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 pct. Both own issued bonds and bonds from other credit institutions + Approximately same cash flow	Max. 15% 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;

> 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 pro-ducts.

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. 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.

VII. 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.

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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".

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;

> Derivative counterparties enjoy the same legal position as senior bonds.

Bonds do not accelerate automatically. Payments fall due according to the original payment sched-ule.

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, ie 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 co-vered 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 make unannounced of 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.

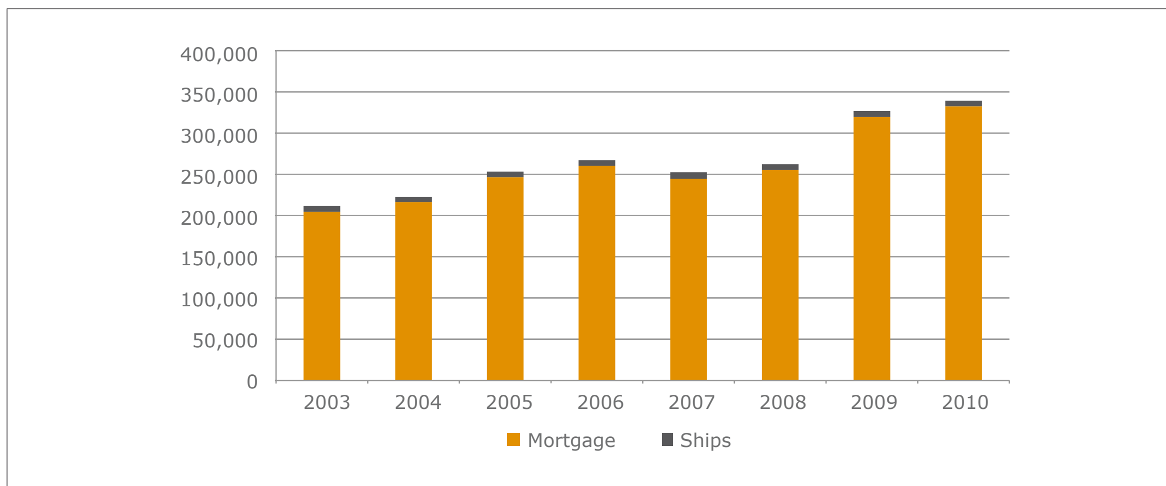
VIII. RISK WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

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.).

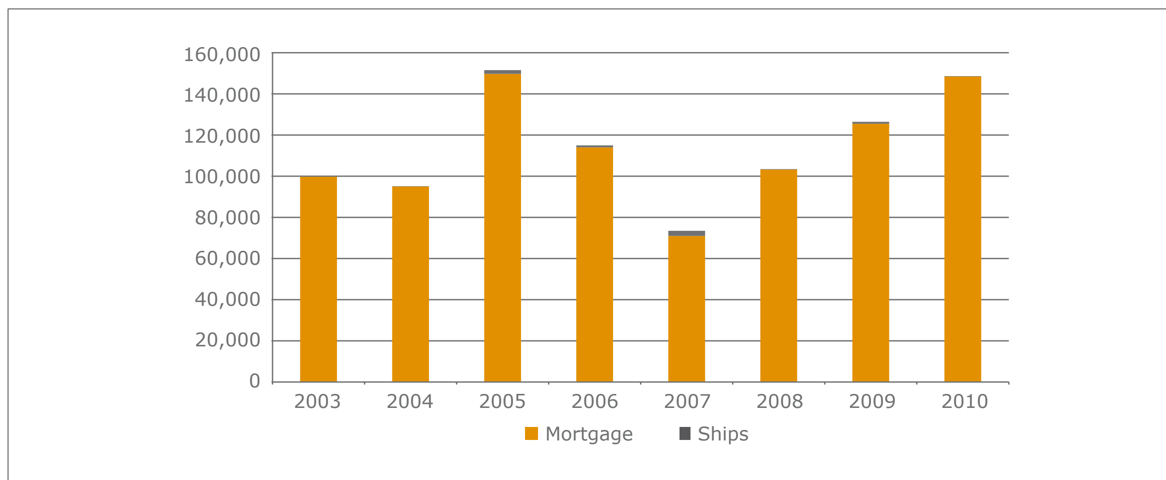
In the Danish legislation on large exposure limits in credit institutions a 90% exemption is given to SDO's and SDRO's. For RO's backed by loans to residential property and issued after 31 December 2007 a 50% exemption from the large exposure limits is allowed.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2010, 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 2010 the mortgage banks' outstanding volume of covered bonds was EUR 339 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 18 bn. Danish Ship Finance is the only Danish issuer of Covered Bonds backed by ship loans.

3.9 FINLAND

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and Ralf Burmeister, LBBW

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 specialized bank, but deposit banks or credit entities are entitled to apply for a license to issue covered bonds. The existing specialized 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 assets 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 specialized 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.

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 per cent 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.

V. 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 52(4), this supervision of a specialized 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.

VI. HOW ARE 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.

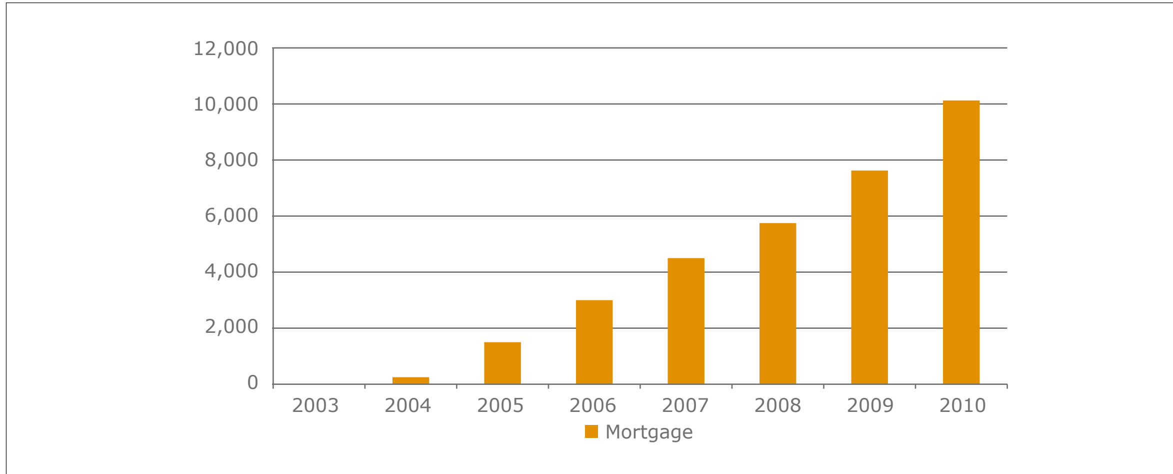
VII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Finnish Covered Bonds 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, 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.

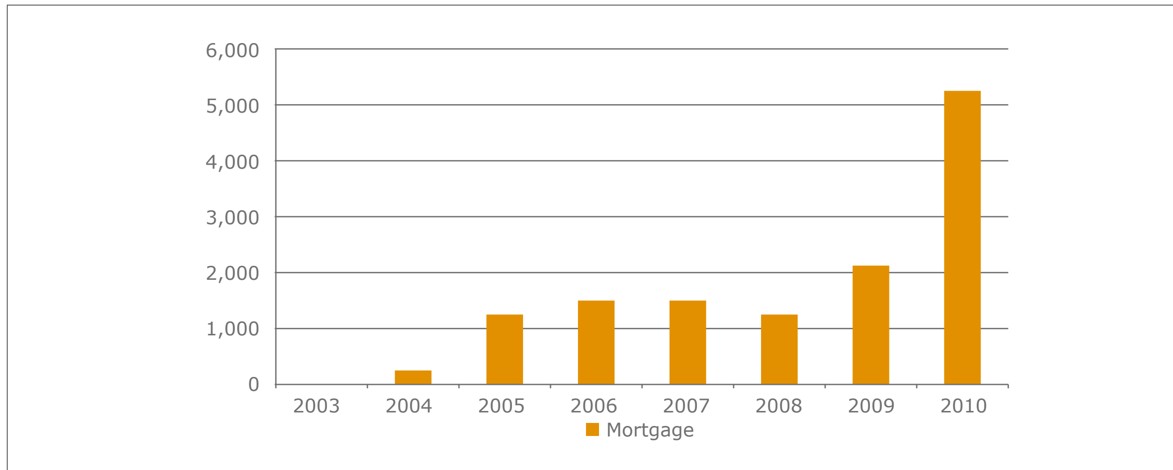
As far as the domestic issuers are aware, there are no further specific investment regulations regarding Finnish Covered Bonds.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2010, 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.

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

The Regulation relating to French covered bond issuers 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*. Consequently, three main covered bond issuing structures exist today in France:

> *sociétés de crédit foncier*,

> *sociétés de financement de l'habitat*,

> Caisse de Refinancement de l'Habitat.

Further, whilst most structured covered bonds have been converted into the société de financement de l'habitat framework, there are also a few general-law based covered bond issuers who have not converted their existing programmes but will no longer issue new covered bonds out of these programmes.

A - SOCIETES DE CREDIT FONCIER

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. LEGAL 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 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 *sociétés 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 EUR 12 m and that isn't a member of the group to which belongs the *société de crédit foncier*. The amount of these loans cannot exceed 35% of the assets of the *société de crédit foncier*;
- public exposures that are totally guaranteed by:
  - 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, 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;
  - European Community, International Monetary Fund, Bank for international Settlements and multilateral developments banks registered by the French Ministry of Finances;
  - others public sector entities and multilateral developments banks as more 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, provided, in accordance with Directive 2010/76/EU (CRD III) of the European Parliament 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.
- 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 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 guaran¬tor 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 ;

> senior units of securitisation funds are weighted 100% if they are rated at minimum AA- (Fitch and S&P) or Aa3 (Moody's), weighted 50% if they are rated A- (Fitch and S&P) or A3 (Moody's), and weighted 0% below these ratings ;

> public exposures and replacement assets are weighted 100%.

> 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, more generally, that the *société de crédit foncier* complies with the law and regulations.

The Specific Controller certifies that the *société 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 500 million euros. 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 *sociétés de crédit foncie*r'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, ASSET VALUATION

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 ;

> an annual report describing (i) the nature and the quality of their assets describ¬ing 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 ;

> 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, …. This report is certified by the Specific Controller and transmitted to the Banking Authority.

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 Independant 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, Part 1, Paragraph 65 a) to f).

Consequently, and subject to local regulations, the banking risk - weighting is 10% according to European solvency criteria.

B - BONDS ISSUED BY CAISSE DE REFINANCEMENT DE L'HABITAT (CRH)

By Henry Raymond, Caisse de Refinancement de l'Habitat

I. LEGAL 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 1st, 2010, CRH is appointed to control debt' service and collateral administration of SFEF.

Today, instead of State guarantee, the French law gives to 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 specialized 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 doesn't borrow for its own account but for the account of banks and doesn't 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 *Autorité de contrôle prudentiel*. Furthermore, its operations are under a specific supervision of *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

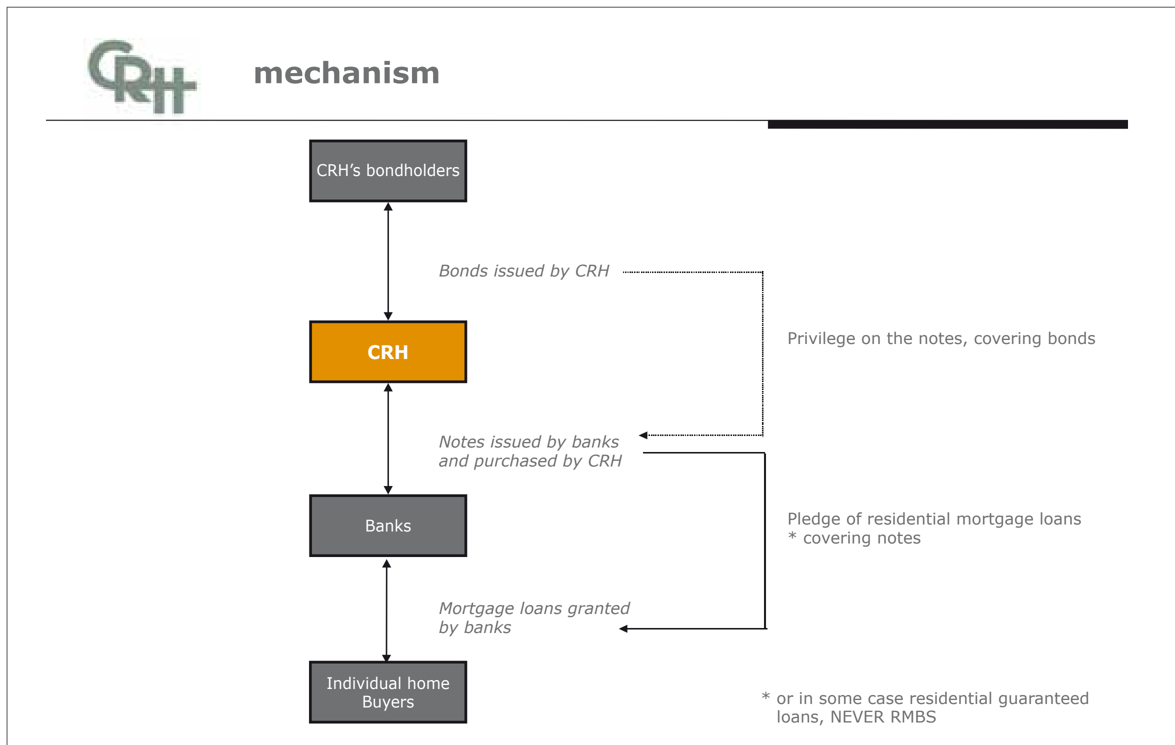
The size of CRH's bonds outstanding is very important. They are very liquid, listed on MTS and several banks are market makers for them. The average full CRH debt turnover ratio is very high. Two of CRH issues have a size of 5 euro billion.

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.



C - OBLIGATIONS DE FINANCEMENT DE L'HABITAT

By Cristina Costa, Natixis and
Boudewijn Dierick, BNP Paribas

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 and is very similar to the existing 'Société de Crédit Foncier' (SCF) framework. The SFH and SCF are now based on the same legal framework.

Under the SFH legislation, the holders of the Obligations de Financement de l'Habitat (OH) benefit from the privilege granted to these bonds over the SFH program's 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 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 satisfies articles L.515-34 and L.515-35 of the Monetary and Financial Code, opt for the status of a home financing company (*Société de Financement de l'Habitat*). Once the supervisor has granted authorisation to operate as an SFH, all covered bonds and equivalent instruments issued by the credit institution prior to its transformation into a SFH shall be converted automatically into Obligations de Financement de l'Habitat, and benefit from the statutory privilege.

At the time of writing, almost all French common-law based covered bond issuers have transferred their status to SFH. Since the enactment of the SFH law, a total of EUR 10 bn Obligations de Financement de l'Habitat have been issued in Euro Jumbo format.

I. FRAMEWORK

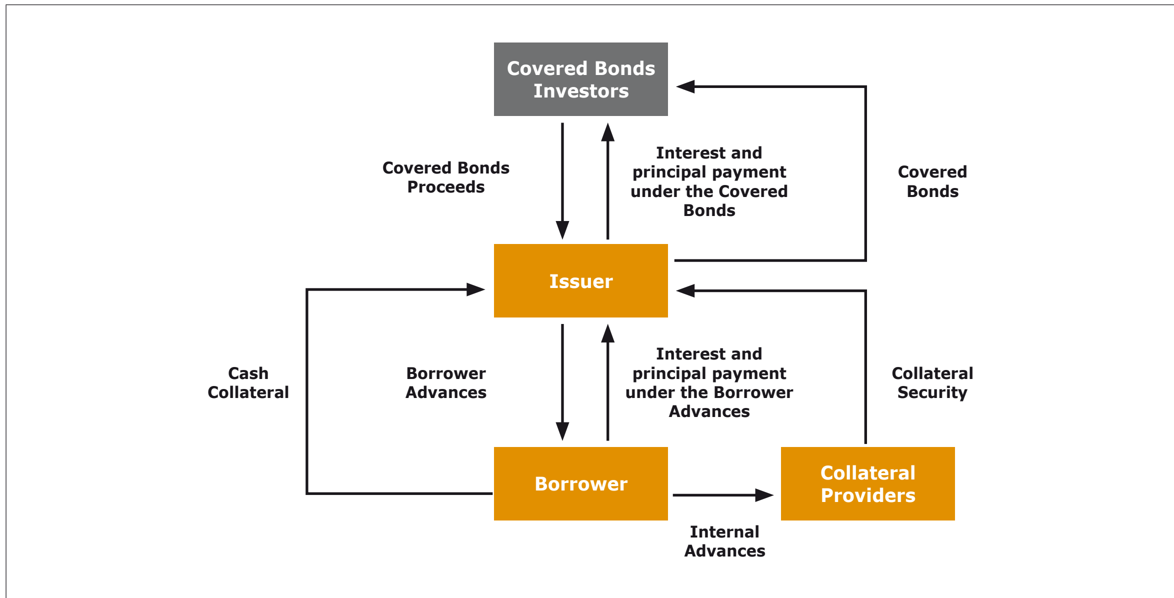
Obligations de Financement de l'Habitat (OH) make use of the implementation of the EU Collateral Directive 2002/47/EC in French law, which allows for a segregation of the assets without an actual transfer of assets to the issuer. This directive was implemented into the French Code Monétaire et Financier (Article L. 211-38 of January 8, 2009). 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 (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 privilege over the cover assets, 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):
  - Cover asset pool remains on the balance sheet of the sponsor bank
  - Cover assets and covered bonds are on different balance sheets;
  - Transfer of assets following insolvency of the participating bank
- Single structure:
  - Cover assets are on the balance sheet of the issuer
  - Cover assets and covered bonds are on the same balance sheet
  - The parent company (=lending institution) transfers loans to the issuer of covered bonds.

Structure of Obligation de Financement de l'Habitat



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, with limited purpose. There are currently seven SFH issuers:

New SFH issuers:

> BPCE SFH: is a licensed financial institution (99.9% owned by BPCE S.A.) regulated by the Autorité de Contrôle Prudentiel (ACP). The issuer was initially incorporated on 26 December 2007, but BPCE S.A. confirmed that it was a dormant entity until its conversion into SFH. The programme will replace both GCE Covered Bonds and BP Covered Bonds as the preferred funding tool of the Groupe BPCE.

Converted SFH issuers:

> BNP Paribas Home Loan SFH: received its Société de Financement de l'Habitat (SFH) license on June 15, 2011. The issuer is a French limited-purpose credit institution which is 99.9%-owned by BNP Paribas.

> Crédit Mutuel Arkea Home Loans SFH (previously Crédit Mutuel Arkéa Covered Bonds): received its SFH agreement on April 1, 2011. The issuer is a special affiliate of the Crédit Mutuel Arkéa group

and has been licensed by the French banking regulator for the purpose of making Borrower Loans and issuing Covered Bonds.

> Cédit Mutuel-CIC Home Loan SFH (previously CM-CIC Covered Bonds): received its SFH agreement on March 28, 2011. The issuer is a subsidiary of Banque Fédérative du Crédit Mutuel and licensed as a credit institution with limited and exclusive purpose.

> Crédit Agricole Home Loan SFH (previously Crédit Agricole Covered Bonds): received its SFH agreement on April 5, 2011. The issuer is a licensed financial institution (99.9% owned by Crédit Agricole S.A.) regulated by the Autorité de Contrôle Prudentiel.

> HSBC SFH (France) (formerly HSBC Covered Bonds (France)): received the SFH agreement on March 28, 2011. The issuer is a licensed financial institution regulated by the Autorité de Contrôle Prudentiel.

> Société Générale SFH: was initially incorporated on 21 February 2003 (although not as an SFH, like for BPCE SFH). Following enactment of the SFH Law, the issuer opted for the SFH regime. The issuer is a subsidiary of Société Générale, licensed as a credit institution with limited and exclusive purpose by the French ACP. The issuer was a dormant entity until its conversion into an 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 sureté immobilière conférant une garantie au moins équivalente, 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 note (*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).

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.

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 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 will apply 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).

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 CB 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

Overcollateralisation: By law, the SFH framework must maintain a nominal overcollateralisation 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. COVER POOL MONITOR & BANKING SUPERVISION

The issuer is a regulated French credit institution, which is subject to regulation, supervision and examination by the French regulator (*Autorité de Contrôle Prudentiel*). 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 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.

VII. 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:

> Privilège / 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 reorganisation 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).

> 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.

VIII. 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. This is because of the amount of guaranteed home loans exceeds 35% in existing SFH.

D - STRUCTURED COVERED BONDS

By Cristina Costa, Natixis and
Boudewijn Dierick, BNP Paribas

The first French structured covered bond programme was issued in November 2006. This route was chosen to use the bank's collateral more efficiently, than the established legal framework for Obligations Foncières. In particular, the cap on guaranteed housing loans had been a major obstacle, given that more than 50% of the bank's housing loans and circa two thirds of its new origination are secured by guarantees. As of end-2010 there were seven active issuers in the market.

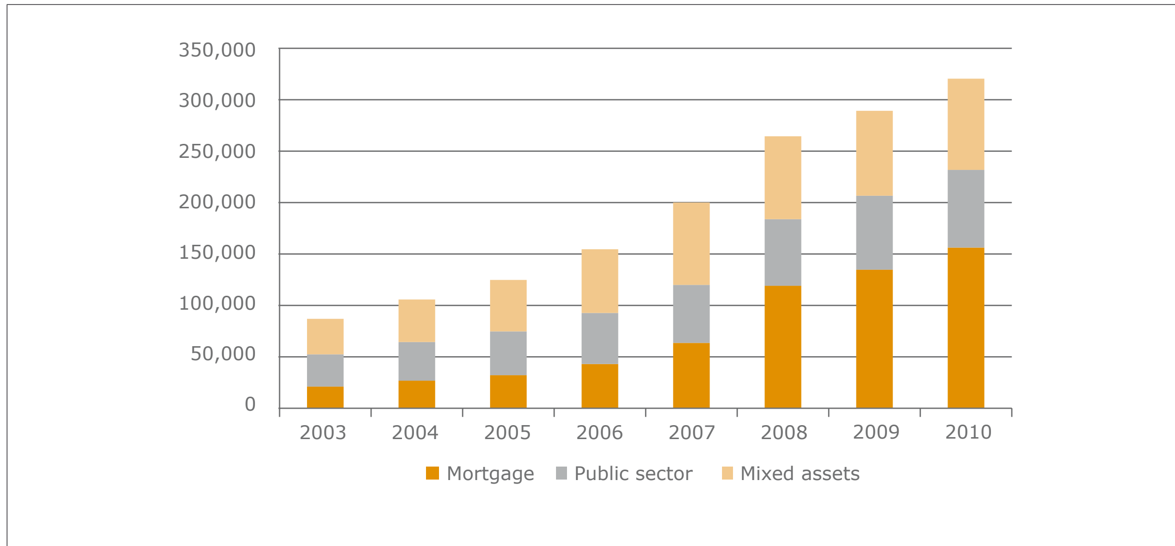
Following the enactment of the Law n°2010-1249 dated October 22nd, 2010 on the banking and financial regulation and its implementing Decree n° 2011-205 dated February 23rd, 2011, the SFH law came into being. The new legislation aims to provide a legislative framework for French residential mortgage-backed structure covered bonds.

According to the SFH law (please refer to section C. of this chapter for more information) a credit institution licensed as a finance company by the French supervisor (*Autorité de Contrôle Prudentiel*) may opt for the status of Société de Financement de l'Habitat. Once the supervisor has granted authorisation to operate as a Societé de Financement de l'Habitat, all covered bonds and equivalent instruments issued by the credit institution prior to its transformation into a SFH shall be transferred automatically into Obligations de Financement de l'Habitat.

At the time of writing, almost all French common-law based covered bond issuers have transferred their status to SFH. The only two remaining issuers are Banques Populaires Covered Bonds and GCE Covered Bonds, which will remain French common-based covered bond issuers but will not longer issue (the BPCE Group will issue Obligations de Financement de l'Habitat via BPCE SFH). What follows is an abridged version of the French structured covered bond chapter.

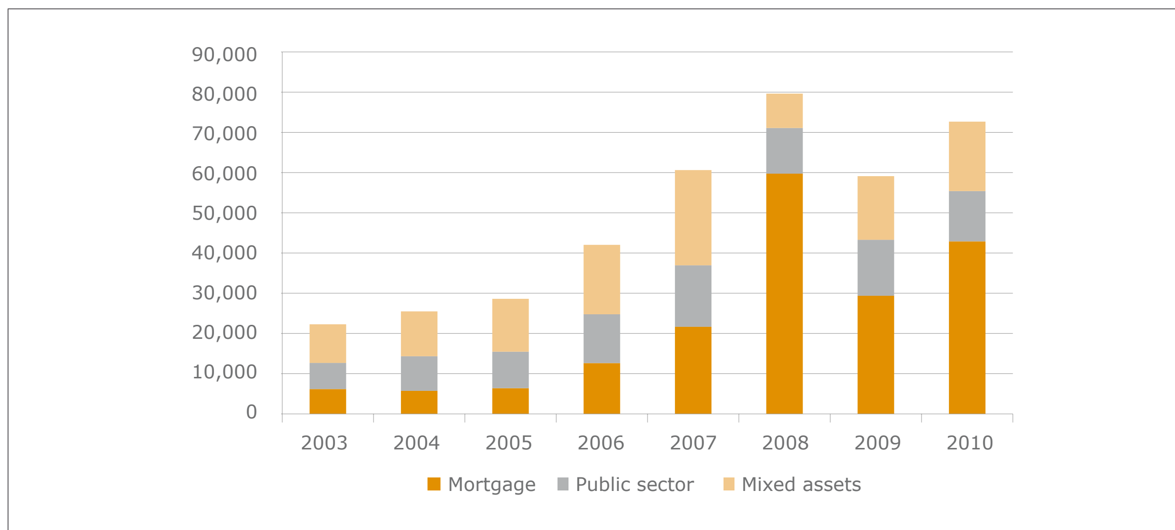
Please refer to the 2010 edition of the Fact Book for the full version of this chapter.

> Figure 1: Covered Bonds Outstanding, 2003-2010, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2010, 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, Credit Foncier et Communal d'Alsace et Lorraine (CFCAL), 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.

Comparison of French covered bonds

	Obligation de Financement de l'Habitat	Obligations Foncières
Legal Framework	French Monetary and Financial Code, Articles L.515-15 to L.515-38, Decree no. 2011-205 of 23 February 2011 and the Banking and Financial Regulation Act no. 2010-1249 of 22 October 2010	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
Eligible assets	- Residential home without limitation for guaranteed home loans - Securitization of the above (subject to specific rules and criteria	- 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
Overcollateralisation	2%	
LTV ratio	- First-rank residential mortgage loans and guaranteed home loans: max. 80% LTV - State-guaranteed real-estate loans: max. 100% LTV	- 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
Substitution assets	Max. 15% of total OF and other privileged resources.	
Liquidity	Requirement to cover all cash flows for a period of 180 days, taking into account all cash flows resulting of future payments on principal and interests on its assets, and cash flows pertaining to term instruments.	
Investor protection	Overcollateralisation, 180-day liquidity needs coverage and ability to repo own issuances, controlled ALM	
Issue's structure/Transfer of assets	Effective transfer of cover assets or financial guarantee	Effective transfer nearly exclusively (financial guarantee for certain public assets)
Supervision	Autorité de contrôle prudentiel (ACP), Comité des Etablissements de Crédit et des Entreprises d'Investissement (CECEI), AMF (Autorité des Marchés Financiers) and specific controller	
UCITS Conformity	Yes	
Risk-weighting according to EU CAD	20%	10%
Rating (M/S&P/F)	Aaa/AAA/AAA	Aaa/AAA/AAA

Source: Natixis, French Monetary and Financial Code, Banking and Financial Regulation Act

French common-law covered bonds	Caisse de refinancement de l'Habitat
Code de Commerce and Code Monétaire et Financier (in particular Art. L.431-7 ff. concerning the bankruptcy remoteness of the cover pool)	Specific legal framework: article 13 of Law n°85-695 of July 11 1985 referring to Code Monétaire et Financier Art L.313-42 to 313-49 and Art L.515-14-1.
- First-rank residential mortgage loans or promissory mortgage notes - Real-estate loans guaranteed by a credit institution - Only loans for housing; commercial real estate loans are not eligible.	- 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
8.11%	25%
LTV ratio: max. 100%	- Residential mortgage loans: max 80% LTV, max 90 % LTV if overcollateralisation of 25% - State guaranteed mortgage loans: max 100% LTV
Max. 20% of total cover pool	Non eligible
Contractual requirements	-
Overcollateralisation, pre-maturity and collection loss reserve tests, hedging strategy	Overcollateralisation, full recourse to the participating banks in case of collateral shortfall
Effective transfer or financial guarantee	Financial guarantee exclusively
ACP, asset monitor and external auditors	ACP and CECEI
No	Yes
20%	10%
Aaa/AAA/AAA	Aaa/-/AAA

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 22nd of May 2005. It supersedes the general bankruptcy regulation (§§ 30-36 of the Pfandbrief Act).

In addition and for historic reasons, three further legal frameworks are existing 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 in force on 25 November 2010 and on 1 January 2011.

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 25 million euros
- 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).

Transparency of cover assets:

§ 28 PfandBG requires issuers to publish detailed data on the composition of cover pools. 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 granularity 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;

Within the scope of the vdp Transparency Initiative the transparency reports of vdp member institutions are published in a uniform format[1].

1 http://www.pfandbrief.de/cms/_internet.nsf/tindex/en_pub_pfandbg.htm

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 over-collateralisation 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 (Barw-ertverordnung).

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 overcollaterali-sation 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 prepay-ment 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. 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.

VII. 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".

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

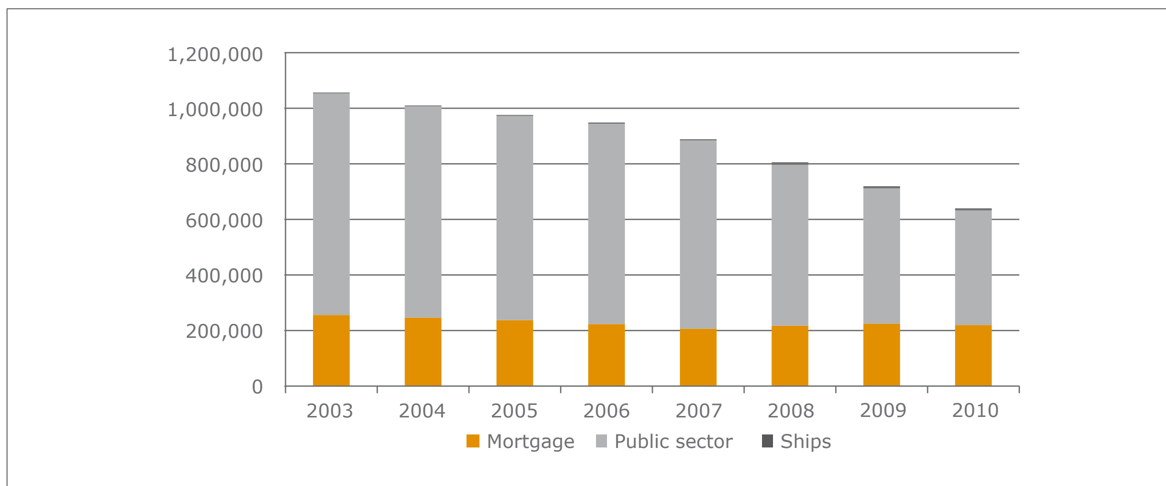
The risk weighting of Covered Bonds (German Pfandbriefe and foreign Covered Bonds) is regulated by Article 20a Kreditwesengesetz (KWG) and the Solvabilitätsverordnung (SolvV), transposing the Capital Requirements Directive into German law.

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).

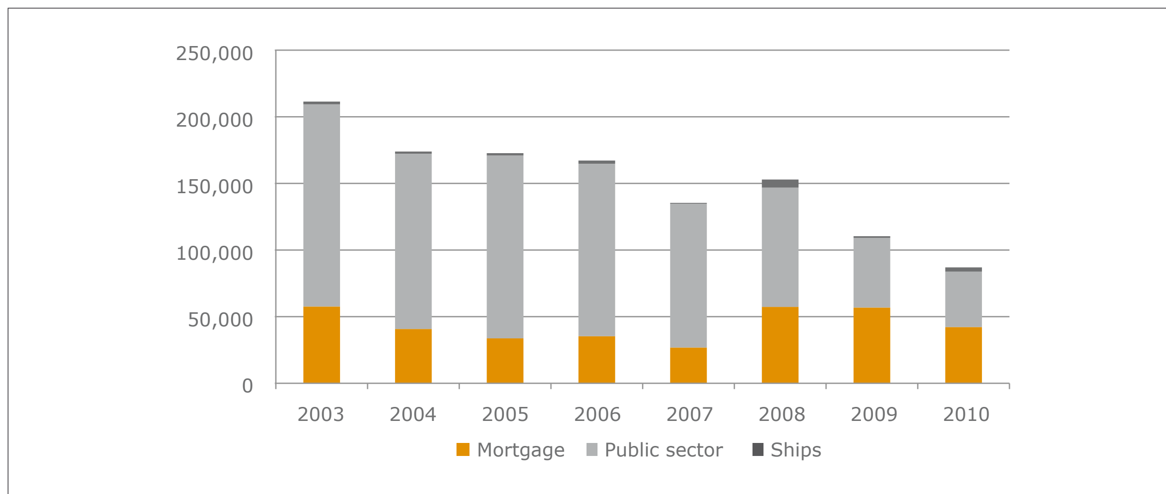
Finally, German investment legislation allows investment funds to invest up to 25% of the fund's assets in Pfandbriefe and furthermore in Covered Bonds issued by credit institutions complying with the requirements of Art. 22 par. 4 UCITS Directive (Article 60 par. 2 German Investment Act).

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2010, 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.

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" as in force from time to time). 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. DIRECT AND INDIRECT ISSUANCE OF COVERED BONDS

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 article 13 was 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 new 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 not approve any future indirect issue of covered bonds.

III. 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:

(a) 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

(b) must have aggregate regulatory capital of at least 500 million Euros and a capital adequacy ratio of at least 9%.

IV. 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.

V. 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 900.000 Euros secured through a residential mortgage over a property valued at 1.000.000 Euros 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 800.000 Euros.

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.

VI. STATUTORY TESTS

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.

VII. 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.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

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. 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.

IX. EXERCISE OF THE CLAIMS OF COVERED BONDHOLDERS 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 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 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.

X. 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.

XI. 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.

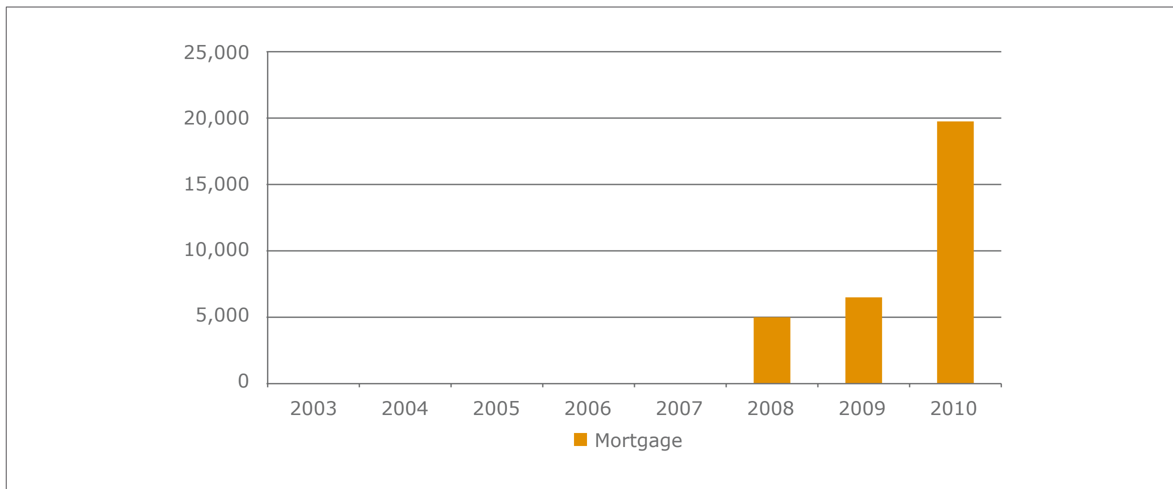
The above-mentioned sale may occur by virtue of the Bond Loan and Securitization Law or the application of the general applicable provisions

XII. 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. 22 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. 22 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%.

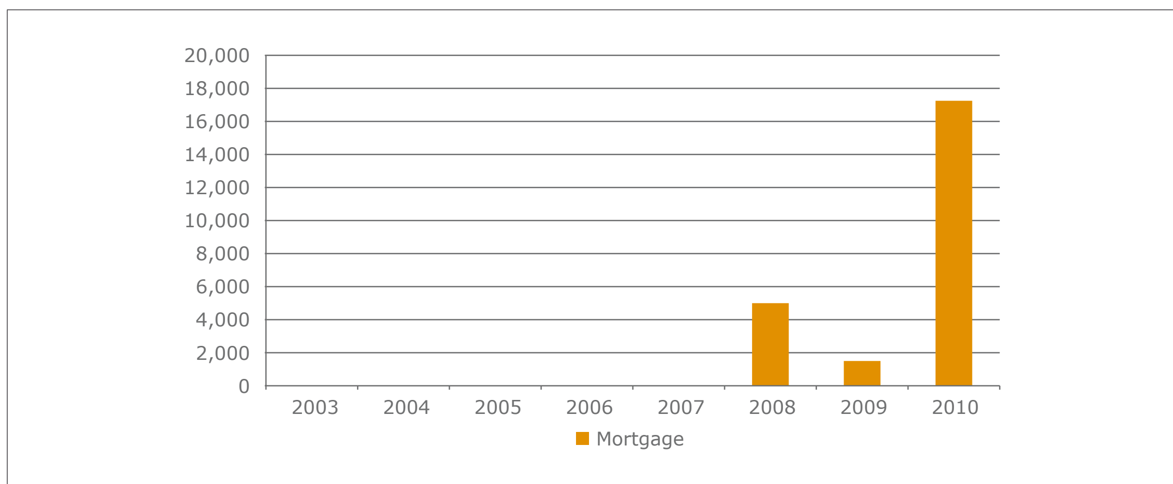
Directly issued Greek Covered Bonds comply with both the UCITS Directive and the Capital Requirements Directive and therefore have the reduced risk weighting mentioned above in Greece and should also have it in other EU member states. In relation to indirectly issued Covered Bonds it must be noted that they do not fall within the letter of art. 22 par. 4 of the UCITS Directive, because they are not issued by a credit institution.

> Figure 1: Covered Bonds Outstanding, 2003-2010, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2010, EUR m



Source: EMF/ECBC

Issuers: There are five issuers in Greece: Alpha Covered Bond Plc (Indirect Issuance); Alpha Bank (Direct Issuance) 2010 - EUR 8 bn; Marfin Egnatia Bank S.A. (Direct Issuance); National Bank of Greece (Direct Issuance); EFG Eurobank Ergasias S.A. (Direct Issuance); Pireaus Bank (Direct Issuance).

3.13 HUNGARY

By Andras Gabor 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 per cent of the mortgage lending value of the property. In case of loans secured by commercial real estate the limit is 60 per cent.

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 per cent 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 per cent 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 per cent of the amount of interest accrued on the nominal value of the outstanding mortgage bonds (Section 14 (2) of the Mortgage Bank Act).

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.

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 the prepayment rules of the Mortgage Bank Act. Pursuant to Section 7, mortgage banks may claim their costs emerging in connection with the prepayment.

VI. 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.

VII. HOW ARE SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS REGULATED?

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.

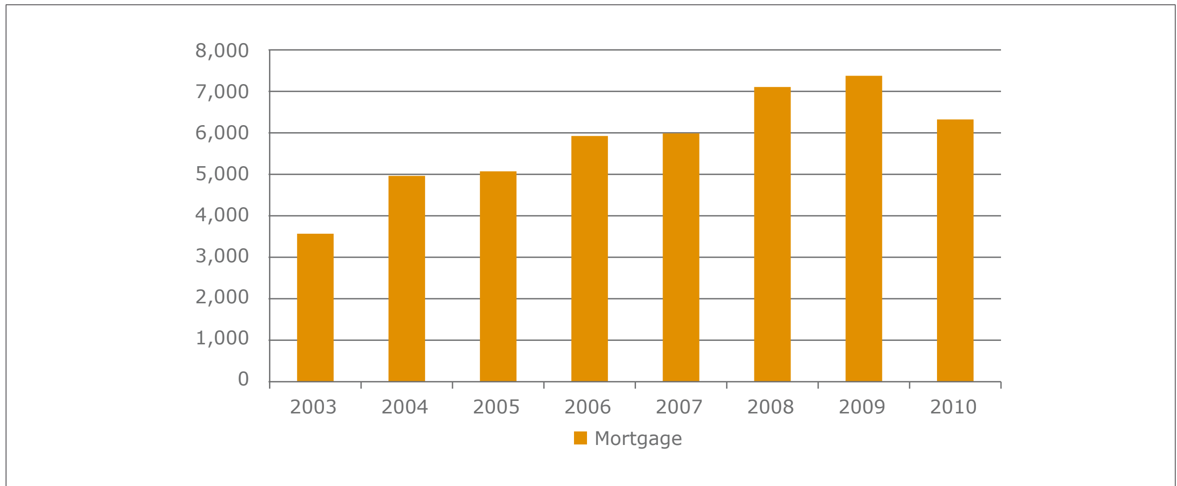
For example, the HFSA is entitled to delegate a supervisory commissioner to the mortgage bank. This extraordinary measurement may be taken by the HFSA prior to the commencement of any insolvency procedure – in accordance with Section 157 (1) of the Credit Institution Act. In this case both the rights 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.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Hungarian mortgage bonds comply with the requirements of Art. 22 par. 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.

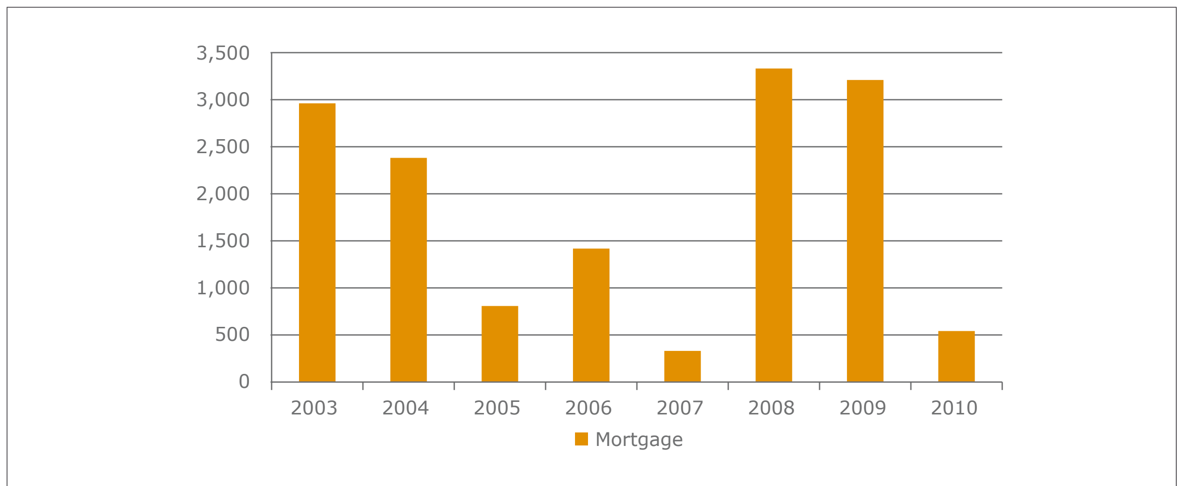
Hungarian covered bonds issued in euro zone countries qualify as ECB eligible; furthermore, in February 2008 one of the Hungarian mortgage banks successfully closed its debut transaction in the "Jumbo" covered bond market.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2010, 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).

3.14 IRELAND

By Nicholas Pheifer, Depfa Bank
Ray Lawless, Bank of Ireland
and Russell Waide, Anglo Irish Bank

I. LEGAL FRAMEWORK AND STRUCTURE OF THE ISSUER

Irish covered bonds benefit from the protection of specialist covered bond legislation under the Irish Asset Covered Securities Act, 2001 and the Asset Covered Securities (Amendment) Act 2007 (the "**ACS Act"**) and the regulations thereunder. The ACS Act follows the specialist banking principle by requiring an Irish asset covered securities issuer (an "**ACS Issuer**") to have, or to obtain, a banking licence and to limit the scope of its banking activities. As a bank an ACS Issuer is regulated by the Irish Financial Regulator. Furthermore each ACS Issuer must be registered as a designated credit institution to issue asset covered securities ("**ACS**") in accordance with the ACS Act. 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) 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 they do so in accordance with the controls and other terms and conditions set out in the ACS Act. 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 assets providing '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.

Statutory Preference

The claims of ACS holders are protected by a statutory preference under the ACS Act. As preferred creditors ACS holders are entitled to have recourse to the cover assets included in the cover pool ahead of other creditors (who do not benefit from the statutory preference under the ACS Act) such as members of and contributories to the ACS Issuer and all other creditors of the ACS Issuer, its parent entity or any company related to the ACS Issuer. In this way the ACS holders have protection against the general Irish insolvency laws.

Restriction on business activities

An ACS Issuer's primary focus will be to issue ACS for the purpose of financing its public sector financing or mortgage or commercial mortgage lending activities.

The ACS Act provides that an ACS Issuer may not carry on a business activity other than a permitted business activity as set out in the ACS Act. Under the ACS Act permitted business activities are restricted to dealing in and holding public credit, mortgage credit assets or commercial mortgage credit assets and limited classes of other assets, engaging in activities connected with the financing and refinancing of such assets, entering into certain hedging contracts, holding pool hedge collateral and engaging in other activities which are incidental or ancillary to the above activities. The ACS Act limits 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.

For designated mortgage and commercial mortgage credit institutions the aggregate prudent loan to value (LTV) of its overall mortgage book cannot exceed 80%.

II. COVER ASSETS

The classes of assets which are eligible for inclusion in a cover pool is dependent upon whether the ACS Issuer is a designated public credit institution; a designated mortgage credit institution; or a designated commercial mortgage credit institution.

For a designated public credit institution eligible public credit assets are financial obligations (including obligations given as a guarantor or surety, and may be indirect or contingent) 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:

(a) central governments, central banks, ("Sovereigns") public sector entities, regional governments or local authorities ("Sub-Sovereigns") in any EEA country;

(b) Sovereigns in Australia, Canada, Japan, New Zealand, the Swiss Confederation or the USA (the "Non-EEA countries");

(c) Sub-sovereigns in the Non-EEA countries; and

(d) Multilateral development banks or international organisations (which qualify for the purposes of the Capital Requirement Directive, also known as the Codified Banking 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. This means that any Sovereign or Sub-sovereign entity within a Non-EEA country must have an independent credit rating of at least A-/A3 and any Sub-sovereign entity within a 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 Non-EEA countries with credit ratings below AA-/AA3 (but at least A-/A3) cannot exceed 20% of the total aggregate value of the cover pool.

Eligible assets for a designated mortgage credit institution include mortgage credit assets which are financial 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 of the EEA or Non-EEA countries described above. A mortgage credit institution is limited in the amount of mortgage credit assets secured on commercial property that it can include in a cover pool. Such commercial mortgage credit assets cannot exceed 10% of the total prudent value of all mortgage credit assets and substitution assets in the cover pool. 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.

Furthermore a mortgage credit asset may not be included in 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, or if it is non-performing.

Eligible assets for a designated commercial mortgage credit institution are financial obligations 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 Non-EEA countries described above.

'Substitution assets' can also be included in the cover pools provided they comply with the CRD requirements and certain other restrictions. Effectively these are deposits with eligible financial institutions or property of institutions with minimum independent credit ratings of at least Step 2, with a limited duration of 100 days and where the total volume of such assets is limited to 15% of the total prudent market value of the cover pool.

III. COVER ASSET MONITOR AND BANKING SUPERVISION

One of the key features of the ACS legislation is the strong monitoring requirements undertaken by the CAM. The CAM is appointed by the ACS Issuer and such appointment must then be approved by the Financial Regulator.

There are strict eligibility requirements for a CAM. A CAM must be a body corporate or partnership, comprising personnel or partners who are members of a professional representative body. They must demonstrate to the Regulator that they are experienced and competent in (i) financial risk management techniques, (ii) regulatory compliance reporting and (iii) capital markets, derivatives, public credit business. The CAM must demonstrate that it has sufficient resources at its disposal, sufficient academic or professional qualifications and experience in the financial services industry to satisfy firstly the designated credit institution and secondly the Financial Regulator, 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 Act and to report breaches to the Financial Regulator. The CAM issues regular reports to the ACS Issuer (every 1-4 weeks) and submits a report on a quarterly basis to the Financial Regulator.

Some of the CAM's principal obligations include: ensuring that the matching requirements of the ACS Act with respect to the cover assets and the ACS are met; ensuring that the asset eligibility requirements are met; approving any inclusion or removal of a cover asset, ACS or hedge contract from the cover register; checking the level of substitution assets included in the cover pool doesn't exceed the required percentage; and ensuring the contracted level of over-collateralisation is maintained.

The Financial Regulator is responsible for supervising each ACS Issuer. The Financial Regulator 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 Act.

IV. VALUATION AND LTV CRITERIA

Mortgage ACS Issuers

For a mortgage ACS Issuer the maximum prudent LTV levels for mortgages in the cover pool are 75% for residential and 60% for commercial. Prudent LTV levels for loans in the cover pool can exceed the 75% threshold, however the balance of the loan above the 75% is disregarded for valuation purposes. The inclusion in the mortgage 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 Pool at any time.

A mortgage ACS Issuer is first required to determine the market value of the property asset at the time of origination of the mortgage credit asset secured on it. The mortgage ACS Issuer is then required to

calculate the prudent market value of each property asset at the time of inclusion in the cover pool and also at such intervals (at least once a year) as may be specified by the Financial Regulator so that it can demonstrate compliance with the asset-liability requirements of the ACS Act and any over-collateralisation commitment. In practice the CAM imposes additional requirements on the mortgage ACS Issuer to ensure that the requirements are met at least on a quarterly basis.

It is a legal requirement for a mortgage ACS Issuer to obtain a valuation report on the property before the loan is advanced and it is market practice that such valuation report is provided by an independent valuer. This initial market valuation is used to calculate the prudent market value going forward using a recognised house price index. This calculation is verified by the CAM on a monthly basis.

Commercial Mortgage ACS Issuers

For a commercial mortgage ACS Issuer the maximum prudent LTV levels for mortgages in the cover pool is 60%. Prudent LTV levels for loans in the cover pool can exceed the 60% threshold, however the balance of the loan above the 60% is not considered for eligibility 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 designated commercial property reference index 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 commercial mortgage ACS Issuer is required to calculate the prudent market value of each property asset at the time of inclusion in the cover pool and at least once every 3 months thereafter.

V. ASSET-LIABILITY MANAGEMENT

The ACS Act includes important asset-liability controls to minimise various market risks.

Duration matching: The weighted average term to maturity of the cover pool cannot be less than that of the ACS that relate to the cover pool.

Over-collateralisation: The prudent market value of the cover pool must be at least 3% (10% for commercial mortgage ACS issuers) greater than the total of the principal amount of the ACS in issue. (For contractual levels of over-collateralisation see further discussion below under separate heading.)

Interest matching: The amount of interest payable on the cover assets over a 12 month period must not be less than the amount of interest payable on the ACS over the same period.

Currency matching: The currency in which each cover asset is denominated has to be the same as the currency in which the ACS are denominated, after taking into account the effect of any cover assets hedge contract.

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 asset. All such hedge contracts are entered on the cover register. 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 an ACS Issuer insolvency the hedge contract will remain in place subject to the terms of the underlying hedge contract. No collateral can be posted by an ACS Issuer to a hedge counterparty. Any collateral posted under a hedge contract by a hedge counterparty will be maintained on a separate register within the cover pool.

Over-collateralisation

There is a minimum 3% over-collateralisation of cover assets in the cover pool required by law for public credit and mortgage ACS. The minimum over-collateralisation for commercial mortgage ACS is 10%. In addition, each existing public and mortgage ACS Issuer has committed to a minimum level of 5% over-collateralisation by contract (on a nominal basis) which is then specified in the documentation for each programme. The commercial mortgage ACS Issuer has committed to a minimum level of 10.5% over-collateralisation by contract. The CAM is responsible for monitoring the level of regulated and contractual over-collateralisation. Upon an ACS Issuer insolvency the ACS holders will benefit from any cover assets which make up the over-collateralisation.

Cover Asset Register

Each ACS Issuer must maintain a cover register including the details of the ACS in issue, the cover assets and substitution assets backing the ACS and any cover asset hedge contracts in existence. The cover 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 in the cover pool entitling the ACS holders and hedge counterparties to benefit from the insolvency protection specified in the ACS Act. It further means that their removal from the pool can be achieved only with the permission of the CAM as entries or amendments to the cover register can only be made with the consent of the CAM or the Financial Regulator.

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, in both cases subject to the terms and conditions of the documents under which they were created.

Upon an ACS Issuer 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 Act 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 Act makes provision for the management of the cover pool 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 Financial Regulator or the NTMA then the NTMA will attempt to locate an appropriate body corporate as a new parent entity for the ACS Issuer. Failing that the Financial Regulator will appoint the NTMA to act as a temporary manager until a suitable manager or new parent is found. Upon their appointment the manager will assume control of all the cover assets of the ACS Issuer and its ACS business. The manager shall manage the ACS business of the ACS Issuer in the commercial interests of the ACS holders and the hedge counterparties. The manager shall have such powers as may be divested to it by the Financial Regulator under its notice of appointment. It is possible for such manager to obtain a liquidity facility through the use of a hedge contract which would rank such facility provider pari passu with the bondholders and other hedge counterparties.

Preferential Treatment of ACS holders

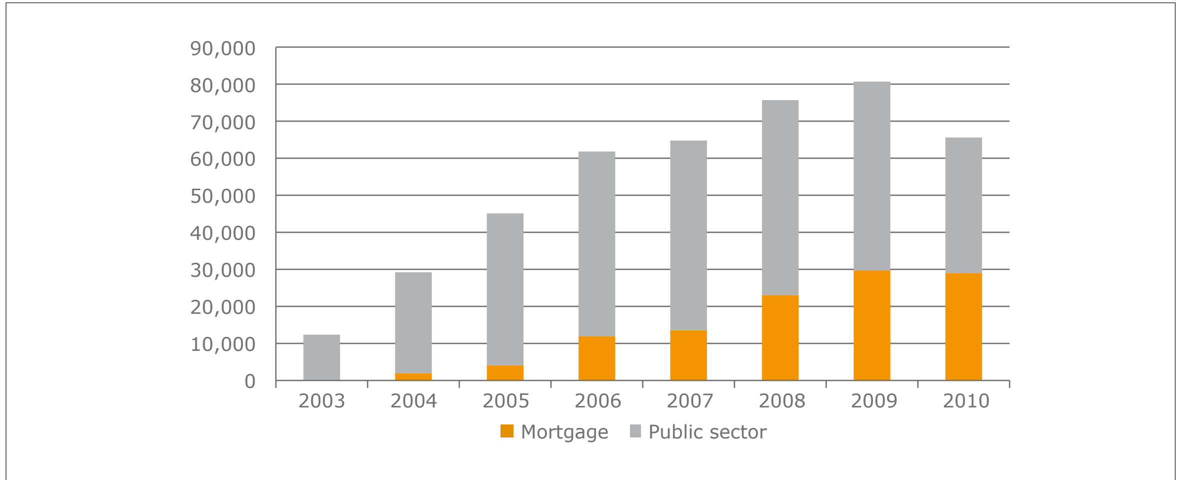
ACS holders are preferred creditors in relation to the cover assets (ranking after the CAM and the NTMA and equally with the hedge counterparties). Cover assets included in a cover pool do not form part of the assets of the ACS Issuer for the purposes of insolvency until such time as the creditors benefiting from the insolvency protection under the ACS Act have been satisfied.

If the claims of the ACS holders (and other parties benefiting from insolvency protection including the 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.

VI. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

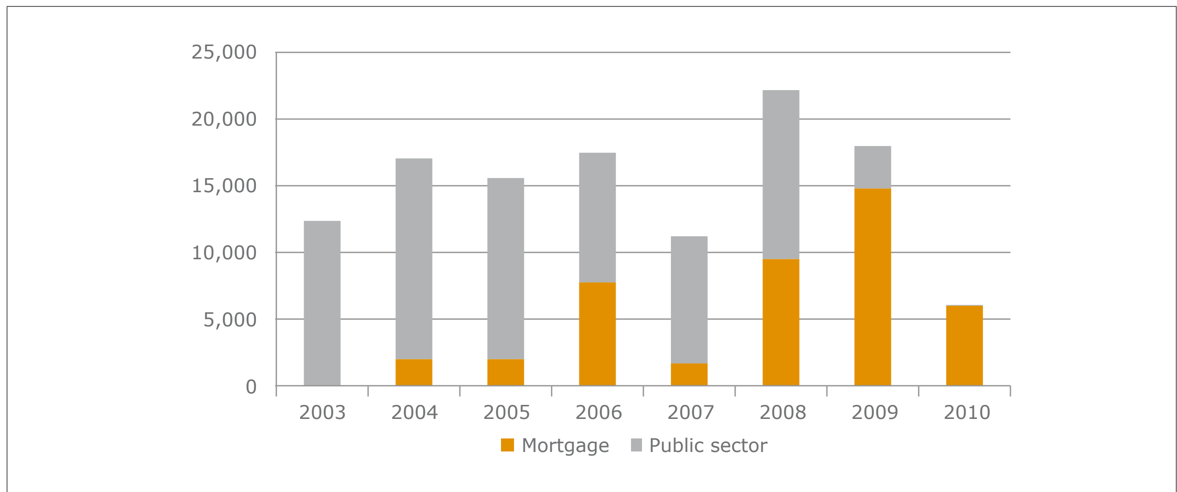
The ACS meet the requirements of UCITS 52(4) and currently benefit from a risk-weighting of 10% as applied by the Financial Regulator. The eligibility of cover assets set out in the ACS Act also match the criteria for the preferential risk weighting of covered bonds set out in the CRD.

> Figure 1: Covered Bonds Outstanding, 2003-2010, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2010, EUR m



Source: EMF/ECBC

Issuers: There are 6 issuers in Ireland: Bank of Ireland Mortgage Bank, Depfa ACS, EEA Covered Bond Bank plc, Allied Irish Mortgage Bank, EBS Mortgage Finance and Anglo Irish Mortgage Bank.

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:

1. 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;
2. 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);
3. the bank transferring the assets (or another bank) issues covered bonds;
4. 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 mln

> 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:

a) residential mortgage loans with a maximum LTV of 80% or commercial mortgage loans with a maximum LTV of 60%;

b) 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%;
- public entities of non-EEA member countries with a risk weight of 0%;
- other entities of non-EEA member countries with a risk weight of 20%.

c) 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:

1. the transfer of additional eligible assets to the pool;
2. the opening of deposit accounts at banks located in an EEA member country, or in other countries with a 0% risk-weight;
3. 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. 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 m 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*).

VI. ASSET SEGREGATION AND IMPACT OF INSOLVENCY PROCEEDINGS ON COVERED BONDS AND DERIVATIVES

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.

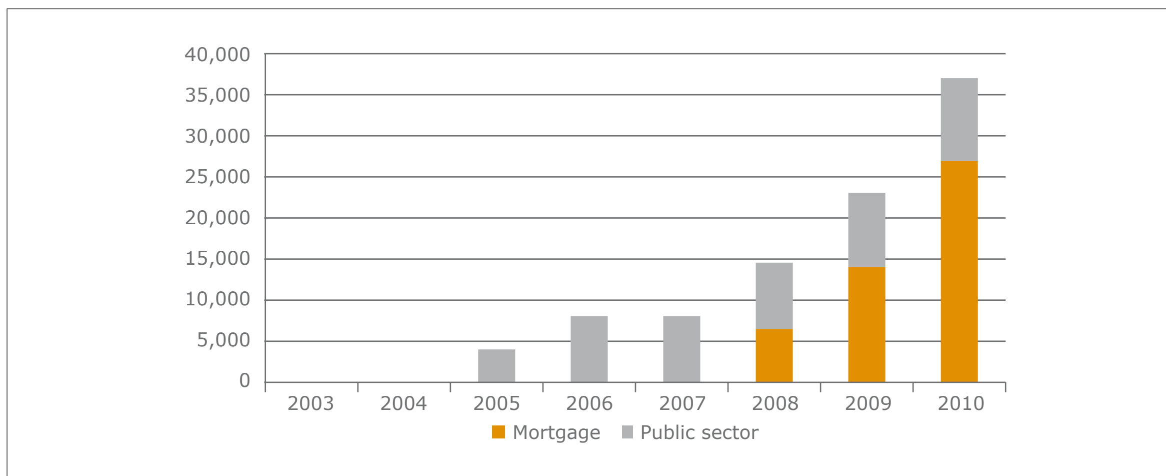
All the amounts obtained as a result of the liquidation procedure will become part of the cover pool and therefore used to satisfy the rights of covered bondholders. The redemption of the subordinated loan granted by the issuer of the covered bonds to the SPV is junior to any outstanding claims of covered 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.

VII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

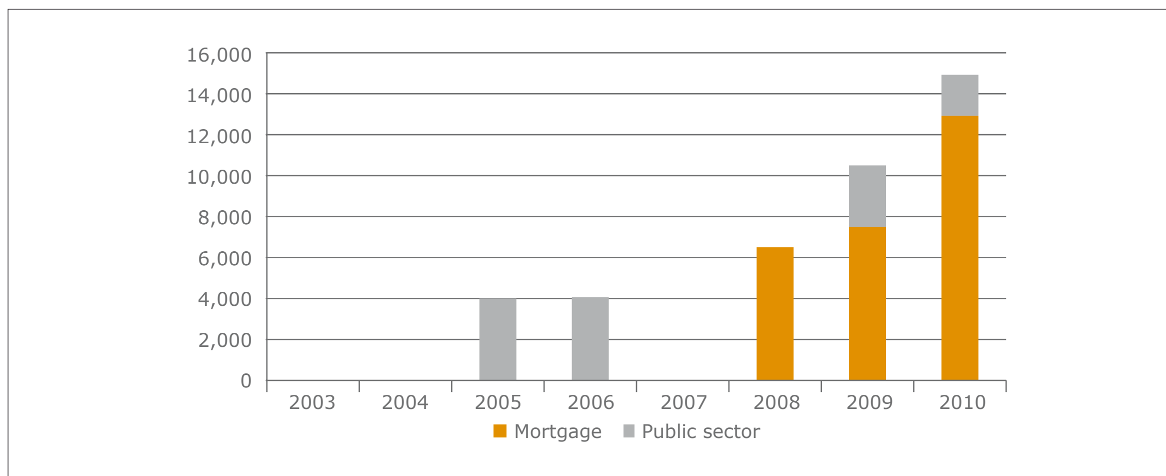
Italian covered bonds fulfil both the criteria of UCITS 52(4) and Annex VI, Part 1, Paragraph 68 (a) to (f) of the Capital Requirements Directive. They are also eligible in repo transactions with the Bank of Italy. The risk-weight is 10%.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2010, EUR M



Source: EMF/ECBC

Issuers: There are 9 active issuers in Italy: Banca Carige SpA, Banca delle Marche, Banca Monte dei Paschi di Siena, Banca Popolare di Milano, Banco Popolare, Credem, Intesa Sanpaolo, UBI and UniCredit.

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

(a) cash,

(b) balances with the central banks of the EU member states and

(c) 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. HOW ARE SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS REGULATED?

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 Bonds.

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

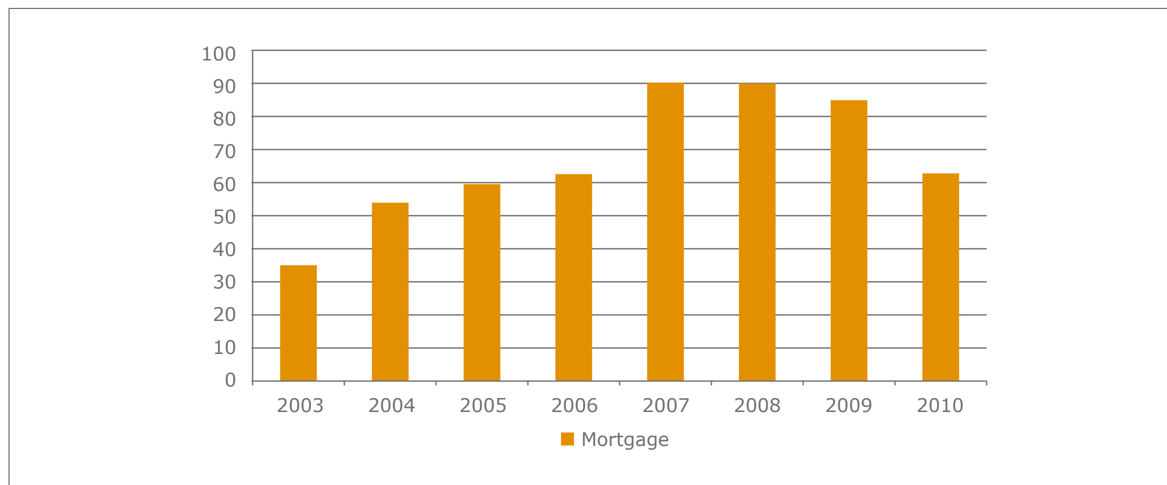
The HKZL and the Law on Credit Institutions provide that the cover assets in a case of insolvency of issuer are transferred to other bank chosen by the FCMC. The bank to which the cover assets are transferred, also takes responsibility for all the obligations arising from outstanding mortgage bonds.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Latvian mortgage bonds comply with the requirements of Art. 52(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, 2003-2010, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2010, EUR m

Source: EMF/ECBC

Issuers: At the end of 2010, there were four issuers in Latvia: A/S Privatbank (Parex Bank),GE Money, Mortgage and Land Bank of Latvia and Trasta.

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). Moveable 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 moveable 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 moveable 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 five 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 be 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. COVER POOL MONITOR AND BANKING SUPERVISION

The supervisory authority of covered bond issuers is the general banking regulator “Commission de Surveillance du Secteur Financier (CSSF)”. 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 Commission de Surveillance du Secteur Financier (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 moveable 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.

VII. HOW ARE 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.

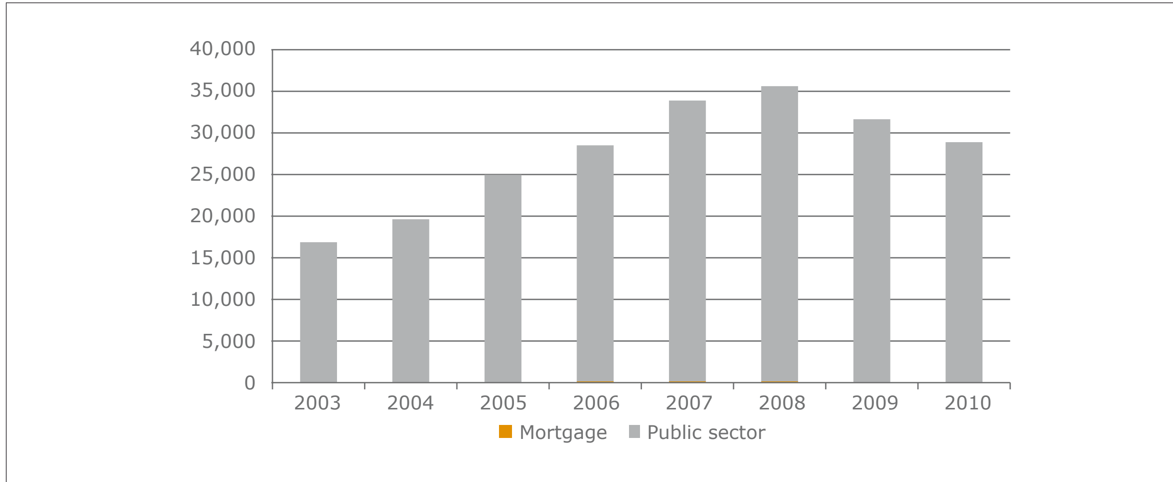
There is no explicit provision in the law regarding any voluntary overcollateralisation. However, Article 12-8 (5) stipulates that assets remaining after the creditors enjoying the preferential rights have been paid off in full, shall be transferred to the general pool of assets comprised in the liquidation 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)) and Lettres de Gage enjoy therefore a 10% risk weighting under Basel I rules in Europe. 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, 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.

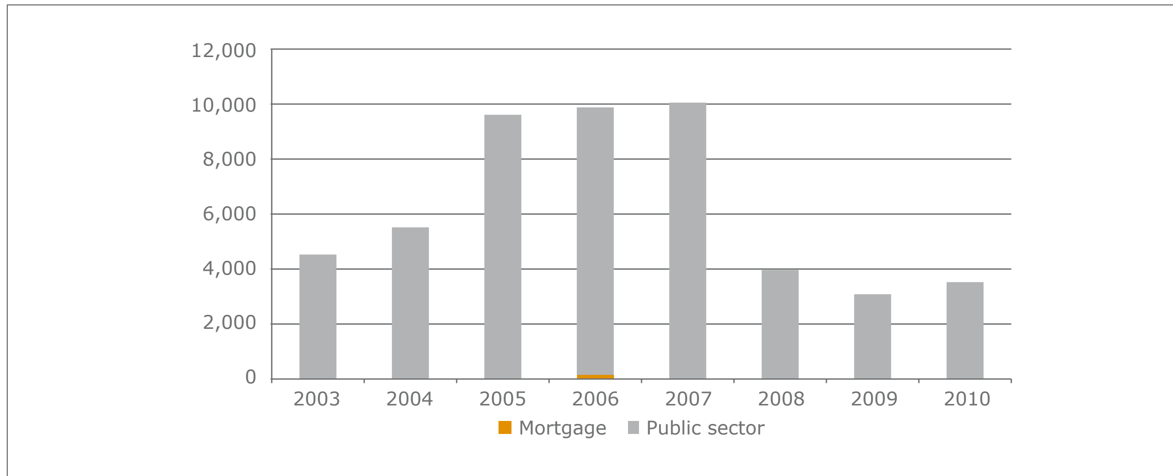
Lettres de Gage are principally eligible for repo transactions with the European central bank. But this applies only to Lettres de Gage issued in Euro and in New Global Note format for Euro-System eligibility.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2010, EUR M



Source: EMF/ECBC

Issuers: There are five 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. and Nord/LB Covered Finance Bank S.A.

3.18 THE NETHERLANDS

By Daniëlle Boerendans, ABN AMRO Bank N.V.
Rezah Stegeman, Clifford Chance LLP
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I. FRAMEWORK

The Dutch regulation for covered bonds (the "**Regulation**") came into force in the Netherlands on 1 July 2008 and 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 embraces a segregated structure, being a structure where the cover assets are segregated from the issuer and owned by a covered bond company (the "**CBC**"). Under the Regulation, asset segregation takes place on the basis of the Dutch Civil and Bankruptcy Codes. The applicable statutory provisions are relatively creditor-friendly and have enabled the Dutch legislator to take a time-efficient and principle-based approach without having to amend the Dutch Civil or Bankruptcy Code.

The Regulation is not a separate instrument but a collection of rules forming part of the following two layers of secondary legislation implementing the Dutch Financial Supervision Act (Wet op het financieel toezicht; the "**FSA**"):

> the FSA Prudential Rules Decree (*Besluit prudentieel toezicht Wft*); and

> the FSA Implementing Regulation (*Uitvoeringsregeling Wft*).

There is however a third Dutch regulation which contains specific covered bond provisions, being the Regulation on Solvency Requirements for Credit Risk and Large Exposures FSA 2010 (*Regeling solvabiliteitseisen kredietrisico* en grote posities Wft 2010; the "**Solvency Requirements FSA**"). An important distinction to bear in mind is that the Regulation focuses on issuance of covered bonds by Dutch banks out of The Netherlands (which is what this chapter is about), whereas the relevant Solvency Requirements FSA focus on investment by Dutch banks (and investment firms) in covered bonds issued out of any country that is a party to the European Economic Area. The relevant Solvency Requirements FSA are a number of years older than the Regulation and stipulate the regulatory beneficial treatment for investments in covered bonds that are backed by CRD-compliant assets. CRD-compliant assets are basically assets that meet the requirements of item 68 of Annex VI to the Banking Consolidation Directive (2006/48/EC; the "**BCD**"), which together with the Capital Adequacy Directive (2006/49/EC) constitutes the Capital Requirements Directive (the "**CRD**").

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) 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 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 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

To date all Dutch covered bond programmes (i.e. ABN AMRO, Achmea, ING, NIBC and SNS) are backed by residential mortgage loans. In addition they allow for inclusion of substitution assets, meaning euro-denominated:

> cash; or

> other assets eligible under the CRD to collateralise covered bonds, 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.

Although the Solvency Requirements FSA contain detailed provisions on cover assets as prescribed by the CRD, the Regulation only lists the general requirements of article 52(4) of the Undertakings for Collective Investment in Transferable Securities Directive (85/11/EC; "UCITS"). The Regulation therefore regards CRD-compliance as an option, and not as a requirement. It allows issuers of (and thus investors in) Dutch covered bonds the flexibility to choose whether they wish to issue (or invest in) covered bonds which are either:

> UCITS-compliant; or

> both UCITS- and CRD-compliant.

The ABN AMRO, ING, NIBC and SNS covered bond programmes are designed to be both UCITS- and CRD-compliant. The Achmea covered bond programme is designed to be both UCITS- and CRD-compliant in all respects but one: it applies a 125% rather than an 80% LTV Cut-Off Percentage. This will be explained in more detail in paragraph IV below.

UCITS- and CRD-compliance of Dutch covered bonds can only be achieved if the relevant covered bonds are registered by DNB under the Regulation. The DNB register indicates whether the relevant covered

bonds are CRD-compliant. All covered bonds registered by DNB are in principle UCITS-compliant. The requirements for, and status of, registration of Dutch covered bond programmes will be set out in paragraph VI below.

IV. VALUATION AND LTV CRITERIA

The above feature of CRD-compliance as an option, should be seen against the background that 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 covered bond programmes take a two-step approach towards LTV-ratio's of Dutch residential mortgage loans, as follows:

> the loan is only eligible as cover asset if the LTV-ratio did not exceed 125% (subject to some exceptions in some programmes; the "**Eligibility Percentage**") at origination; and

> once a loan forms part of the cover assets, the maximum value attributed to it in valuing the cover assets is a certain percentage (this differs per programme; the "**LTV Cut-Off Percentage**") of the value of the underlying mortgaged property at such time. For example, if (a) the relevant LTV Cut-Off Percentage is 80% and (b) 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 determining the value of the cover assets. The 30 excess value of the loan would serve as extra credit enhancement in Dutch covered bond programmes. This would not be the case in integrated covered bond structures used in countries that apply prescriptive (that is rule-based rather than principle-based) regulations.

The LTV Cut-Off Percentage applied to Dutch residential mortgage loans is:

> 80% in Dutch covered bond programmes which are designed to be backed by CRD-compliant cover assets (i.e. ABN AMRO, ING, NIBC and SNS);

> 125% in Dutch covered bond programmes which are not designed to be backed by CRD-compliant cover assets (i.e. Achmea); and

> 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*).

The Regulation does not (nor does the CRD) prescribe whether it is the foreclosure value or the market value of the underlying mortgaged property which should be taken into account when calculating the LTV-ratio . To date under the Dutch 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 which is set at 85-90% (this differs per programme) of the applicable foreclosure value at origination, subject to indexation. As to indexation, (a) if prices go up, the property value is increased by 85-100% (this differs per programme) of the increase and (b) if prices go down, the value is reduced by 100% of the decrease.

V. ASSET - LIABILITY MANAGEMENT

Under all current Dutch covered bond programmes a total return swap is entered into at inception of the programme in relation to the cover assets. 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 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 covered bonds.

All Dutch covered bond programmes require the issuer to establish a reserve fund equal to 3 month's interest payments on the covered bonds plus certain costs and expenses for 1 month if the issuer's short term rating is or falls below P-1/F1/A-1 or A-1+ (this differs per programme).

To mitigate liquidity risk on principal payments all Dutch covered bond programmes use either:

> a pre-maturity test which is taken on each business day during 6 or 12 months preceding the maturity of the relevant 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 is or falls below P-1/F1+/A-1+. A breach of the pre-maturity test requires (a) the issuer to cash-collateralise hard bullet maturities or (b) the CBC to procure alternative remedies such as a guarantee of the issuer's obligations, a liquidity facility and/or a sale or refinancing of cover assets; or

> a one-year 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 covered bond programmes a minimum level of over-collateralisation is required, which is measured by applying an asset cover test with asset percentages ranging from approximately 70 to 85%.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

Under all Dutch 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 safeguardvalid 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 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.

To date the ABN AMRO, ING, NIBC and SNS covered bond programmes have been registered by DNB. The register 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. If the 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 covered bond. 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.

VII. HOW ARE SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS REGULATED?

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.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

As explained above, Dutch covered bonds registered by DNB under the Regulation 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 covered bonds registered under the Regulation:

Dutch covered bond category **Type of investor**		**UCITS -compliant**	**UCITS- and CRD-compliant**
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 covered bonds in the context of banks and investment firms entering into repurchase transactions (repo's) with the Dutch covered bond issuing banks. If the issuing Dutch bank posts its own CRD-compliant covered bonds as collateral under the repo, then such covered bonds qualify as financial collateral under the Solvency Requirements FSA for the purpose of mitigating the credit risk

of the bank/investment firm on the issuing Dutch bank as its repo counterparty if such covered bonds are CRD-compliant.

Finally, if Dutch 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 are eligible even where the posting bank is the issuer (or has 'close links' with the issuer or guarantor) of the covered bonds. This means for example that a Dutch bank wishing to borrow from DNB may use its own UCITS-compliant covered bonds as collateral (informal assurance suggests that CRD-compliance is currently not required and that 'own' general-law-based covered bonds will not be accepted);

> they need not be admitted to trading on a regulated market (as defined in the Markets in Financial Instruments Directive; MiFID); and

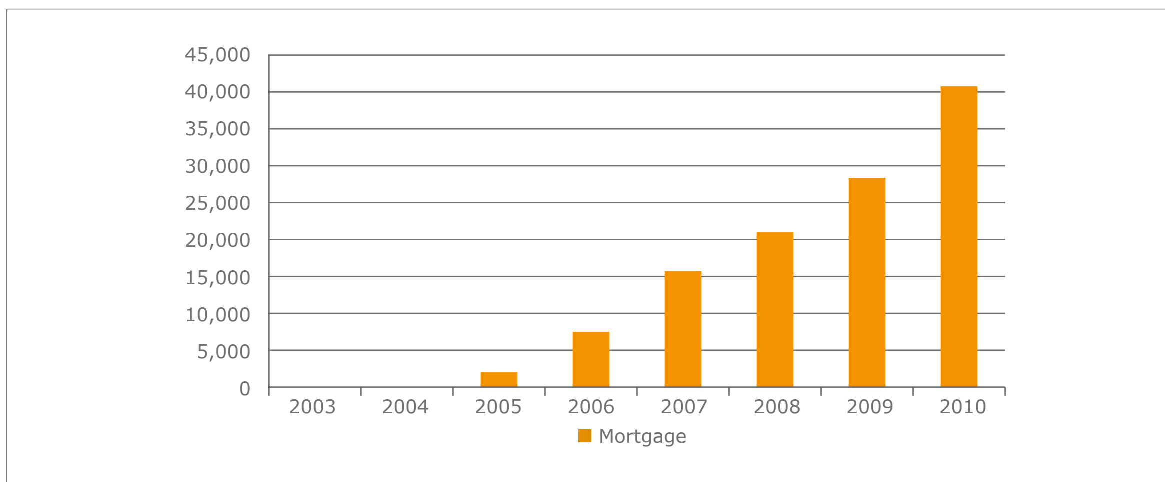
> unlike other asset-backed securities:

(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

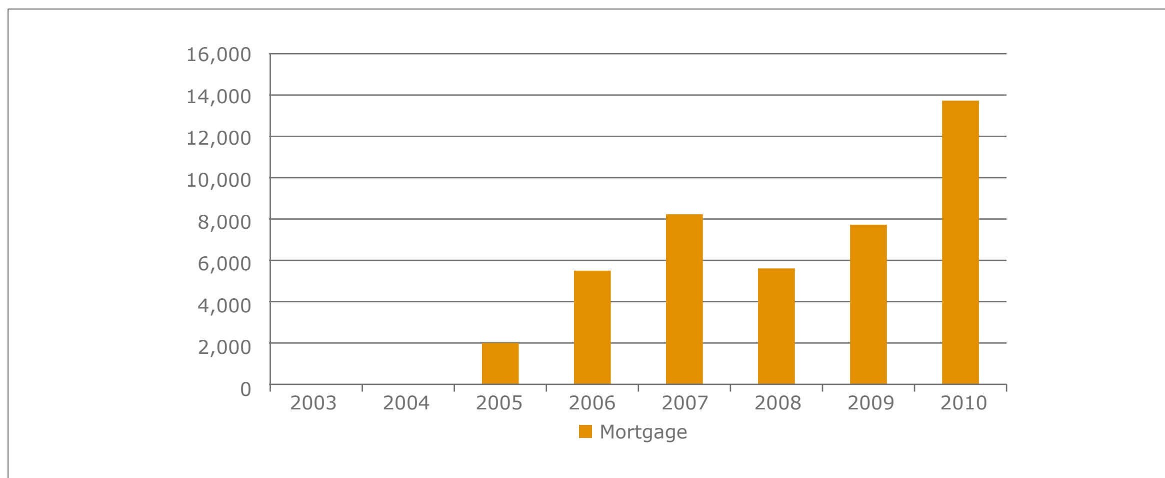
(c) they are exempt from certain true sale requirements. In addition, if issued prior to 1 January 2008, they are exempt from certain credit quality thresholds. However, these exemptions are of lesser relevance for Dutch UCITS-compliant covered bonds because the Regulation requires a segregated structure as well as a credit rating of at least AA-/Aa3.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2010, EUR M



Source: EMF/ECBC

Issuers: There are five issuers in the Netherlands: ABN AMRO Bank N.V., Achmea Hypotheekbank N.V., ING Bank N.V., NIBC Bank N.V. and SNS Bank N.V.. Except for Achmea all issuers are registered at DNB.

3.19 NEW ZEALAND

By Mahes Hettige, Bank of New Zealand
and Frank Will, RBS

In June 2010, Bank of New Zealand opened the covered bond market in New Zealand and issued the first covered bond out of New Zealand. New Zealand has no legal covered bond framework and the issuers in New Zealand use the well-tested structured covered bond approach following in the footsteps of the UK, France, Canada, and the US. However, the regulatory authorities in New Zealand are currently developing a dedicated covered bond legislation to support further growth of this market segment.

I. FRAMEWORK

In June 2010, Bank of New Zealand was the first issuer out of New Zealand to issue covered bonds. At that time no covered bond regulation was in place and issuance of covered bonds was neither prohibited nor limited by any prudential requirements or other regulation. Two years earlier in 2008, the Reserve Bank of New Zealand (RBNZ) had already started preliminary discussions with a number of banks about the issuance of covered bonds and indicated to these banks that they may issue covered bonds but only at modest, conservative levels.

In May 2010, two months before the inaugural covered bond issuance, the RBNZ publicly stated that it supports the development of a covered bond market in New Zealand. In October 2010, it released a consultation paper on a wider regulatory framework including legislative changes 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. It limits the value of assets encumbered for the benefit of covered bondholder to 10% of total assets of the issuing bank. This is an initial limit and its appropriateness will be reviewed by the central bank within the next two years, taking into account the developments within the covered bond market in New Zealand.

Following the implementation of a covered bond legislation or additional regulation in New Zealand, several covered bond issuers would have the right 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 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 2011, two issuers from New Zealand have issued covered bonds, BNZ International Funding Limited and Westpac Securities NZ Limited. The bonds were issued through their London branches and are guaranteed by the issuers. However, in both cases the ultimate Australian parent companies NAB and Westpac do not guarantee the covered bonds. ANZ National Bank Limited has also setup a Covered Bond Programme and more banks are expected to follow in these banks' footsteps over the coming years. The RBNZ emphasised from the outset that it is supportive of the covered bond product despite the fact that the majority of large banks in New Zealand are foreign-owned and operate outside the domestic market of their ultimate parent company.

Banks can issue bonds backed by a dynamic pool of assets, 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 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 three programmes are listed below.

> are denominated and repayable only in New Zealand Dollars in New Zealand;

> 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 NZD1.5mln (Westpac)/NZD 2.0mln (ANZ)/ NZD2.5mln (BNZ)

> are not delinquent/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, except cash that has no limit, are subject to an overall limit of 10-20% of the cover portfolio depending on the issuer (Westpac 20%, BNZ 15%, ANZ 10%).

The covered bond legislation is yet to be finalised, but two different frameworks to ensure the preferential claim of the covered bonds investors are currently being discussed. The first option would be a 'registration framework', under which investors' rights to the asset pool of a registered covered bond would be protected from the insolvency or statutory management of the issuer. The second option would be 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.

If the framework were to include registration, this would involve the recognition of a covered bond issue by a New Zealand issuer, rather than authorisation of an issue. The effect would be that the cover assets would be explicitly protected from the insolvency or statutory management of the issuer. The process of registration would most likely be set out in regulations, which would specify the requirements for admission to the register. Such requirements could involve the provision of information to the RBNZ, including the background of the issuer, details of the proposed issuance programme, and independent verification of the transaction documents. A crucial point for the RBNZ is the bankruptcy remoteness of the cover assets. Unregistered covered bonds may still be issued, but will not enjoy the protection conferred by registration.

The RBNZ may introduce minimum eligibility criteria for the assets that can be included in the cover pool of a registered covered bond. However, the RBNZ has indicated that if a registration framework is adopted, it would seek to ensure that covered bond programmes that were established prior to the introduction of the register would be grandfathered.

IV VALUATION AND LTV CRITERIA

In New Zealand, every property is typically valued during the underwriting process. Any mortgage with an original LTV of above 80% must have undergone an external independent valuation at the time of origination.

All three existing covered bond programmes do not have a hard cut-off LTV limit for mortgage loans in place. However, in the case of Westpac, the Assets Coverage Test (ACT) caps the nominal amount of any loan at 75%. In case of BNZ, and ANZ, the loan-to-value (LTV) cap is 80% which means that covered bonds are only issued against the portion of loans with an LTV of up to 80%. Nonetheless, the over-collateralisation can consist of mortgages with an LTV above the respective LTV cap.

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 holder to 10% of the total assets of the issuing bank. As highlighted by the RBNZ, this is an initial limit and its appropriateness will be reviewed within the next two years, taking into account the development of the covered bond market.

Currency & Interest Hedging: The underlying mortgage loans have to be denominated in NZD. However, the issuers can issue covered bonds denominated in other currencies introducing currency risks for the issuer. Moreover, the interest payable for the covered bonds will usually 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 (BNZ, Westpac and ANZ) can issue hard bullet covered bonds or covered bonds with extendable maturity of one year ('soft bullet' bonds). Hard bullet covered bonds will be subject to a 12-month pre-maturity test giving the CB guarantor 12 months to raise liquidity by selling assets of the pool.

VI COVER POOL MONITOR AND BANKING SUPERVISON

The existing issuers provide investor reports on a quarterly basis. In addition, quarterly reports are prepared for the rating agencies. The agencies check the asset percentage used in the ACT on a regular basis and prior to each issuance under the respective covered bond programme. Moreover, before any new covered issuance, the rating agencies need to confirm that the additional issuance will not negatively impact the covered bond ratings. The RBNZ has indicated that new disclosure requirements will be introduced as part of the upcoming covered bond regulation (1) to improve the information available to covered bond investors and (2) to provide details on the dilution and structural subordination of other creditors and depositors.

The asset monitor, which has to be an independent audit firm, performs tests in respect of the asset coverage test or amortisation test, as applicable, and checks the arithmetic accuracy of the calculations performed by the calculation manager (usually the issuer) on an annual basis. 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 intercompany 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.

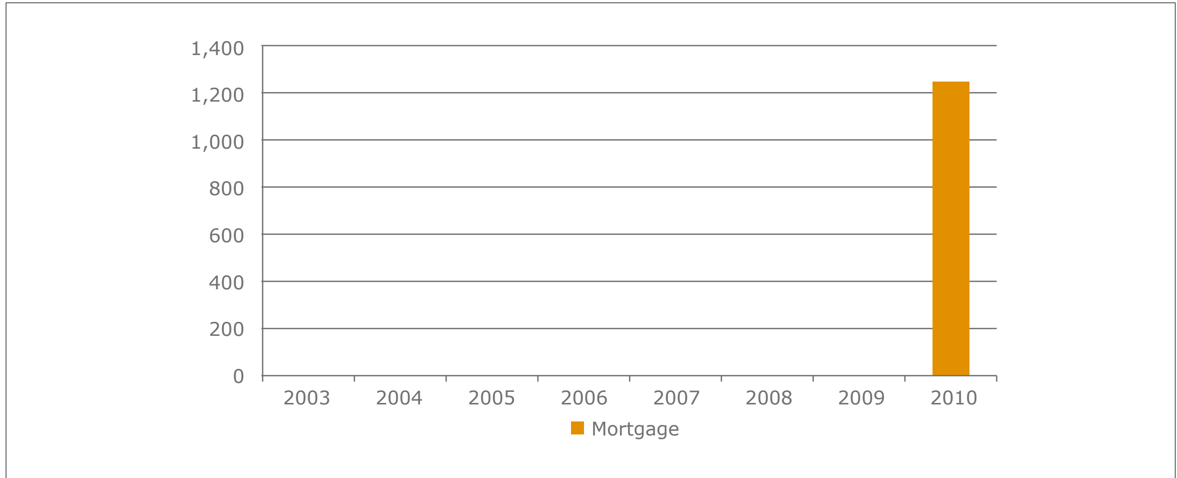
Under the existing covered bond programmes, the sale of the loans and their underlying security by the seller to the CB Guarantor is in form of equitable assignment of the seller's rights, title, interest and benefit in and to the loans, their related security and the other assets which are being sold. The equitable assignment does not require 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 issuer until legal assignment are delivered to the CB guarantor and notice of sale is given to the borrowers. The perfection of the assignment of the loans and their related 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 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 NZ$ 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.

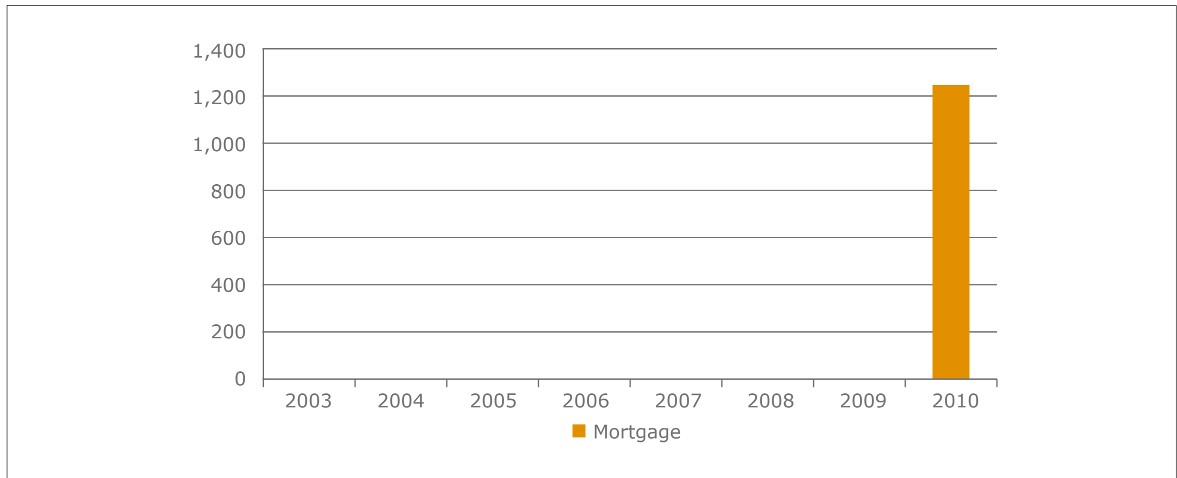
The covered bonds issued directly by financial institutions with registered offices in New Zealand are neither CRD nor UCITS compliant as both frameworks require the issuer to be based in the EU. Moreover, the UCITS directive (and therefore the CRD) requires special legal supervision – usually in form of a dedicated covered bond law which as of August 2011 does not exist in New Zealand. The covered bonds therefore do not benefit from the lower risk weighting for bank treasuries in the EU. However, some of the issuers issue covered bonds out of their international subsidiaries which have registered offices in the UK. Hence, bonds issued out of those entities may qualify for repo transactions with the ECB, as soon as New Zealand establishes a legal framework for covered bonds.

> Figure 1: Covered Bonds Outstanding, 2003-2010, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2010, EUR m



Source: EMF/ECBC

3.20 NORWAY

By Stein Sjølie, FNO and Bernd Volk, Deutsche Bank

INTRODUCTION TO THE NORWEGIAN COVERED BOND MARKET

Covered Bonds

The Norwegian covered bond legislation was adopted in June 2007. It came as a result of a lengthy study and reviews sponsored by the government and with strong support by the financial industry. It is a modern and up to date legislation that provides investors strong protection from the cover pool. The legislation is closely matching corresponding EU directives and regulation, 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.

Issuance of the first Norwegian covered bonds started with euro denominated bonds in second half 2007, and had thus just 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.

During 2008 and 2009 a total NOK 230 bn. (ca. EUR 30 bn.) of Norwegian covered bonds were lodged in swap agreements with the Government. These bonds must be refinanced in the market during the coming years, and this refinancing began in the beginning of 2011.

Specialized credit institutions

Today more than 20 Norwegian specialized credit institutions are licensed to issue covered bonds. Norwegian covered bonds are protected by law, and the issuers are subject to a particular supervisory regime involving both an independent inspector and the public supervisor, Finanstilsynet. 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.

Cover pools are dominated by residential mortgages; issuers tend to specialize, and the large majority of the issuers are specialized residential mortgage institutions (cf. the name "Boligkreditt"). Just a small number of issuers are specialized on commercial mortgages or on public sector loans.

Trading of covered bonds

The covered bonds are listed. The domestic issues listed on Oslo Børs may be traded on the exchange, but more often are traded off exchange and then reported to and publicized by Oslo Børs. International issues may be listed anywhere, usually somewhere within the currency zone in which the bonds are denominated. Some of the issuers supplement their bond issuance with private placements. Private placements and bondholders' claims rank pari passu in the cover pool.

NORWEGIAN COVERED BOND LEGISLATION

Background

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 on 25 May 2007 the Ministry of Finance adopted a supplementary regulation, hereafter "the Regulation", to the Act.

The legislation fulfils and is in compliance with the relevant EU legislation, i.e. EU UCITS 52(4) and Directive 2006/48/EC. Hence the Norwegian Covered Bonds are in compliance with the UCITS, the CRD directive, and 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 issuance of covered bonds – a specialist banking principle

The legislation permits specialised 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 by 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.

Regulation and 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 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. 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.

Eligible assets – loan to value ratios

According to the Act the cover pool may consist of the following assets:

a. Residential mortgages

b. Commercial mortgages

c. Loans secured on other registered assets (subject to further regulations)

d. Public sector loans

e. Assets in form of derivative agreements (in accordance with the Regulation)

f. 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 national government of the country where the mortgaged property or the borrower has its location.

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 an open auction 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, ref the matching regulations, described below. The same principle applies to loans that are in default, i.e. more than 90 days in arrears.

Derivative agreements and substitute assets

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.

Matching regulations

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. However, if an issuer chooses to provide voluntary overcollateralization, these assets are part of the cover pool, and bankruptcy remote in case of the issuer going into bankruptcy proceedings. 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.

Register and inspector

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.

Timely payment

As long as the cover pool fulfils the matching requirements, the bondholders and counterparties in derivative agreements have the right to timely payment, even in case of the issuer going into bankruptcy proceedings. 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 proceedings

In case of bankruptcy of the mortgage credit institution an administrator shall be appointed by the court. The bankruptcy manager shall ensure proper management of the cover pool and also ensure that holders of covered bonds and derivative counterparties receive agreed and timely payments. Bankruptcy or insolvency does not in itself give holders of covered bonds and derivative counterparties right to accelerate their claims. Should it not be possible to make contractual payments when claims fall due, and an imminent change that will ensure that such contractual payments are unlikely, the bankruptcy manager shall introduce a halt to payments. Thereafter further administration of the cover pool shall proceed under the general bankruptcy legislation.

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 property, 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 mortgages on real property. 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.

NORWEGIAN COVERED BOND MARKET REVIEW

The year 2010 represented a normalization of the market after the international financial crisis and the very serious liquidity problems facing all bond markets. The Norwegian Government had, already by end 2009, as the market improved, discontinued the swap program, by which the Norwegian banks swapped covered bonds against treasury bills with the Government. Thus, there was no government sponsored program stimulating the market in 2010.

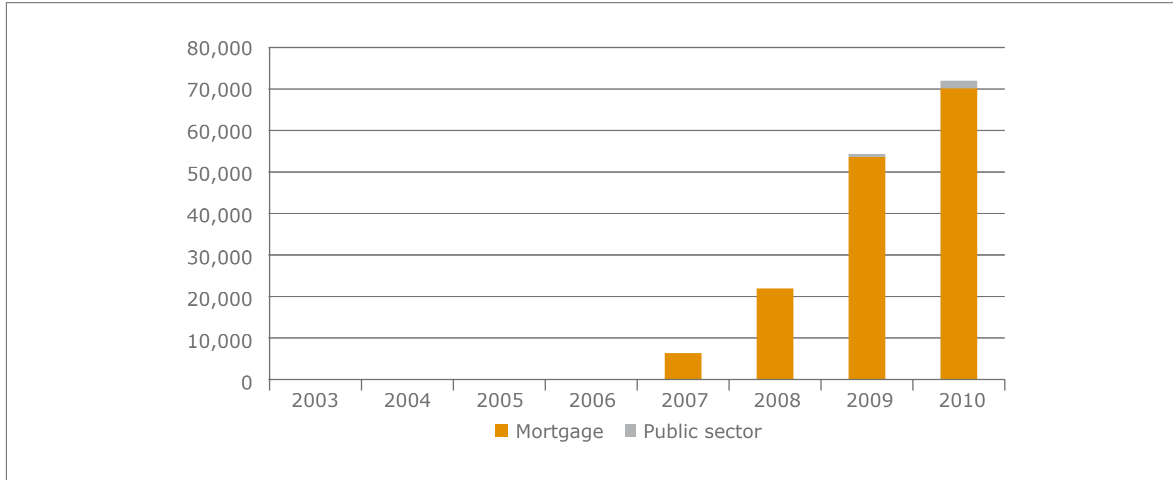
Thanks to the market improvement Norwegian issuers were able to issue new covered bonds totalling EUR 23 bn. during 2010, bringing the total outstanding to EUR 72 bn. by the end of the year. Of the total issuance EUR 11 bn., or close to the half, was euro denominated. A bit more than a third, or an amount corresponding to EUR 8 bn., was denominated in NOK (national currency). The rest was issued in other foreign currencies, mainly USD.

Of the total outstanding by the end of the year an amount corresponding to EUR 46 bn. was denominated in NOK, of which about EUR 30 bn. was lodged in the swap program with the Government. These bonds must be refinanced in the market as the swap agreements reach their term. The agreements, booked in last quarter 2008 and in 2009, have three to five years duration, but the banks have the option to terminate earlier, and early termination started in first half year 2011.

Today more than 20 Norwegian specialised 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. Cover pools are dominated by residential mortgages, and the large majority of the issuers are specialized residential mortgage institutions (cf. the name "Boligkreditt"). Just a small number of issuers are specialized in commercial mortgages or in public sector loans.

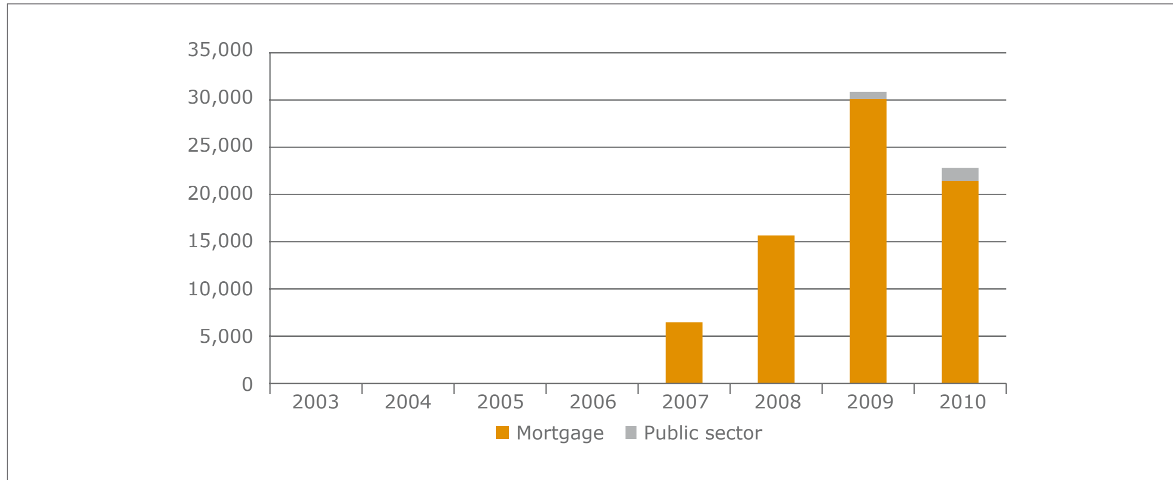
The covered bonds are listed. Virtually all active issuers have issues listed on the Norwegian market places offered by Oslo Børs, either on the regulated market or on the non-regulated market place run by Oslo Børs. The activity in the Norwegian market increased during 2010, and has showed an increasing trend so far in 2011. Today (June 2011) 18 issuers with more than 110 issues are traded on the Norwegian market places. International issues may be listed anywhere, usually somewhere within the currency zone in which the bonds are denominated. Some of the issuers supplement their bond issuance with private placements. Private placements and bondholders' claims rank pari passu in the cover pool.

> Figure 1: Covered Bonds Outstanding, 2003-2010, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2010, EUR m



Source: EMF/ECBC

3.21 POLAND

By Agnieszka Drewicz-Tułodziecka, Mortgage Credit Foundation
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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 - *Art. 442 – Art.450* - Bankruptcy and Reorganisation Law of 28th of 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 Art. 12 LZ Act, the core operations of mortgage banks include:

1) granting credits secured with mortgages;
2) 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;
3) 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;
4) 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;
5) 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:

1) accepting term deposits;

2) taking credits and loans;

3) issuing bonds;

4) safekeeping securities;

5) 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;
6) keeping bank accounts for servicing investment projects financed through credits granted by a mortgage bank;
7) providing consulting and advice with respect to the property market, including help in establishing the mortgage lending value of the property;
8) 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.

a. 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:

(i) 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;

(ii) in the National Bank of Poland;

(iii) 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% (Art. 23 of LZ Act).

b. 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:

1) 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
2) credits granted to entities listed in point 1); or
3) 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 can not 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 Art. 18 of the LZ Act:

1. 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.
2. The bank's income from interest on its mortgage-secured receivables, referred to in paragraph 1, 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. COVER POOL MONITOR AND BANKING SUPERVISION

According to the art. 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:

1) commitments pertaining to the outstanding mortgage bonds are at all times covered by the mortgage bank in compliance with the provisions of LZ Act;

2) 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;

3) 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.

4) the manner in which the mortgage bank keeps the mortgage cover register is in compliance with this Act;

5) 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.

VII. HOW ARE SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS REGULATED?

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 (Art. 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 estat*e.

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 art. 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.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

In order to apply a preferential risk-weighting for covered bonds, the instrument need to meet the criteria of UCITS Directive and CRD.

Polish covered bond (*list zastawny*) already fulfils 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 76/2010. 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 July 2011, the haircut level for repo amounts to: 4,5 (up to 7D repo); 15,0 (3M repo); 20,0 (6M repo); 25,0 (pawn credit) - average maturity of covered bonds - 5 years.

In Poland, the investment regulations pertaining to the limits for covered bonds are as follows:

> Banks – no limits

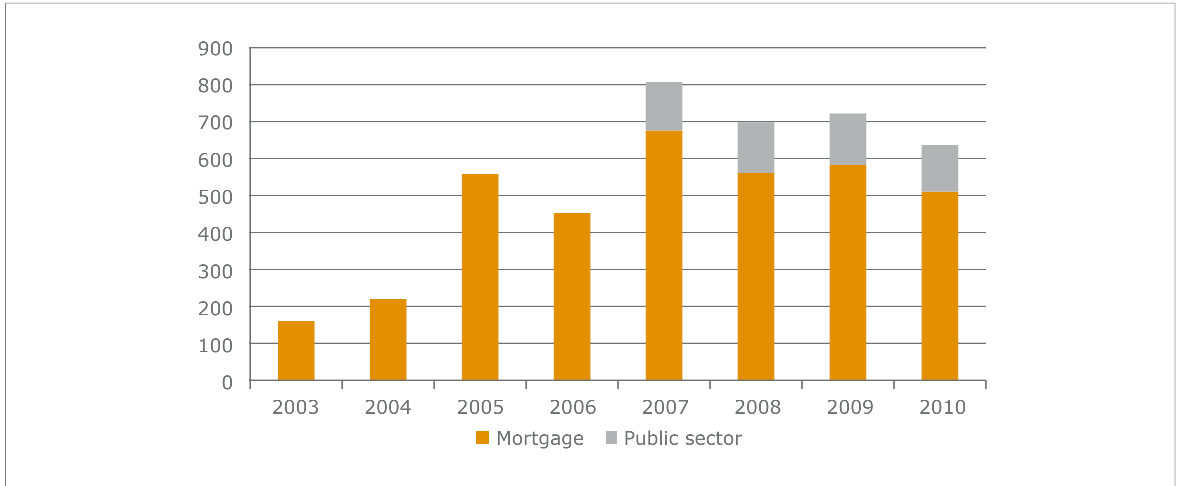
> Insurance companies – up to 40% of technical-insurance reserves – insurance companies (10% in covered bonds which were not allowed to public trading)

> 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.

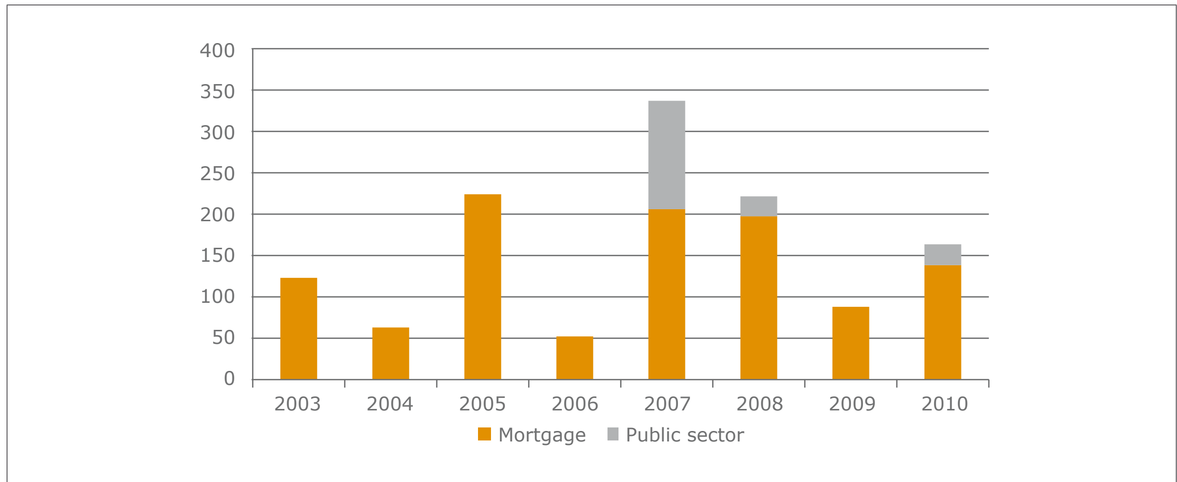
Only the specialised mortgage banks are entitled to the issue of the "list zastawny" (the Polish covered bond). The current "list zastawny" issuers are: BRE Bank Hipoteczny S.A., BPH Bank Hipoteczny S.A. and ING Bank Hipoteczny S.A.

> Figure 1: Covered Bonds Outstanding, 2003-2010, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2010, EUR m



Source: EMF/ECBC

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 7 500 000 euros. 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 si. 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.

Derivatives 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;

> 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 EUR 1 m 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 31st of 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. 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

4 Regulatory Instrument n.º 13/2006

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.

VII. 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 Bondholders, and consequently there is no automatic acceleration of the mortgage bonds.

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.

VIII. 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.

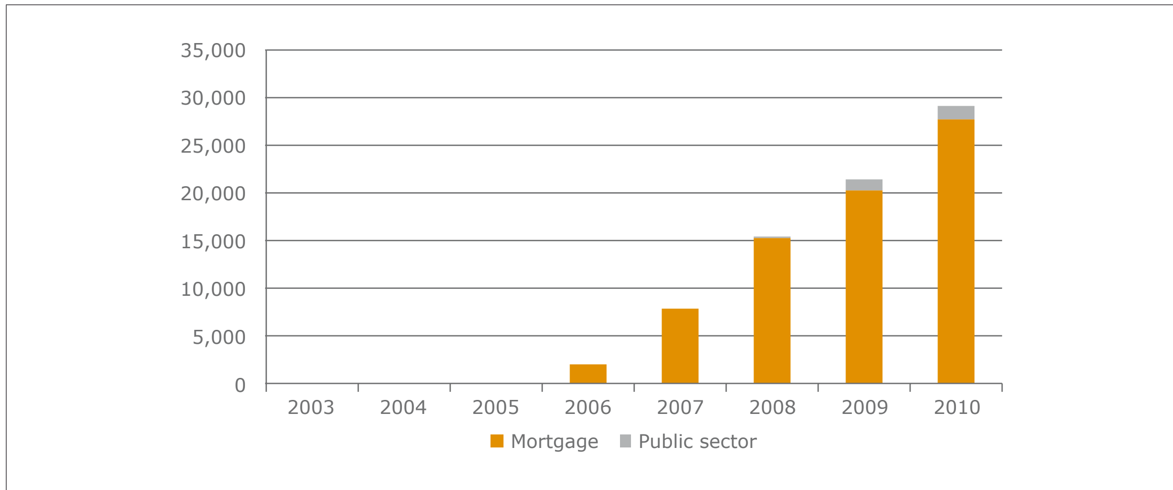
Portuguese Covered Bonds also meet the requirements of the Annex 6 of CRD of June 2006.

5 Notice n.º8/2006

6 Designated Credit Institution

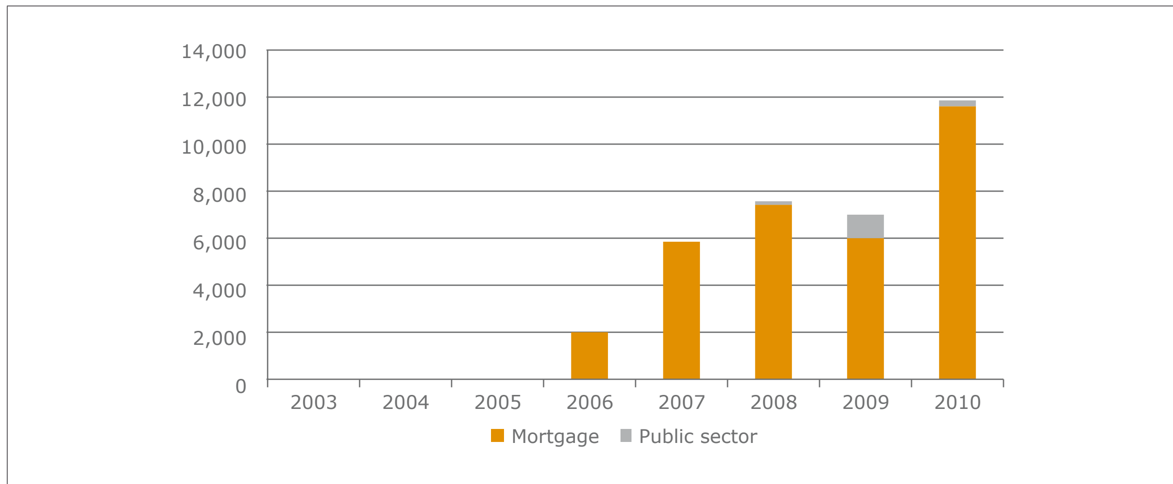
7 Notice n.º7/2006

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2010, 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.

DEVELOPMENTS IN THE PORTUGUESE COVERED BOND MARKET

In the 1st quarter of 2010, Banco BPI, CGD and Banco Santander Totta tapped the Jumbo market with public issues still boosted by the Covered Bond Purchase Programme launched by the ECB in May 2009. In January, Banco BPI launched a 5 years Jumbo mortgage covered bond issue and Caixa Geral de Depósitos offered its 3rd mortgage bonds under its Programme with a maturity of 10 years and in March Banco Santander Totta also launched a 3 years mortgage issue.

However, in May 2010, S&P downgraded the rating of the Portuguese Republic by two notches, while still placing the rating on a negative outlook, thus setting-off a trend of uncertainty that would last for the remainder of the year and into the early part of 2011. The other rating agencies soon followed suit and various other downgrades took place throughout the year as the economic situation in Greece and Ireland deteriorated and Portugal started to be seen as the next potential country in need of an EU/IMF bailout.

Rating downgrades of the banking sector soon followed these moves on the sovereign rating. However, given the inherent quality of the Portuguese covered bond law – clearly segregating covered bond collateral from the assets of the issuer, application of risk management techniques and the role of supervision – and of the collateral eligible for the pool, there had always been a decoupling between the rating of the issuer and of the funding tool resulting in covered bond issues being more highly rated than the issuer and even the sovereign.

Nonetheless, given the economic uncertainty, rating agencies began to revaluate the rating criteria placing greater emphasis on availability of liquidity and refinancing costs leading to a greater need for overcollateralisation and, in some cases, even as that was criteria was met, rating downgrades.

As the year progressed, the combination of rising suspicion about Portuguese public finances resulting in sovereign downgrades and the review of the covered bond rating methodology led to a shutdown of the Portuguese covered bond market, and Portuguese Covered Bonds continued to underperform thereafter.

Notwithstanding the spill over effects from the sovereign bond market, at the beginning of 2011 Portuguese Obrigações Hipotecárias were trading tighter than Portuguese Government Bonds. The reason for this is that the Portuguese housing market has maintained its stability with housing prices actually showing moderate increases. Additionally, overcollateralization has been standing at around 120% well above the regulatory level of 105%. This factor coupled with LTV ratios below 60% for the collateral pool of the biggest issuers, grant investors a considerable level of security reinforcing the safety characteristics of this asset class.

By May 2011, Obrigações Hipotecárias and Obrigações sobre o Sector Público combined achieved an outstanding of EUR 15.65 bn of Jumbo issues with a residual weighted average tenor of 3.87 years.

3.23 ROMANIA

By Martin Schweitzer, Erste Group
and Adrian Sacalschi, FHB Bank

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 issues which will be amended.

II. STRUCTURE OF THE ISSUER

The issuer can be only 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 an issuer and no other special covered bond license is required.

Mortgage banks are credit institutions, but their licensing is limited since these types 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 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 projected new 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:

a. the pool is homogenous comprising of only one type of mortgage loan according to its investment destination;

b. 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 at the date of issue;

c. 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;

d. 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;

e. each mortgage loan in the cover pool meets the general eligibility criteria provided by this law and the performing criteria established through the prospectus;

f. 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;

g. the amount representing the principal granted through a mortgage loan agreement has been fully disbursed to the beneficiary;

h. 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;

i. the receivables deriving from the mortgage loans are not subject to a security interest in favor of any other person;

j. the mortgage loan must not register delayed payments exceeding 61 days;

k. 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 were 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 projected new Romanian covered bond legal framework it will be possible to have only two cover pools (a mortgage cover pool and a public 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 new Romanian covered bond legal framework will introduce a lending limit of 60%, so that mortgages may be used as cover only up to the first 60% of the value of the property*

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 new Romanian covered bond legal framework will introduce details about the calculation of a stress-tested NPV, the liquidity needed and hedging with derivatives.

VI. 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 new Romanian covered bond legal framework.

VII. HOW ARE SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS REGULATED?

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 allows that.

The new 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 a 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.

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.

VIII. 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). Therefore they should enjoy a 10% risk weighting.

3.24 RUSSIA

By Tim Lassen[1], EUROHYPO AG, Representative Office, Moscow

I. FRAMEWORK

In Russia, the legal basis for covered bonds is the Law on Mortgage Securities.[2] This law is supported by rules in the Mortgage law, the Bankruptcy law, the Credit organisations bankruptcy law and Securities market law.

In addition the Central Bank of the Russian Federation (CBRF) issued the Mortgage cover mandatory requirements instruction[3]. The Federal Financial Markets Service (FSFR) released

> the Mortgage cover determination order,[4]

> a joint order containing (i) the Special depositor decree and (ii) the Register maintenance rules[5] and

> the Mortgage administrator/cover special depositor data reporting decree[6].

Further rules are in general regulations of the CBRF and the FSFR.

II. STRUCTURE OF THE ISSUER

The Russian Law on Mortgage Securities foresees three types of securities:

> Two types of "mortgage obligations"[7] (art. 7 sec 1[8]): Obligations[9] issued

(i) by a credit organisation (covered bonds) or

(ii) 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.[10]

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.[11]

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1 Special thanks goes to colleagues from Bank VTB Capital and DeltaCredit for proofreading and commenting on this article.

2 In this Fact Book edition the correct translation for the title of the law is used (in Russian: Federal'nyy zakon "Ob ipotechnykh tsennykh bumagakh"). Instead of "Covered bond law", as in the former editions. A list of the legal framework is attached to the country report in ECBC Fact Book 2010, p 274 – 276.

3 Instruction of the CBRF dated 31 March 2004 No 112-I "On mandatory requirements for credit organisations, issuing securities with mortgage cover". Last amendment: Direction dated 21 January 2011 No 2569-U, published Herald (Vestnik) of the CBRF No 12 (1255) dated 22 February 2011).

4 Order dated 1 November 2005 No 05-59/pz-n "On confirmation of the Decree on the method of determination of the mortgage cover". Last amendment by Order dated 21 January 2011 No 11-1/pz-n (pt 4) published Bulletin (Byulleten') of Normativ Acts of Federal Executive Authorities 2011, No 17, registration no (Ministry of Justice) 20290.

5 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".

6 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"

7 Language of the law: "Obligations with mortgage cover".

8 Law citations without link are citations of the Law on Mortgage Securities.

9 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).

10 For details see: Gabov, Andrey V.: Tsennye bumagi (Securities), Moscow 2011, p 518 – 525.

11 Knowing, that in fact MBS are no covered bonds!

As a general rule mortgage obligations are secured by basically static cover pools (other as dynamic cover pools in most other European countries[12]). 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 MSB structers, a dynamic element is implemented: For already issued covered bonds, permanently new mortgage secured claims have to be added, to secure the volume of the cover pool (art 13 sec 1 para 2).

1. Credit institution (art 7 sec 2)

A credit organisation has to comply with the Banking law and the rules, set up by the Central Bank for covered bond issuing 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[13] the CBRF has set up special regulations for:

> Minimal ratio between the cover pool and the equity of the credit organisation: 10% (pt 2.3 Mortgage cover mandatory requirements instruction),

> Minimal ratio between the volume of the cover pool and the volume of the issued covered bonds: 100 % (pt 2.4 Mortgage cover mandatory requirements instruction),

> Maximum ratio of all claims against the credit organisation, privileged before the covered bond holders[14] and the equity: 50% (pt 2.5 Mortgage cover mandatory requirements instruction).

The Central Bank has not used its right to set a limit special limit for covered bond issuers of the interest rate and foreign exchange risk.[15]

2. 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 covered bonds (art 8 sec 1 para 1). This has to be foreseen in its charter, theses parts of the charter can not 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 covered bond issues, this agent is founded for. After this issuance(es) 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

12 European Central Bank: Covered Bonds in the EU Financial System, December 2008, p. 7.

13 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.

14 Due to art 50.36 sec 3 and 4 Credit organizations bankruptcy law physical persons as holders of deposits have to be served before creditors secured by a pledge. Despite the regulations, that the cover pool is separated from the bankruptcy estate, the ranking between physical deposit holders and mortgage securities' holders is not clear.

15 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.

19 The former rule of a general liquditiy of 20% for mortgage securities' issuers (former pt. 2.2 Mortgage cover mandatory requirements instruction) was abolished by CBRF-Direction dated 18 February 2005 No 1550-u.

20 Even not by general rules, although it is foreseen in art 62 Central bank law. 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.

organ organisation). If the commercial organisation, acting as executive organ, exercises transactions in contrary to 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).

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 ("ipotechnye pokrytie"), mortgage agent ("ipotechnyj agent") and "mortgage specialized organisation" ("ipotechnaya spezializirovannaya organisatsiya")[16] may be used only for the purposes of the Law on Mortgage Securities.[17]

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)[18] 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 can not be part of the cover pool, where it represents a share in the mortgage secured claims. (Art 3 sec 5).

16 "Mortgage specialized organization" is another allowed name for "mortgage agent" (art 8 sec 1 para 5).

17 The word "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).

18 A mortgage certificate is only eligible, if it is not pledged of another purpose (art 3 sec 3 para 1).

Publishing of information

The Law on Mortgage Securities stipulates a wide range of publishing information on the covered bonds 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 covered bonds have special reporting duties to the Central bank (art 7 sec 1 para 3; pt 3.1 – 3.5 Mortgage cover mandatory requirements instruction).[19]

Main points for publishing information are:

If the covered bonds are rated by a rating agency, this rating has to be published (art 37 para 2).

Interested persons have the right to get knowledge of the cover register (art 39 para 1). The issuer is obliged to allow all interested persons to get knowledge of the information, contained in the cover register.[20] 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 his 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 covered bond issuers in the general acts on disclosure of information.[21] Issuers of mortgage securities have – in addition to the general requirements – to disclose (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 (pt 10.1.1 Order FSFR No 06-117/pz-n/2006).

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.[22]

Mortgage securities qualify as secured bonds.[23] The pledge over the cover pool has to be named as security for the bonds.[24]

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[25], also information on the structure of the mortgage secured claims[26]. Similar information have to be shown in the quarterly data report.[27]

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19 Instruction of the CBRF dated 31 March 2004 No 112-I "On mandatory requirements for credit organisations, issuing securities with mortgage cover".

20 For credit organisations as issuers explicitly stipulated in pt 14.5 Instruction CBRF 128-I/2006.

21 FSFR: Order No 06-117/pz-n/2006 and Order No 07-4/pz-n/2007.
Central Bank: Instruction No 128-I/2006.

22 Annex 5 pt 5.2 sec 4 Instruction CBRF 128-I/2006.

23 In Russian: "Obligaciya s obespecheniem". Pt 6.4 Instruction 128-I/2006.

24 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.

25 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.

26 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.

27 Annex 10 pt 8.5; 8.5.1 Order FSFR No 06-117/pz-n/2006.

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 the valuation.

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/or 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 month,

> 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,

> No insurance of the mortgage object for more than 6 month.

Only in these cases and in case, that 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 state registration of the issue, the volume of the cover pool has to be not less than the nominal value of the covered bonds (art 13 para 3 sec 1). For proper performance of the obligations under the covered bonds 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).

The decision of the terms of issue of the covered bonds 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).

The Instruction 128-I/2006 of the CBRF foresees that the cover pool has to secure completeness ("polnota") of payment and timely payment (pt 6.4.2 sent 8 Instruction 128-I/2006):

28 Information according to pt 10.1.1 lit a, b and zh has also to be published in print media.

29 The form of publishing this information is fixed in annex 10 Order No 06-117/pz-n/2006 (pt 10.2.2).

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).

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

> amount of mortgage secured claims which have to be performed until this payment date,

> together with the cash money and the value of the state securities in the cover pool,

cover 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 covered bonds (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 bases 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).

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 have 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 covered bonds (art 13 sec 1 para 2).

Money received from the repayment of the mortgage secured claims 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 (art 13 sec 4).

The mortgage securities' holders have the right to claim for prepayment of the covered bonds in the following cases (art 16): Breach of the rules regarding

> volume of the cover pool,

> replacement of cover assets,

> proper fulfilment of obligations under the covered bonds,

> the issuer is active in fields not allowed for it,

> other reasons stipulated by the decision on issuing covered bonds.

VI. COVER POOL MONITOR, COVER REGISTER AND BANKING SUPERVISION

Cover Pool Monitor

The cover pool is controlled by a cover monitor (the "specialized depositar of the mortgage cover"[30]), art 33 sec 1. The cover monitor has to be a commercial organisation[31], licenced for depositary activities for investment funds, non-state pension funds and 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 – when the issuer is a credit organisation – 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[32], 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, if this disposal is in contradiction to the Law on Mortgage Securities or other legal acts (art 34 sec 1 para 3).[33]

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),[34]
- submission of data information to the FSFR,[35]
- information of the covered bond holders of their right to claim for prepayment of the covered bonds according to art 16 (pt 4.7 Special depositar decree).

30 In Russian "spetsializirovannyj depozitariy ipotechnogo pokrytiya".
31 Not affiliated with the issuer (art 33 sec 3 para 2).
32 In Russian "reglament spetsializirovannogo depozitarya".
33 In case of non-fulfillment of these tasks the cover monitor has a shared responsibility with the issuer in front of the covered bond holders (art 34 sec 2).
34 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.
35 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).

For safekeeping e. g. mortgage certificates, evidencing a mortgage secured claim, have to be kept by the depositar (art 16 sec 2 subsec 6 Law on Mortgage Securities; pt 3.4 sec 2 Special depositar decree).

For including assets in 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 covered bond holder on his own account (art 36).

Cover register

Cover assets have to be registered in a "register of mortgage cover"[36] (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[37] in the cover register (pt 4.1 Register maintenance rules). Basis for the entry is a disposition[38] 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[39] (pt 3.8 Register maintenance rules).[40]

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).

A copy of the register has to be given to the issuer montly (pt 7.2), to state authorities on request (pt 7.3).

Register maintenance ends – based on an dispositon 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).

36 In Russian "reestr ipotechnogo pokrytiya".
37 In Russian "zapis'".
38 In Russian "rasporyazhenie". Documents to be added to the disposition are named in pt 4.9 Register maintenance rules.
39 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.
40 Similar rules are existing for deletion (pt 5.1 – 5-11 Register maintenance rules) and replacement (pt 6.1 – 6.9) of cover assets.

Supervision

State regulation of issuing covered bonds is done by the FSFR in co-ordination with the Central Bank of the Russian Federation (art 42).

Banks, issuing covered bonds, are supervised by the Central Bank (art 7 sec 2), mortgage agents are by the FSFR (art 43 sec 2).

Issuing of covered bonds

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.[41]

For issuing securities, Russian law foresees a four step process:[42] (i) Decision on issue[43], (ii) state registration of issue, (iii) distribution of securities and (iv) state registration of the report on results of the issue.[44] For these general steps the FSFR and the CBRF set up special requirements for the issue of mortgage securities.

The decision on the issue[45], taken by the issuer, has to show, that the issuer is a credit organisation,[46] contain information of the security for the bonds,[47] of composition, structure and volume of the cover pool[48], procedure for exclusion and replacement of cover assets[49], on the special depositar[50], on the bonds[51], insurance of the issue and service agents (if applicable)[52] and procedure of prepayment[53]. The decision has to foresee interest payments to the investors, not less than once a year[54] and can foresee costs to be paid from the cover pool[55]. On the first page of the decision has to be written "Obligations with mortgage cover", it has to be signed by the special depositar.[56] The prospectus has to be singed 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).

41 Restictions 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 covered bonds.
42 Pt 2.1.1 Order FSFR No 07-4/pz-n/2007.
43 The decision sustains of two parts: Taking the decision and approval of the decision.
44 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".
45 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.
46 Pt annex 4 Pt 10.6.1 sec 5 Instruction CBRF 128-I/2006.
47 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).
48 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).
49 Pt 6.7.2.4 Order FSFR No 07-4/pz-n/2007. The replacment 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.
50 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.
51 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.
52 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.
53 6.7.2.8 Order FSFR No 07-4/pz-n/2007.
54 6.7.2.9 Order FSFR No 07-4/pz-n/2007; annex 4 pt 13.2.5 Instruction CBRF 128-I/2006.
55 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.
56 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.

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[57] (on the date of presentation) have to be presented.[58] 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.[59]

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.[60] 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.[61]

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.[62]

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[63], 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.[64] Credit organisation 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.[65]

The state registration has to be refused, if based on changes in the cover register the cover assets are not securing the due performance of the mortgage securities.[66] 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.[67]

VII. HOW ARE SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS 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).

57 In Russian: "Spravka o sovokupnom razmere (summe) obespechenykh ipotekoy trebovaniy" and "spravka o razmere ipotechnogo pokrytiya".
58 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.
59 Pt 13.3 sent 2 sec 3 and 4 Instruction 128-I/2006.
60 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.
61 Pt 13.10 sent 2 sec 1 and 2 Instruction CBRF 128-I/2006.
62 Pt 6.7.4.1 Order FSFR No 07-4/pz-n/2007.
63 This note has to contain information on the volume of non performed 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.
64 Pt 6.7.5.1 Order FSFR No 07-4/pz-n/2007.
65 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.
66 Pt 6.7.5.2 Order FSFR No 07-4/pz-n/2007.
67 Pt 16.18 sent 2 sec 11 Instruction CBRF 128-I/2006.

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 this claims and to make payments to the covered bond 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 Covered Bonds

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 fulfill all conditions of the decision on issuing the covered bonds. 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 covered bond 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 Covered Bond holders

Covered bond 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 covered bond holders may ask for satisfaction from the general bankruptcy estate of the issuer (art 16.1 sec 1 para 3).

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 covered bond 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 Law on Bankruptcy

law (art 16.2 sec 2). If the covered bonds 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 covered bond 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 covered bond 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[68] and the FSFR[69].

If the issuer does not or not properly fulfil his obligations in front of the holders of the covered bonds, the holders have the right for enforcement into the cover pool based on a court decision.[70] As the cover pool is pledged to the covered bond 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.[71]

Realisation of the mortgage cover in a public auction can not take place earlier than two month after the date, on which the liability under the mortgage securities has become due.[72] The covered bond holders can apply to the issuer to receipt the proceeds from the realisation of the cover.[73] The proceeds from realisation of the cover are paid to covered bond holders, who have applied before the public auction for the cover takes place.[74] Applications can be made after this moment, but not later as stipulated in the decision on the issue of the bonds.[75]

If the proceeds from the realisation – after deduction of costs related to foreclosure and realisation - exceed the amount of the covered bond claims, the difference has to be paid back to the issuer.[76] The amount of proceeds, not exceeding the amount of covered bond claims and remaining after satisfaction of covered bond holders, having applied, has to be paid in a notariel deposit. Covered bond holders, which have not applied in written form earlier, can get satisfaction from this deposit.[77] If the amount of

68 Pt 6.4.3; annex 4 B pt 10.6.2.3 no 8 and 9 Instruction CBRF 128-I/2006.

69 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.

70 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.

71 Art 15 sec 1 para 2 Law on Mortgage Securities.

72 Art 15 sec 2 para 1 Law on Mortgage Securities. This has to be shown in the decision on the issue: Pt 6.4.3 para 2 and 3, annex 4 B pt 10.6.2.3. no 8 para 2 Instruction CBRF 128-I/2006, pt 6.7.2.1 lit m para 2 and annex 4 (7) B pt 12.2.1 lit k para 2 Order FSFR No 07-04/pz-n/2007.

73 Art 15 sec 2 para 2 Law on Mortgage Securities. This has to be shown in the decision on the issue: Annex 4 B pt 10.6.2.3. no 8 para 3 Instruction CBRF 128-I/2006, pt 6.7.2.1 lit m para 3 1st half and annex 4 (7) B pt 12.2.1 lit k para 3 Order FSFR No 07-04/pz-n/2007.

74 Art 15 sec 2 para 3 Law on Mortgage Securities. This has to be shown in the decision on the issue: Annex 4 B pt 10.6.2.3. no 8 para 4 Instruction CBRF 128-I/2006, pt 6.7.2.1 lit m para 4 and annex 4 (7) B pt 12.2.1 lit k para 4 Order FSFR No 07-04/pz-n/2007. The procedure of transfer the proceeds to the bond holders has to be shown in the decision on the issue. This has to be shown in the decision on the issue: Annex 4 B pt 10.6.2.3. no 8 para 5 Instruction CBRF 128-I/2006, pt 6.7.2.1 lit m para 5 and annex 4 (7) B pt 12.2.1 lit k para 5 Order FSFR No 07-04/pz-n/2007.

75 Pt 6.4.3 para 4 sent 1 Instruction CBRF 128-I/2006.

76 Art 15 sec 2 para 4 sent 1 Law on Mortgage Securities, pt 6.4.3 para 4 sent 2 Instruction CBRF 128-I/2006

77 Art. 15 sec 2 para 4 sent 2 and 3 Law on Mortgage Securities, pt 6.4.3 para 4 sent 4 and 5 Instruction CBRF 128-I/2006. This has to be shown in the decision on the issue: Annex 4 B pt 10.6.2.3. no 8 para 6 Instruction CBRF 128-I/2006, pt 6.7.2.1 lit m para 6 sent 1 and annex 4 (7) B pt 12.2.1 lit k para 6 sent 1 Order FSFR No 07-04/pz-n/2007. The FSFR also stipulated, that this has to contain details on the notarius: Pt 6.7.2.1 lit m para 7 and annex 4 (7) B pt 12.2.1 lit k para 7 Order FSFR No 07-04/pz-n/2007.

the proceeds is not sufficient, it will be divided proportionally among the bond holders, having applied for satisfaction.[78] As this is not a bankruptcy situation, it should be possible to demand unsatisfied claims under the covered bonds from the issuing credit organisation.

When, in cases foreseen in the law, claims and other assets belonging to the cover pool, have to be transferred into ownership of the covered bond holders[79], the claims and assets are transferred into joint shared ownership[80] of the holders.[81]

In case that one cover pool secures more than one bond issue and among the issues an order of priorities is defined, than the claims of the higher ranking bonds have to be satisfied first.[82]

If the pledge over the cover pool assets contains other conditions, this has to be shown in the decision on the issue.[83]

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

No special treatment for covered bonds is foreseen.

Russian covered bonds, issued by credit organisations, comply with the requirements of art 52 sec 4 UCITS as well as those of the Directive of the business of credit institutions[84], Annex VI, Part 1, Paragraph 68 a) to f).

IX. INVESTMENT REGULATIONS

The EU investment regulations for covered bonds are not transferred into Russian law. Nevertheless different investment rules and privileges for mortgage securities are existing. In any case the investment rules are always include further requirements for mortgage securities to be eligible for investment.[85]

Mortgage obligations are included into the CBRF's Lombard list.[86] For lombard eligibility mortgage obligations have to fulfil one of the following criterias[87]:

> Minimum rating on the international scale by at least one agency of long term creditworthiness of the issuer in foreign currency of BB (Standard & Poor's, Fitch Ratings) or Ba2 (Moody's Investors Service).

78 Pt 6.4.3 para 4 sent 3 Instruction CBRF 128-I/2006.

79 Russian law knows the *lex commissoria* as one kind of realisation of pleged assets.

80 In Russian: Obshchaya dolevaya sobstvennost'.

81 Art. 15 sec 2 para 5 Law on Mortgage Securities, pt 6.4.3 para 5 Instruction CBRF 128-I/2006. the order of the transfer has to be shown in the decision of the issue: Annex 4 B pt 10.6.2.3. no 8 para 7 Instruction CBRF 128-I/2006, pt 6.7.2.1 lit m para 7 and annex 4 (7) B pt 12.2.1 lit k para 7 Order FSFR No 07-04/pz-n/2007.

82 Art. 15 sec 3 Law on Mortgage Securities. This has to be shown in the decision on the issue: pt 6.7.2.1 lit m para 3 2nd half Order FSFR No 07-04/pz-n/2007.

83 Annex 4 B pt 10.6.2.3. no 9 Instruction CBRF 128-I/2006, pt 6.7.2.1 lit n and annex 4 (7) B pt 12.2.1 lit l 1st sent Order FSFR No 07-04/pz-n/2007. This can be e. g. inclusion of money, received from repayment of the cover mortgages, annex 4 (7) B pt 12.2.1 lit l 2nd sent Order FSFR No 07-04/pz-n/2007.

84 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.

85 For details, see ECBC Fact Book 2010, p 269 – 271.

86 Instruction of the CBRF "On the schedule of securities, to be included in the Lombard list of the Bank of Russia" dated 27 November 2008 No 2134-U (published Herald (Vestnik) of the CBRF No 74 (1090) dated 24.12.2008), as amended by Instruction dated 13 January 2009 No 2168-U (Herald No 5 (1096) dated 28 January 2009) and Instruction dated 01.07.2010 No 2455-U (Herald No 34 (1203) dated 23.07.2010). Following: Instruction CBRF No 2134-U/2008.

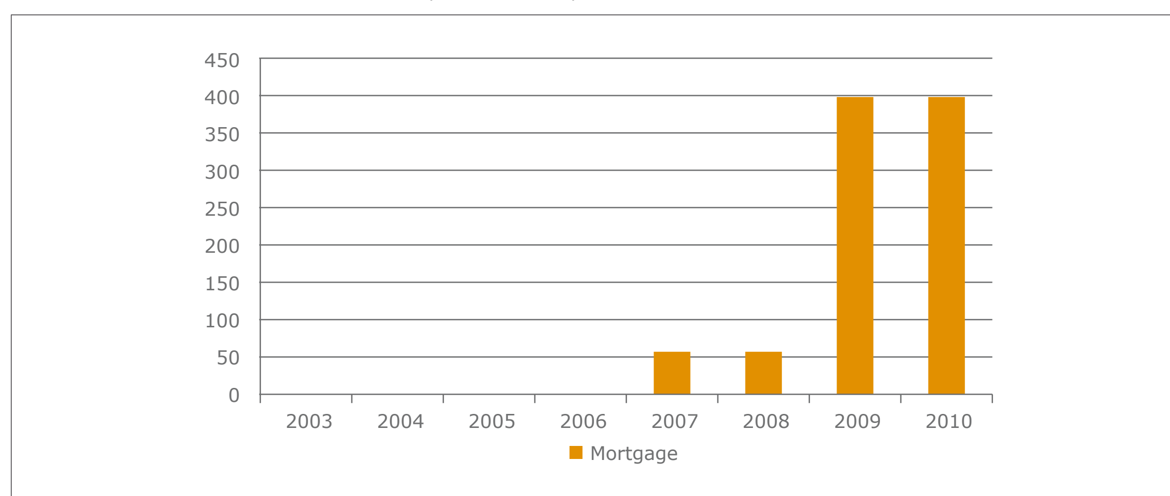
87 Pt. 1.8; 2.2 Instruction CBRF No 2134-U/2008. The same applies for obligations of the federal Agency for restructering housing mortgage loans (www.arhml.ru), pt 1.8 Instruction CBRF No 2134-U/2008.

> The obligations for payments under the mortgage obligations are guaranteed
    - by the Russian Federation, or
    - joint surety of the federal Agency for housing mortgage lending (AIZhK[88]).

Only fulfilling these criterias, the CBRF can take a decision of inclusion of a concrete issue into the Lomard list.[89]

X. COVERED BOND STATISTICS AND ISSUERS

> Figure 1: Covered Bonds Outstanding, 2003-2010, EUR m

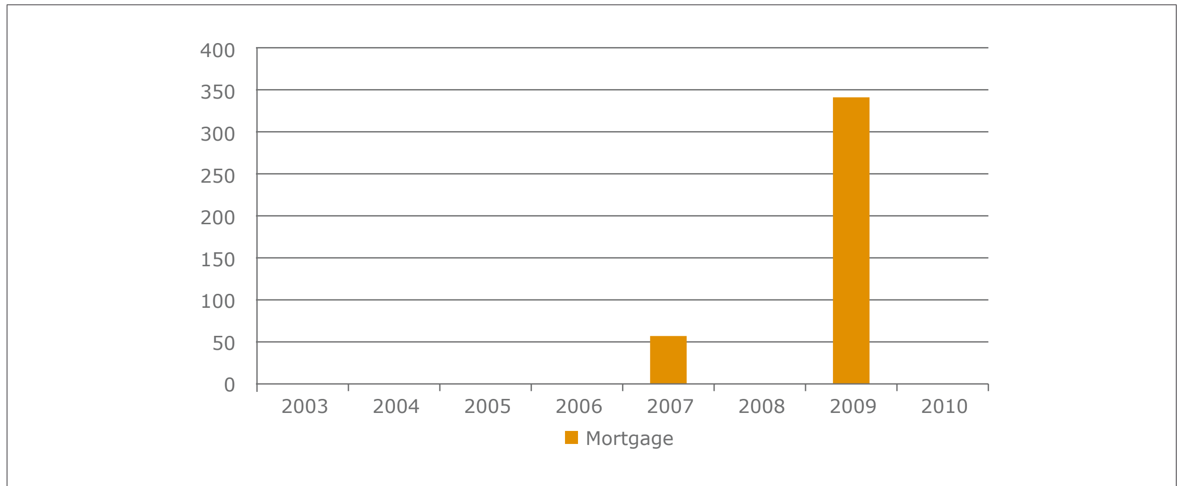


Source: EMF/ECBC

88 www.ahml.ru.

89 All non-federal state securities need a decision of the CBRF to be inclued in the Lomard list, after fulfilling respective criterias, pt 2 Instruction CBRF No 2134-U/2008.

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2010, EUR M



Source: EMF/ECBC

The Commercial Bank "Moscow Mortgage Agency" (OAO) issued the first Russian covered bond already 11 October 2007. Second issue took place on 16 December 2009: Bank VTB 24 (ZAO)[90] issued the first large issue of a covered bond by a credit organisation: A bond on 15 bln RUB.[91]

In March 2011 ZAO Commercial Bank DeltaCredit[92] registered an issue of 5 bln RUB[93], which will be distributed during 2011.

90 www.vtb24.ru
91 On issuing date ~ 499 mln USD / ~ 341 mln EUR.
92 www.deltacredit.ru.
93 On 15 March 2011 ~ 174,43 mln USD / 125,20 mln EUR.

3.25 SLOVAK REPUBLIC

By Viktória Múčková, Mortgage trustee[1], 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 mn) 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 license 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

1 The term mortgage trustee can be used interchangeably with cover pool monitor or mortgage controller.

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.

How are segregation of cover assets and bankruptcy remoteness of covered bonds regulated?

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".

VII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Slovak "Hypotekárny záložný list" fully comply with the requirements of Art. 52 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.

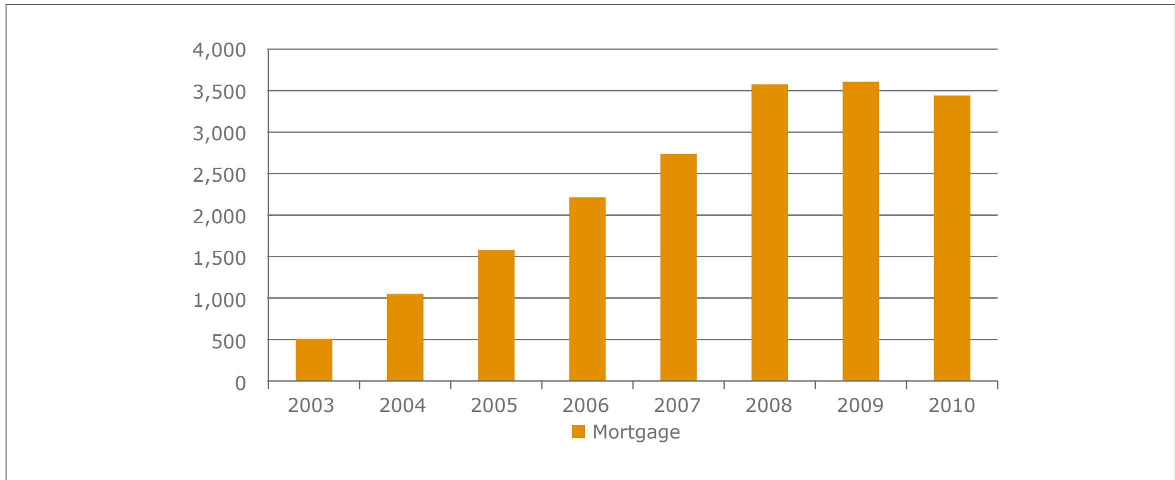
(11) Bonds which are issued in the Slovak Republic and meet the criteria laid down in paragraph (7) shall be deemed to include **mortgage bonds** and **municipal bonds** (municipal debt) issued by a bank which, with the funds raised from their sale, provides a municipal loan to a municipality or higher territorial fund share, and provided that these municipal bonds are guaranteed in accordance with the conditions stipulated by a separate law (Act on Bonds).

In 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.

> Figure 1: Covered Bonds Outstanding, 2003-2010, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2010, EUR m

Source: EMF/ECBC

Issuers: There were eight issuers in Slovakia as of the end of 2010: CSOB, Dexia Banka, Istrobanka, Volksbank, OTP Banka Slovensko, Slovenská sporitelna, Tatra Banka, UniCredit Bank (Slovakia) and Všeobecná úverová Banka.

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 25.7.2006), 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 25.7.2006), 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 25.7.2006) 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 25.7.2006) 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 25th March, on the regulation of the mortgage market (hereinafter, "Law 2/1981"), Law 41/2007, of 7th December, by which Law 2/1981, of 25th 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 24th 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 9th 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 27th 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 his 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 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, there 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:

(i) 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.

(ii) The mortgage that guarantees the loan or credit must be a first-ranked mortgage.

(iii) 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.

(iv) 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 circumstance 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 markets 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 27th 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) per cent 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 III. 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 percent 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:

(a) Cash deposit or deposit of government paper in the Central Bank of Spain.

(b) Acquisition of CHs in the relevant marketplace.

(c) Execution of new mortgage loans or acquisition of mortgage participations, provided that they are eligible to cover CHs.

(d) Redemption of CHs by the pertinent amount until balance has been reinstated, which, if necessary, can be executed through

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. COVER POOL MONITOR AND BANKING SUPERVISION

The institution issuing the cédulas will keep a special accounting register. Please refer to Section III 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 29th 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.

VII. 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 lap 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.

VIII. 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)

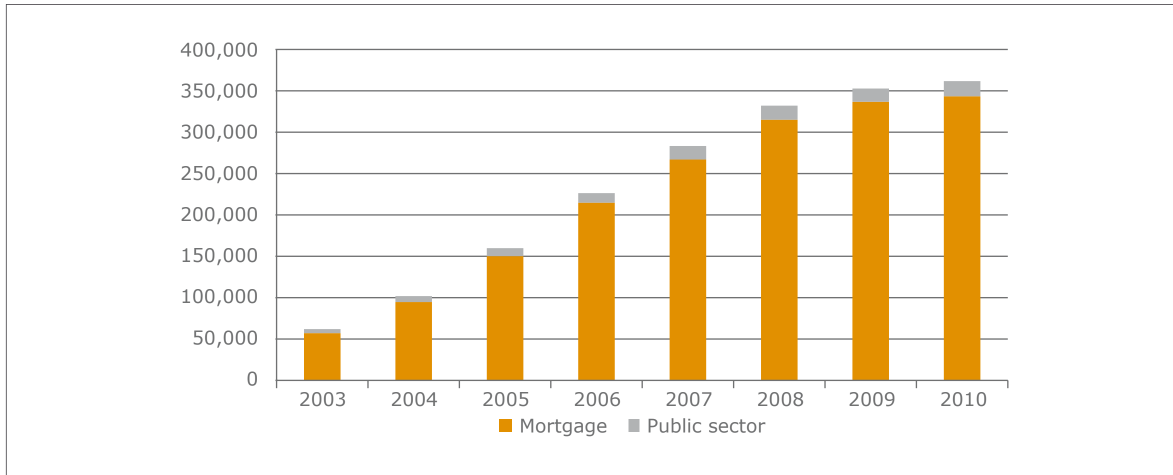
The CHs listed on a recognised secondary market (as AIAF) are eligible for investing the assets of the UCITS up to 25% of its net worth.

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.

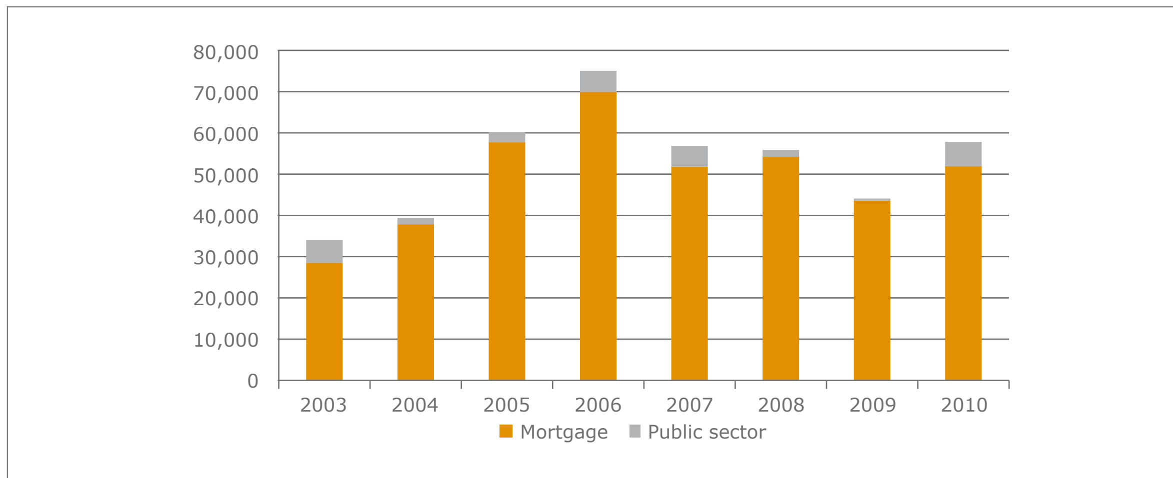
Finally, the CHs upon being listed or applied for listing are eligible for: i) investment by insurance companies of their technical provisions obligations; ii) the investment by mutual guarantee companies; iii) investment by Pensions Funds.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2010, EUR M



Source: EMF/ECBC

Issuers: At the end of 2009, there were 70 issuers in Spain.

3.28 SWEDEN

By Tomas Tetzell, 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 CBL.
- The issuer must conduct the covered bonds business according to the CBL and related regulatory provisions.
- Outstanding mortgage bonds to finance loans that may be included in the cover pool must be converted into covered bonds or administered in an equivalent manner with respect to the creditors.
- The issuer must submit a financial plan for the next three financial years indicating that its financial situation 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 issuer must submit an operational plan that calls for sound management and supervision of the covered bond business (including information on the IT business).

The SFSA may withdraw a licence if:

- The institution is in material breach of its obligations pursuant to the CBL; 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 will be on mortgage Covered Bonds.

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 page 3).

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 independent 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 all times exceeds at 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 overcollateralisation (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. 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).

VII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY PROCEEDINGS

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 Bondholders 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 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.

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.

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.

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.

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, as the latter does not constitute a legal entity. 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 the 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.

VIII. 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 per cent. 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.

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).

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. 52(4) and issued by a credit institution situated in the EEA area (ECB: "Implementation of Monetary Policy in the Euro Area", Feb, 2005).

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.

IX. 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 seven banks and securities firms that act as market makers in treasury bonds and bills on the secondary market. A majority of the market makers in government bonds are also market makers in covered bonds. 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 qoted 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.

X 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").

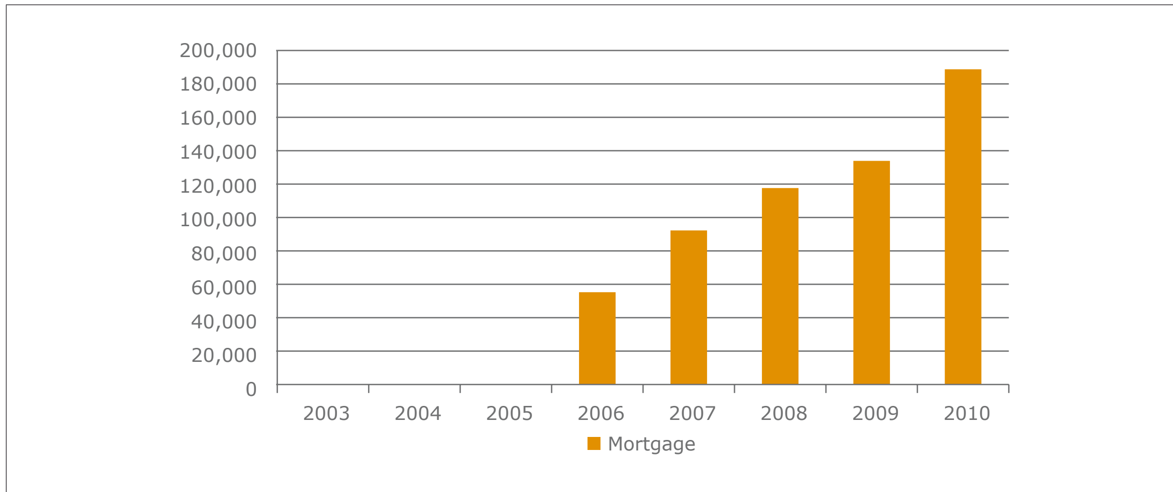
- Cover pool data shall comprise only loans and collateral included in the pool. When a loan is only partially included in the pool, only the eligible part is accounted for.
- In case a loan is secured by both mortgage deeds and a guarantee from the state or municipality, the part of the loan with guarantee 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. Presentations were made by Mattias Persson, Head of the Department for Financial Stability at the Riksbank, Robert Bergqvist, chief economist at SEB, 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.

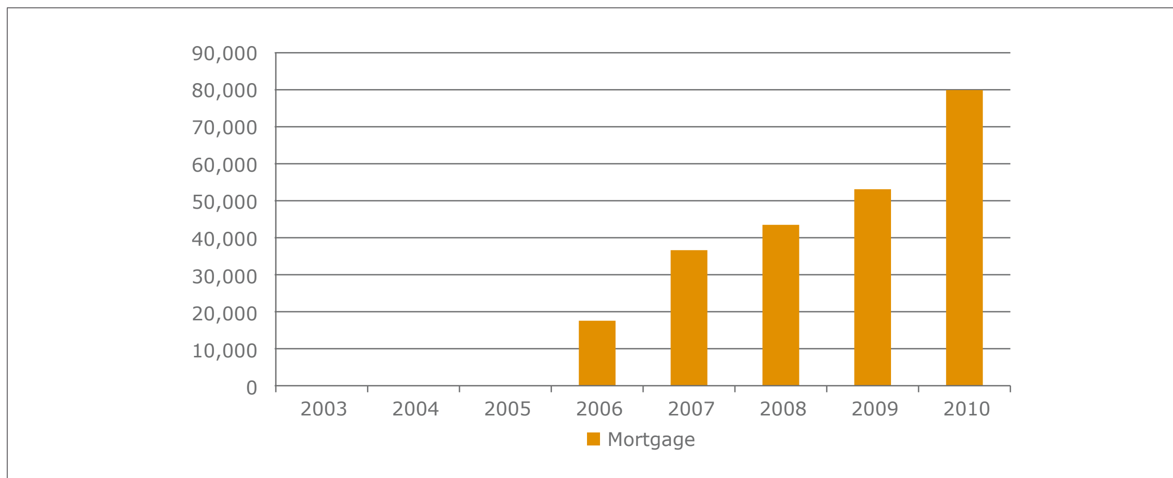
Further information concerning the road show, the LTV-method as well as the Swedish covered bond market is accessible at the website of ASCB (www.ascb.se).

> Figure 1: Covered Bonds Outstanding, 2003-2010, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2010, EUR m



Source: EMF/ECBC

Notes: The first covered bonds were issued in 2006 with the application of the Covered Bonds Issuance Act. Prior to 2006 only mortgage bonds were issued in Sweden and as they are not directly comparable to covered bonds they are not included in the figures. A large part of the mortgage bond stock has been converted into covered bonds. The figures include both the converted bonds and the new bonds issued during the year.

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.

APPENDIX

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,
> to actively support trading of these bonds in the secondary market, and
> to 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 50 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, can not 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.

3.29.1 SWITZERLAND - 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 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 2011 the total outstanding Swiss Pfandbriefe of PBZ amount to CHF 24.0 billion (EUR 18.4 billion).

PBB was founded in 1930 and counts 239 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 2010 the total outstanding Swiss Pfandbriefe of PBB amount to

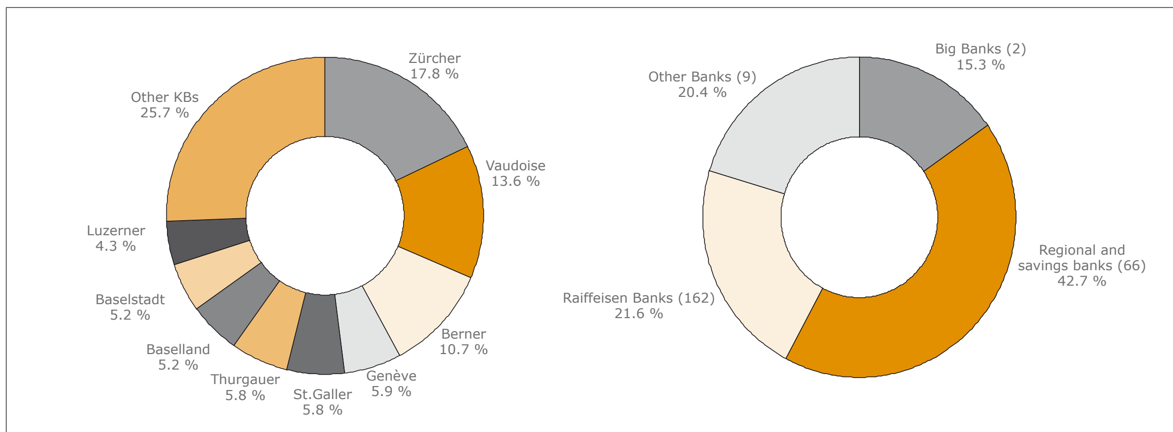
1 Three of PBZ's member banks do not benefit from a cantonal guarantee or have a limited guarantee, namely Banque Cantonale de Genève AG (limited guarantee), Banque Cantonale Vaudoise AG (no guarantee) and Berner Kantonalbank (limited guarantee until end of 2012).

CHF 46.2 billion (EUR 37.0 billion). PBB operates with 7 employees, a cost income ratio of 5.5 % and a profit of CHF 51.2 million (EUR 41.0 million) for the business year 2010.

The chart below shows the structure of the shareholders:

> Chart 1: Shareholders of PBZ

> Chart 2: Shareholders of PBB



Source: PBZ, as of 31.03.2010

Source: PBB, as of 31.12.2010

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 standardised to a great extent. They are a commodity, denominated only in Swiss francs, with a long-term duration of 3 to 22 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 536 million. Whenever possible, existing bonds are reopened. The maximum size should not exceed CHF 1 billion.

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 8 March 2011 PBB issued series 539 with a duration of 9.7 years at Swap Mid minus 8.0 basis points.

All of the about 110 publicly issued Swiss Pfandbriefe are listed on the Swiss Exchange. Swiss Pfandbriefe amount to 22.4 % of all bonds listed on the Stock Exchange. Private placements are not listed.

The total volume of all outstanding Swiss Pfandbriefe as of 31 December 2010 amounts to CHF 69.7 billion (EUR 55.8 billion). For years the two Swiss Pfandbrief institutes have been the major bond issuers in Switzerland, even more important than the government. In 2010 they issued Swiss Pfandbriefe amounting to CHF 13.5 billion (EUR 10.8 billion).

About 20 % of investors in Swiss Pfandbriefe are pension schemes, 25 % institutional investors (such as asset managers), 15 % banks and investment funds, 24 % insurances und the rest are retail investors and others.

III. 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 239 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 will be 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 110'000 individual mortgages all over Switzerland, which provides a good diversification. 95 % are residential and only 5 % 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.

External audit firms audit the annual reports of member banks and Pfandbrief institutes and the compliance of member banks' cover registers with the PfG. The auditors must report their findings to FINMA.

In total about 9 % of all Swiss mortgages are financed through Swiss Pfandbriefe.

IV. 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 %), the cover value of the cover register assets have to exceed the Pfandbrief loans given to member banks 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).

Insolvency scenarios

In the event of the 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 insitute'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.

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).

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 amortise the loans granted by PBB.

V. INVESTORS 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, derivates, foreign mortgages etc.

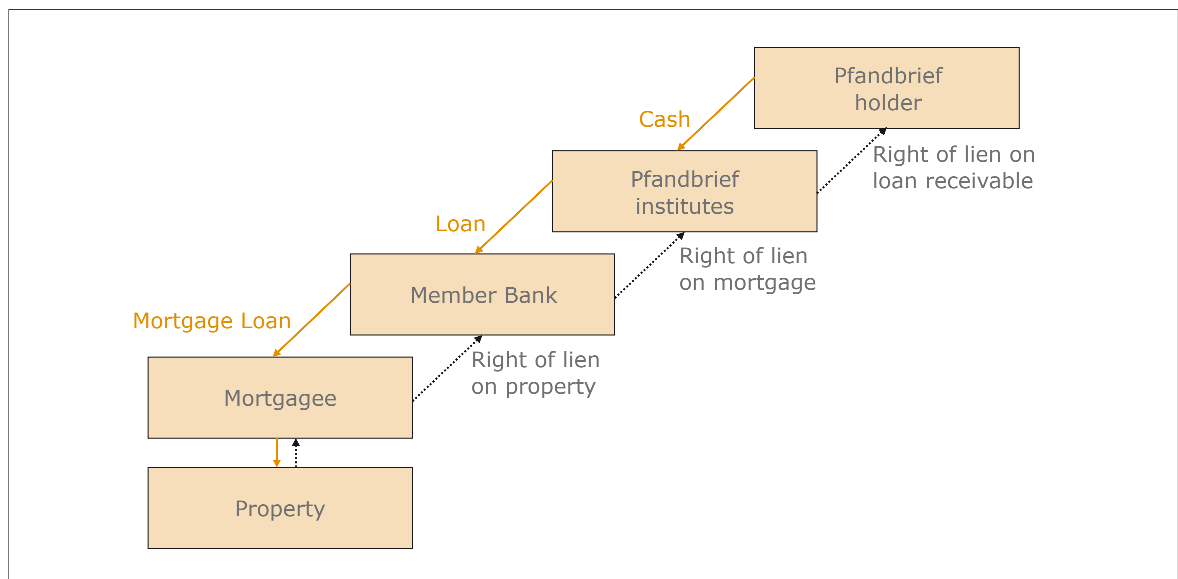
> the fourfold security which is 1) the creditworthiness of the Pfandbrief institute, 2) the creditworthiness of the member bank, 3) the creditworthiness of the proprietor of the property and 4) creditworthiness of the property itself.

> 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.

> CHART 3: THE SWISS PFANDBRIEF MODEL



Source: Credit Suisse AG

VI. FACTS AND FIGURES

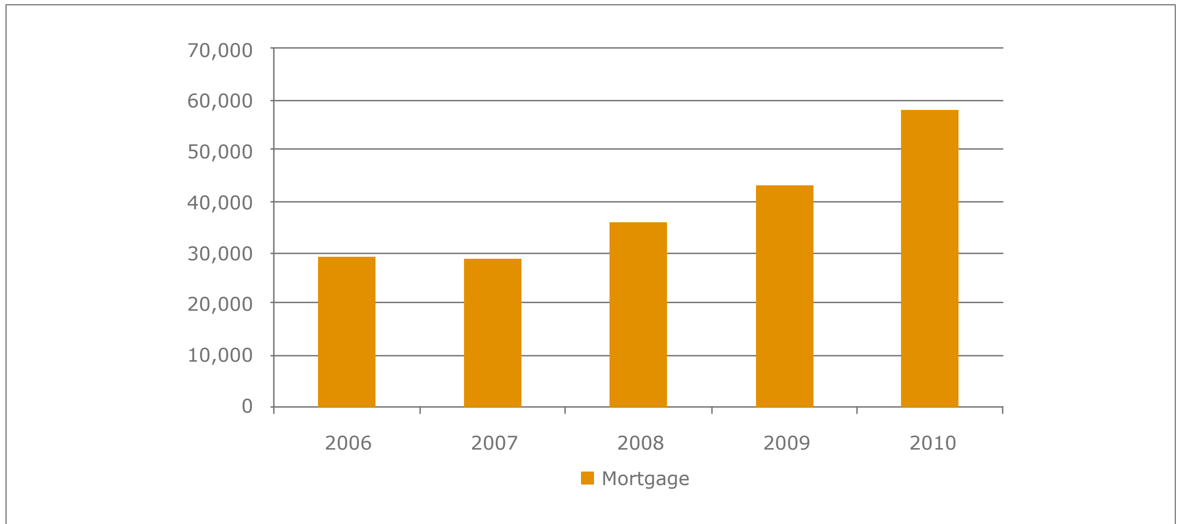
(CHF million)	PBB	PBZ
As of	31.12.2010	31.03.2011
Swiss Pfandbriefe outstanding	46'197	24'028
Average interest rate for outstanding Pfandbriefe (%)	2.355	2.649
Balance sheet total	47'904	25'332
Free Assets	1'158	644
Equity capital (PfV Art. 18)	1'073	790
Moody's rating	AAA (stable)	AAA (stable)

VII. CONTACT ADDRESSES

For PBB:
Pfandbriefbank schweizerischer Hypothekarinstitute AG
Nansenstrasse 16
CH-8050 Zürich (ZH)
+41 44 315 4455
www.pfandbriefbank.ch

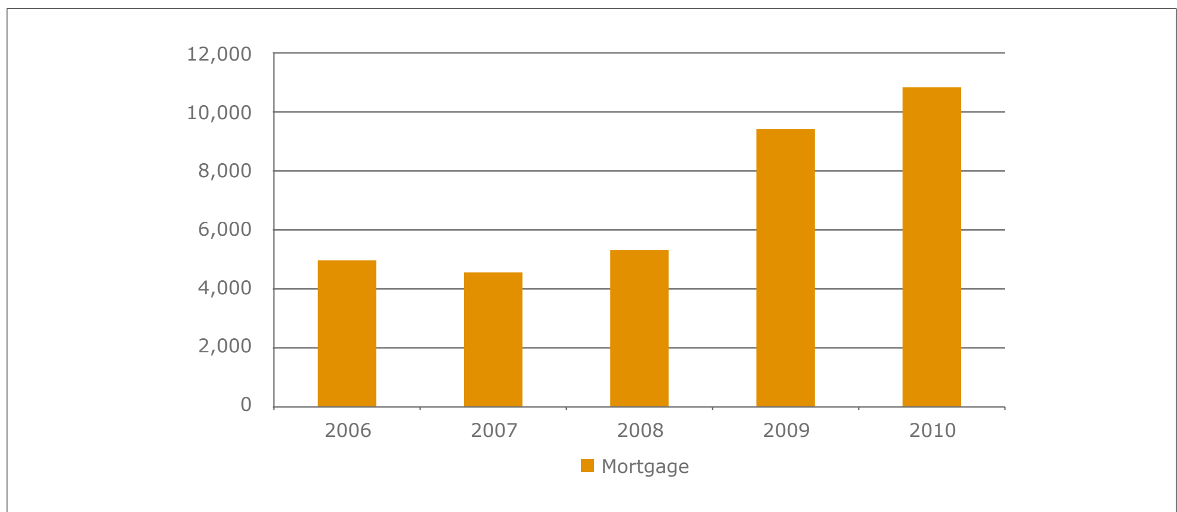
For PBZ:
Pfandbriefzentrale der schweizerischen Kantonalbanken AG
Bahnhofstrasse 9
CH-8001 Zürich
+41 44 292 2778
www.pfandbriefzentrale.ch
www.cldg.ch (French)

> FIGURE 1: SWISS PFANDBRIEFE OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 2: SWISS PFANDBRIEFE ISSUANCE, 2003-2010, EUR M



Source: EMF/ECBC

3.29.2 SWITZERLAND - STRUCTURED COVERED BONDS

By Richard Kemmish, Credit Suisse and Chris Spyridis, UBS

In addition to instruments issued under the Swiss covered bond act, the statutory 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.

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, VALUATION AND LTV CRITERIA

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.

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.

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.

For both programmes LTV is calculated using market values.

For all properties that comply with its standard valuation boundaries (eg 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).

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. 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.

V. COVER POOL MONITOR & 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.

VI. SEGREGATION OF COVER ASSETS & BANKRUPTCY REMOTENESS

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. .

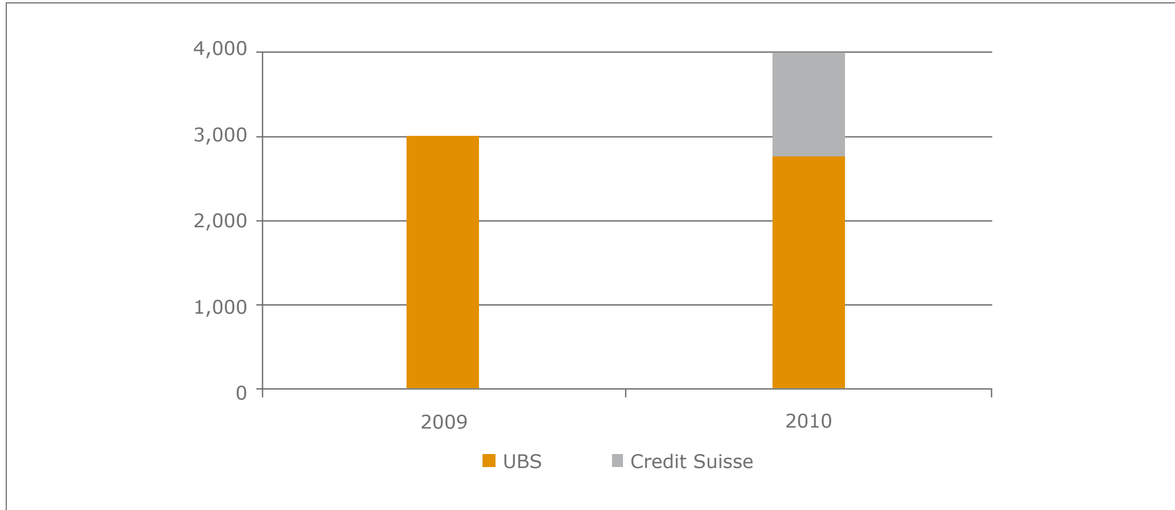
The second event of default is the guarantor event of default. This would arise after an issuer event of default if the guarantor failed to make any payments when due, an amortisation test failed or the guarantor was declared bankrupt. A guarantor event of default would cause the acceleration of payments to covered bondholders and their early redemption at the amount relevant to that particular covered bonds series.

VII. RISK-WEIGHTING AND 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.

VIII. APPENDIX: SWISS STRUCTURED COVERED BONDS STATISTICS

> Swiss general-law based Covered Bond Issuance*, EUR m



* as of end-March 2011

Source: Credit Suisse, UBS

3.30 TURKEY

By Fritz Engelhard, Barclays Capital
and Batuhan Tufan, 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:

a) 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)

b) All interest and principal payments have been secured by a mortgage and all obligations have been met on time.

c) The property must be located in Turkey and must possess a certificate of occupancy.

d) For the entire life of the loan, the real estate has to be fully insured against earthquakes, fire and any kind of natural hazard.

e) 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:

a) 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.

b) 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.

c) 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. 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.

S/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.

VI. HOW ARE SEGREGATION AND BANKRUPTCY REMOTENESS OF COVERED BONDS REGULATED?

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.

VII. 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".

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. Replace-

ment 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.

VII. HOW ARE SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS REGULATED?

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
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UNITED KINGDOM

Covered bonds in the UK have been issued through a combination of structured finance techniques and statutory provisions following the implementation of specific UK covered bond legislation in March 2008 by HM Treasury and the Financial Services Authority. The first UK covered bonds were issued in 2003 prior to the implementation of the dedicated covered bond regulatory framework, with the market growing steadily until Q3 2007. Although structured covered bonds issued by UK entities are recognised as secure products in their own right, in February 2008 HM Treasury and the Financial Services Authority implemented a specific UK covered bond legislation. The Regulated Covered Bonds Regulations 2008 (the "Regulations") overlaid the existing common law and contractual structures, providing the necessary underpinning for UCITS Article 52(4) (formerly UCITS Article 22(4))compliance and thereby providing the benefits of higher prudential investment limits, higher investment thresholds for insurers and lower risk weights under the BCD.

Under the Regulations, the FSA is designated as the special public supervisor for regulated covered bond issuers, with its stated objectives being 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. There are currently 11 regulated covered bond issuers in the UK, 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 some unregulated covered bond programmes; however we confine this summary to the principal features of Regulated Covered Bonds as we expect that the market will be dominated by regulated covered bond issuance going forward.

UK REGULATED COVERED BONDS

I. FRAMEWORK

The UK Regulations came into force on 6 March 2008. 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 VI 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.[1] The Regulations only apply to those covered bonds which have been admitted to the register. As at July 2011 these issuers are: Abbey National Treasury Services plc, Barclays Bank plc, Bank of Scotland plc (residential mortgage programme), Clydesdale Bank plc, 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.

1 The register may be found at http://www.fsa.gov.uk/Pages/Register/rcb_register/index.shtml

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 the EU Capital Requirements Directive (Directive 2006/48/EC, referred to as the CRD).

Certain elements of the Regulated Covered Bond structure are governed by contract: for example, the cover assets are ring-fenced by means of a "true sale" to a special purpose entity and several cover pool collateral sufficiency tests are set out in the programme documents. However, the FSA has a veto over material amendments to the contracts and broad powers to enforce its provisions. In addition, the priority of claims against the cover pool in a winding up scenario is as set out in the Regulations – no counterparty may have any claim against the cover pool in priority to bondholders, regardless of what is set out in the contracts.

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 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 of 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 covered 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 there is a call on the guarantee (see Section VII below), the LLP will use the cash flows from the cover pool (eg, 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 allow those assets which are listed in Annex VI, Part 1, Section 12, Paragraph 68 a) to f) of the CRD to be permitted in the cover pool, subject to the following restrictions:

> deposits and other exposures to credit institutions with ratings below Credit Quality Step 1 (AA-) are not permitted; and

> in order to ensure transparency to the end investor, RMBS and CMBS are only allowed 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.

The Regulations also allow certain assets which are not permitted under the CRD: loans to registered social landlords and loans to public-private partnerships (subject in each case to certain restrictions).

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 to date been registered, the cover pools consist of assets with narrower eligibility criteria than those allowed under the Regulations, and comprise only UK residential mortgages and the substitution assets described below. Mortgage LTV criteria are as described in Section IV below.

Substitution assets can be included in the cover pool. In most programmes their aggregate value can make up to 10% of cover assets, although HSBC has explicitly linked its substitution asset limits to those set out in the CRD and the Regulations (whichever is more strict). In all programmes, substitution assets are limited to short-term investments in sterling, namely bank deposits and debt securities with a minimum rating of 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.

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 desktop valuations) 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 stipulated by the CRD and the Regulations. It is important to note that loans above the LTV limit are 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

The Regulations do not prescribe a minimum level of overcollateralisation (OC). Instead, they require the cover pool to be capable of covering all claims attaching to the bonds at all relevant times. The minimum OC level for any programme is considered by the FSA on a case-by-case basis, taking into ac-

count 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.

Issuers must also carry out a dynamic Asset Coverage Test (ACT) 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.[2] 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 'base', or maximum, asset percentage set out in the programme documents. 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 VII below.

The issuer may also become liable to enforcement action by the FSA. An amortisation test is run on each calculation date after the delivery of a notice to pay (see Section VII below). It 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 VII below. The LLP is required under the programme documents to enter 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, the pre-maturity test, the ACT, maturity extension rules and the amortisation test all ensure cash flow adequacy.

Most UK covered bond transactions 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.[3] It is important to note that the issuer does not have the option to extend the bond's

2 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 governs.

3 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.

maturity; failure by the issuer to repay the bond in full on the originally-scheduled maturity date would result in an issuer event of default.

In some programmes, 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.[4] 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 cash managers, and independent audits of the cash manager's calculations are undertaken on a regular basis.

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 at least the next interest payment on each series of covered bonds (following revisions to Fitch counterparty criteria, it is expected that this requirement will become three months interest on a rolling basis going forward for many programmes). 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. 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 concerning the programme structure, such as the cover pool eligibility criteria, the formulae used to calculate compliance with minimum OC requirements and ratings triggers;
- details concerning asset and liability management, audit and controls;
- arrangements for the replacement of key counterparties;
- cover pool data; and
- legal and audit opinions.

The issuer is responsible for monthly cover pool monitoring; however, the ACT calculation is checked by an independent auditor on an annual basis. The FSA must be notified by the issuer of any breaches of the ACT, may also require the issuer to provide such additional information about the cover pool as it considers fit and also is required to be notified prior to each new issuance. Finally, rating agencies are heavily involved in the programme and need to re-affirm the ratings of the programme as a condition to each issuance.

4 Within the Barclays Bank, Bank of Scotland, HSBC and Nationwide programmes, only covered bonds which are issued as "hard bullet Covered Bonds" are subject to the prematurity test. The programmes also allow for the issue of bonds with a 12 month maturity extension.

VII. HOW ARE SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS REGULATED?

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 covered 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, for so long as an LLP acceleration event has not occurred (as described below), the LLP will only be required 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. In addition to the secured claim against the cover pool, investors continue to have an unsecured claim against the issuer and any group guarantors for the amounts due under the covered bonds.

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. Residential mortgage backed securities, for example, are severely restricted. However, certain assets which are excluded from the CRD – such as loans to UK housing associations – are permitted in the cover pool under

the Regulations. Therefore, some Regulated Covered Bonds may not qualify for preferential risk weightings in the hands of regulated investors. To date, however, all Regulated Covered Bonds are CRD compliant and therefore benefit from the same preferential treatment as covered bonds from other EU jurisdictions.

> FIGURE 1: OVERVIEW – REGULATED UK COVERED BOND PROGRAMMES*

	Abbey National	**Barclays Bank**	**Bank of Scotland**	**Coventry BS**	**HSBC**	**Leeds BS**	**Lloyds TSB Bank**	**Nation-wide BS**	**Royal Bank of Scotland**	**York-shire BS**
Programme volume in EUR bn	25	35	60	7	25	7	15	45	15	7.5
LTV cap	75%	75%	60%	75%	75%	75%	75%	75%	75%	75%
House price index	Halifax	Halifax	Halifax	Nation-wide	Halifax	Halifax	Halifax	Nation-wide	Halifax	Avg. of Halifax & Nation-wide
Maximum asset percentage applied in ACT	91.00%	94.00%	92.50%	90.00%	92.50%	93.5%	93.00%	93.00%	90.00%	93.50%
Minimum OC	109.90%	106.38%	108.10%	111.11%	108.10%	106.95%	107.53%	107.53%	111.11%	106.95%
Current asset percentage applied in ACT	76.7%	77.3%	70.0%	Not disclosed	78.2%	75.6%	79.9%	84.5%	79.1%	78.0%
Current OC	105.0%**	130.5%	113.6%	108.0%**	116.4%	107.5%	144.3%	118.00%	111.50%	143.4%
In arrears accounting (over three months)	Max. 40% if LTV ≤75%, max 25% if LTV >75% or repurchase	Max. 40% if LTV ≤ 75%, max 25% if LTV >75% or repurch.	No recognition	Max. 40% if LTV ≤ 75%, max 25% if LTV >75% or repurchase	Max. 40% if LTV ≤ 75%, max 25% if LTV >75% or repurch.	Max. 40% if LTV ≤ 75%, max 25% if LTV >75% or repurch.	Max. 40% if LTV ≤ 75%, max 25% if LTV >75% or repurch.	Max. 40% if LTV ≤ 75%, max 25% if LTV >75% or repurch.	75% in case in arrears = <3M, 40% in case in arrears >3M	Max. 40% if LTV ≤ 75%, max 25% if LTV >75% or repurch.
"Hard bullet" possible	Yes; pre-maturity test	Yes; pre-maturity test	Yes; pre-maturity test	No	Yes; pre-maturity test	No; 12-month maturity extension	Yes; pre-maturity test	Yes; pre-maturity test	Yes; pre-maturity test	No; 12-month maturity extension
Asset monitor	Deloitte LLP	PWC	KPMG	E&Y	KPMG	Deloitte LLP	PWC	PWC	Deloitte LLP	KPMG

Source: Barclays Capital

* Issuers of Jumbo UK Regulated Covered Bonds
** The minimum OC is calculated excluding other items from the Asset Coverage Tests as these differ between the programmes. These other items, such as adjustments for set-off for savings balances and negative carry, are the reason why the current over-collateralisation in some programmes is

less than the minimum over-collateralisation based on the Asset Percentage. If these items are excluded the current over-collateralisation is higher.

Note: Clydesdale Building Society is also a regulated covered bond issuer but currently they do not have any regulated covered bonds outstanding.

D. RECENT DEVELOPMENTS

(i) Review of the UK's Regulatory Framework for Covered Bonds

In April 2011, HMT and the FSA launched a joint review of the UK regulatory framework for covered bonds[5], with the aims of the review being to ensure that the Regulations continue to support the UK covered bond market, promotion of investor understanding of the UK's regulated covered bond regime, and consultation on a small number of proposed amendments to the existing legislation. The deadline for responses to the consultation was 1 July 2011, with any subsequent amendments not expected to be implemented until the end of 2012.

Going forward, we expect the majority of new issuance to be as regulated covered bonds, as we believe that investors will take more confidence from the additional layers of supervision.

(ii) Bank of England Transparency Initiatives

UK covered bond programmes already benefit from the provision of relatively detailed investor reporting compared to other covered bond jurisdictions. This is in part due to regulated issuers needing to produce detailed reporting to the FSA as special public supervisor, although traditionally the UK market has conformed since inception to a relatively high standard of investor reporting. Notwithstanding this, following its market notice in November 2010[6] the Bank of England has revised its eligibility criteria for the inclusion of covered bonds in its market operations including (amongst others) the provision of loan level data, publication of transaction documentation, transaction summaries and standardised investor reporting. It should be noted that these requirements are not mandatory for issuance however it is expected that some of the UK issuers will move toward the new requirements in due course.

E. DEVELOPMENT OF THE MARKET

The current outstanding volume of publicly and privately placed UK regulated covered bonds (excluding self-retained issuances) amounts to EUR 97.86 billion (equivalent) as of July 2011. The first half of 2011 saw a record issuance of EUR-, USD- and GBP-denominated covered bonds from UK covered bond issuers. As at July 2011, a total of EUR 20.2 bn equivalent of publicly and privately placed covered bonds have been issued, which already surpasses last year's total supply. Furthermore, this sets a record in the first half of the year for issuance in the UK market since its inception in 2003.

This year has also seen increased supply of GBP-denominated covered bonds. Compared to last year, when only a single GBP-denominated covered bond of £0.3bn was issued, this year has seen a total of £6.0bn of GBP-denominated covered bonds issued by UK banks and building societies. Having said that, the UK market is still dominated by EUR-denominated covered bonds which at EUR80.2bn equivalent represent 82% of total outstanding covered bonds.

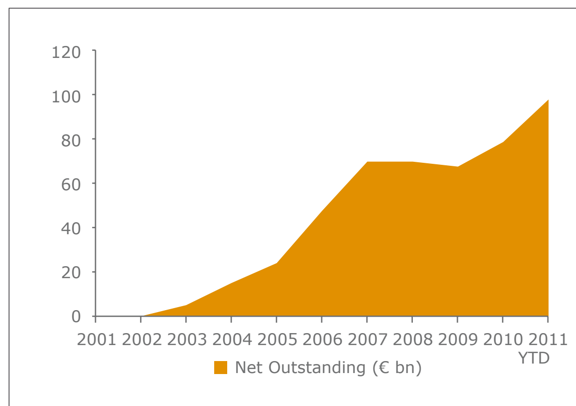
Figure 2 and 3 show the development of total outstanding of UK regulated covered bonds and annual supply of UK covered bonds (publicly and privately placed, excluding self-retained issuances). Figures 4

5 Please see http://www.hm-treasury.gov.uk/consult_covered_bond_review.htm for further details on the UK's Regulatory Framework for covered Bonds.

6 Please see http://www.bankofengland.co.uk/markets/marketnotice101130abs.pdf for further details the Bank of England Transparency Initiatives

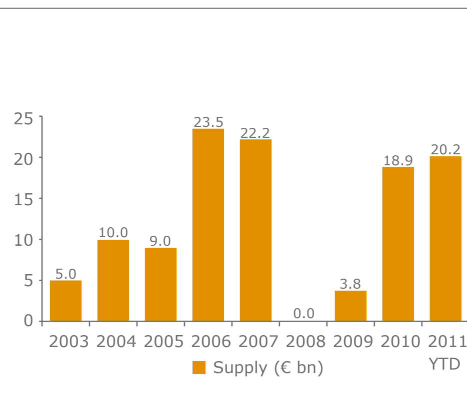
and 5 show the market share (as measured by covered bonds outstanding) per issuer and the currency distribution for outstanding issuances.

> Figure 2: Development of outstanding volume and average size (EUR bn)



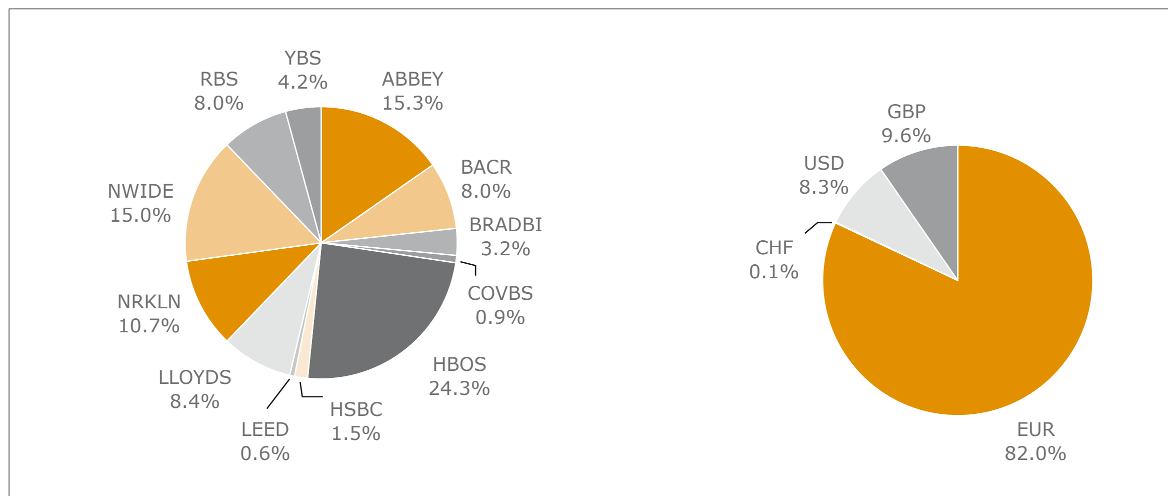
Source: Barclays Capital

> Figure 3: Annual supply (EUR bn)



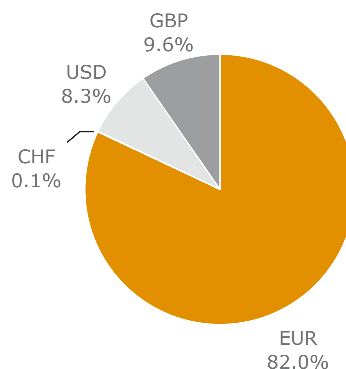
Source: Barclays Capital

> Figure 4: Market share, July 2011



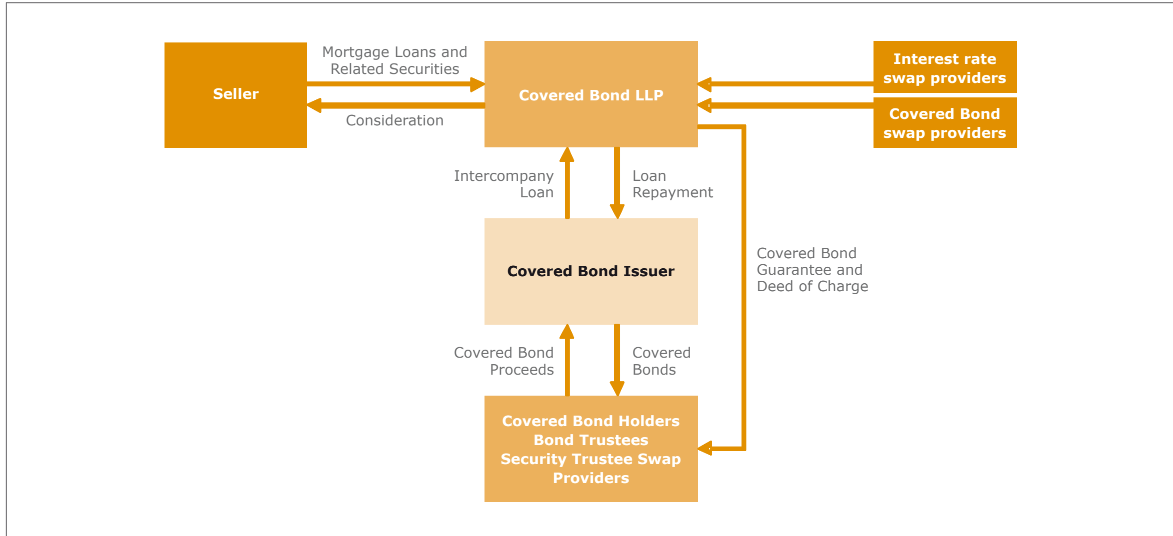
Source: Barclays Capital

> Figure 5: Currency distribution of outstanding issuances (EUR bn)



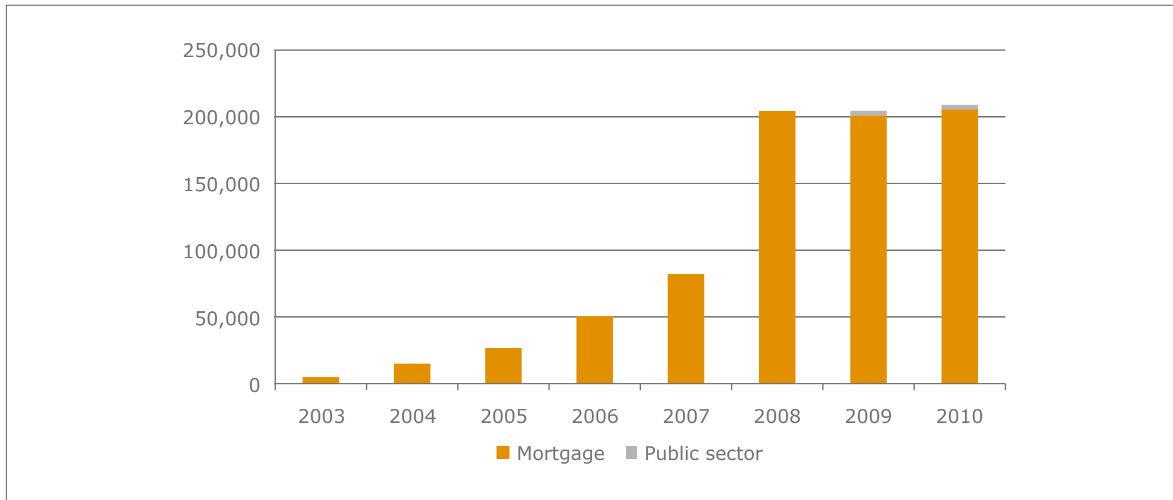
Source: Barclays Capital

> Figure 6: Generic UK covered bond programme structure



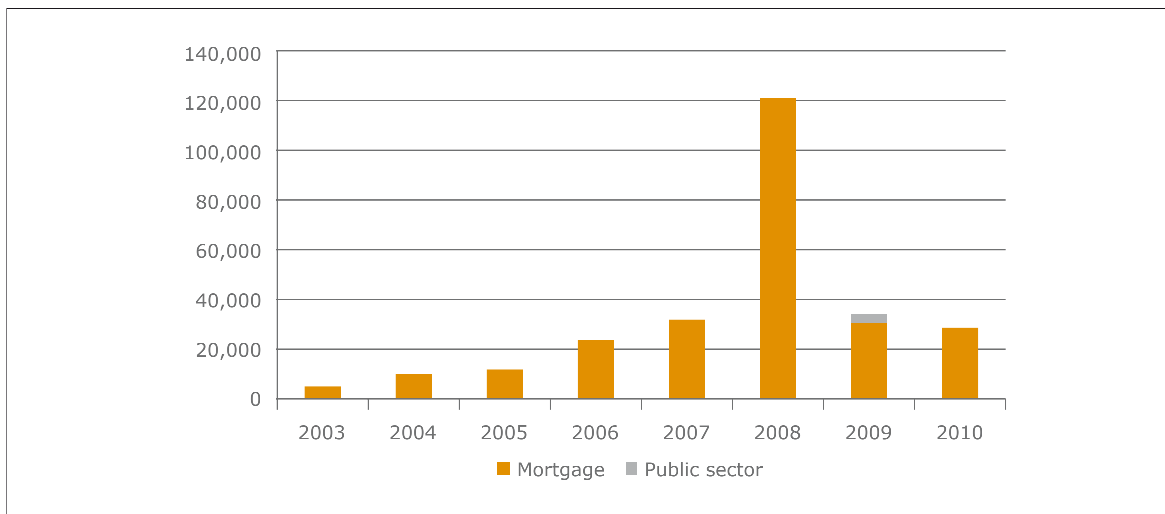
Source: Barclays Capital

> Figure 7: Covered Bonds Outstanding, 2003-2010, EUR m



Source: EMF/ECBC

> Figure 8: Covered Bonds Issuance, 2003-2010, EUR m



Source: EMF/ECBC

Issuers: As of July 2011, currently 22 covered bond issuers in the United Kingdom: Abbey National; Anglo Irish Bank London Corporation; Bank of Ireland (UK); Bank of Scotland Plc (HBOS Treasury Service); Barclays Bank Plc; Bradford & Bingley; Britannia Building Society; Clydesdale Bank plc; Co-operative Bank Plc; Coventry Building Society; HSBC Bank plc; Leeds Building Society; Lloyds TSB Bank plc; Nationwide Building Society; Newcastle Building Society; Northern Rock; Norwich & Peterborough Building Society; Principality Building Society; Royal Bank of Scotland; Skipton Building Society; and Yorkshire Building Society.

An updated list of regulated issuers is available from the FSA:http://www.fsa.gov.uk/Pages/Register/rcb_register/index.shtml

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 market in the US

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. As the crisis unfolded, the growth of the US covered bond market was put on hold. Since June 2007, we have not seen a new 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, subordinated and senior unsecured debt holders were not acquired.

In the absence of covered bond legislation, Bank of America and Washington Mutual Bank developed structures independently. 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 is not only disfavoured by investors, but also 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.

In 2008, the US Treasury and the FDIC worked together and released the Best Practices for Residential Covered Bonds statement (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 the product in the event of lender default and support growth of a standardised US covered bond market. Since their release, it has become apparent that statements alone are insufficient to promote the development of a robust covered bond market populated by domestic and foreign investors.

Necessity is the mother of invention

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 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. The take-off of such market may depend on the resolution of the broader issues associated with the US housing finance market reform, the fate of Freddie Mac and Fannie Mae, and the future role of the Federal

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.

Home Loan Banks. We see covered bonds as a viable alternative to funding assets off-balance sheet. However, on-balance sheet funding instruments cannot replace the multi-trillion securitisation market in the US, in our view. We see covered bonds as a source of complementary liquidity.

There is again an active effort under way to introduce covered bond legislation in the US. We believe that the US authorities' active engagement in the development of a domestic covered bond market significantly increases the likelihood of the introduction of covered bond legislation and the creation of a sustainable covered bond market in the US. In June 2011, the House Committee on Financial Services approved H.R. 940, the United States Covered Bond Act of 2011. This is the first step in the legislative process.

Bills go first to committees that deliberate, investigate and change them before they go to general debate. H.R. 940 is now eligible for a vote by the full House of Representatives. A bill needs to be passed by both the Senate and the House of Representatives and then be signed by the President before it becomes law. Be it enacted, the United States Covered Bond Act would lay the foundation for a special-law-based US covered bond market. The content of the proposed United States Covered Bond Act may be further amended as it makes its way through the legislative process.

Good things finally come to those who wait

The legal framework could consist of three layers. Once primary and secondary legislation is introduced, lenders could start developing individualised programmes tailored to their needs. We view H.R. 940 as a good basis for building a legal framework for US covered bonds. Although there are still lingering issues that require attention and hurdles that need to be taken, H.R. 940 addresses some of the past problems restricting the acceptance and use of the US product.

H.R. 940 seems comprehensive. Nevertheless, market stakeholders, including investors and credit rating agencies, may look for even further improvements – i.e., stricter eligibility criteria, tighter asset-liability matching requirements, higher minimum over-collateralisation levels, more details on the rights and duties of the administrator or servicer of the separate estate and of the asset monitor, and more details on the reporting requirements and other features tailored to a lender's credit risk profile.

Improvements on H.R. 940 may be addressed during the legislative process or in future regulations and should enhance the marketability and investor acceptance of the future US product. We believe that the cultivation of a domestic investor base and the attraction of foreign investors are additional challenges that should be addressed.

Where there is a will, there is a way

We think that the question is not whether, but how, a US covered bond market will take shape. Market stakeholders are approaching 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 the rights of investors, and the lenders' need for viable funding instruments.

There is bi-partisan support for H.R. 940 in the House of Representatives, though there is some tension and disagreement. There was close voting at the mark-up hearing in June 2011 on amendments offered by Barney Frank (D-MA) on behalf of the FDIC dealing with the resolution mechanism and the covered bond regulatory oversight programme.

> Disagreements about the proposed rights, powers and responsibilities of the regulatory authorities, and as to who creates the covered bond regulatory oversight programme. According to the FDIC, the banking agencies should promulgate regulations affecting covered bonds.

> Disagreements about the proposed resolution scheme, in particular the FDIC's rights and powers in a conservatorship, receivership, liquidation or bankruptcy of a lender, and the content and the strictness of the covered bond regulatory oversight programme.

> H.R. 940 is meant to provide an opportunity for smaller-sized US lenders to use covered bonds. There are, however, concerns that the proposed legislation may lead to a further concentration of the banking industry. We argue that the pooling of funding needs is a challenge that needs to be addressed.

The FDIC expressed concerns that the proposed legislation would increase the risk of losses or actual losses to the Deposit Insurance Fund or the receivership of a lender by limiting the FDIC's authorities and ability to maximise recoveries on assets in resolution. According to the FDIC, any covered bond legislation should not restrict its ability to recover losses the Deposit Insurance Fund incurs in resolving a lender and should not grant rights to investors that are superior to any other secured creditor.

Some creditors of US lenders – i.e., the Federal Home Loan Banks and qualified financial contract counterparties – already enjoy rights similar to those investors in covered bonds would be granted under H.R. 940. Covered bonds are a funding alternative for lenders that implies structural subordination of unsecured creditors, including depositors. It is unlikely that the FDIC will endorse covered bonds given its mission to maintain stability and public confidence in the financial system by insuring deposits.

The FDIC expressed its willingness to support a vibrant covered bond market that would increase liquidity to lenders and enable sustainable asset origination. Where there is a will, there is likely to be a way, in our view. For example, to address the FDIC's concerns about asset encumbrance for the benefit of covered bond investors and its ability to recover any potential depositor losses, consideration may be given to lower over-collateralisation and offsetting the negative effect with improved liquidity facilities in the event of lender default.

Not only covered bonds, but also other instruments, including Federal Home Loan Bank advances and qualified financial contracts, result in the encumbrance of assets and imply structural subordination. We think that this issue should be addressed by regulators in a holistic way across the different funding instruments for lenders – potentially as part of the regulators' monitoring process of lenders' controls and risk management processes – rather than by singling out covered bonds for disparate treatment.

H.R. 940 is now eligible for a vote by the full House of Representatives. A next step would be the introduction of a bill into the Senate. Chuck Schumer (D-NY) expressed interest in sponsoring a covered bond bill in the Senate. Bob Corker (R-TN) may be co-sponsor. The prospects for bi-partisan support in the House of Representatives and the Senate are promising, in our view. If the House of Representatives and the Senate pass inconsistent versions of a bill, the differences need to be resolved in a conference committee.

In February 2011, the report, Reforming America's Housing Finance Market, was released to Congress by the Obama administration. This fuelled hopes of developing a US covered bond market because the Obama administration said that it will work with Congress on alternatives to funding mortgages, potentially including the development of a covered bond market. We believe that covered bonds could be part of the US housing finance market reform.

We believe that the prospects for approval of H.R. 940 by the House of Representatives are better than those for moving a covered bond bill quickly through the Senate. As the US housing finance market reform is likely to have a negative impact on the housing market, it is unlikely that comprehensive legislation will be passed before the 2012 elections. Due to the tight congressional calendar, there is uncertainty as to when covered bond legislation will be passed by the Senate and House of Representatives in the 112th Congress. The 112th Congress convened on 3 January 2011 and will end on 3 January 2013.

Primary legislation is a necessary but not sufficient condition for the development of a US covered bond market. Covered bond issuance by US lenders is likely to take even longer because it also depends on the establishment and introduction of secondary legislation. In addition, if tax related provisions are not in the final legislation, there is uncertainty until the Internal Revenue Service takes a position on tax related questions.

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. The proposed United States Covered Bond Act 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 amendment to the Wall Street Reform and Consumer Protection Act of 2009 that was introduced in 2009, but later withdrawn at the request of Barney Frank (D-MA). It 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.

H.R. 940 is meant to establish standards for covered bond programmes and a covered bond regulatory oversight programme, and provide a funding alternative for a broad range of assets. The content of the proposed United States Covered Bond Act may be further amended as it makes its way through the legislative process. H.R. 940 addresses some of the uncertainties restricting the acceptance of US covered bonds, and covers the following points:

> **Issuers**: Eligible issuers would be insured depository institutions, savings and loan holding companies, bank holding companies, non-bank financial 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. Regulators could approve existing programmes. Eligible issuers would be allowed to have more than one covered bond programme.

> **Collateral**: 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[2] and ancillary assets[3]. 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. Loans must not be delinquent for more than 60 consecutive days. Issuers would have to clearly mark collateral in their books and records. Collateral that would not comply with the eligibility criteria could not be taken into account in the Asset Coverage Test (ACT).

2 Substitute assets would be cash, obligations of the US government or a triple-A rated US government corporation or government-sponsored enterprise, and any overnight investments in federal funds.

3 Ancillary assets would be currency swaps, interest rate swaps, credit enhancements, liquidity arrangements associated with, any obligation supporting the payment or performance of, and proceeds of collateral in a cover pool.

> **Supervision**: Covered bond regulators may be the appropriate banking agency[4] or the Secretary. The Secretary and regulators would have to set up a covered bond regulatory oversight programme within 180 days after the enactment of the act. Programmes would require approval by the respective regulator. The Secretary would maintain a publicly available registry of approved programmes and the covered bonds drawn under them. Regulators may direct issuers to cease issuing covered bonds if programmes are not maintained in line with the law and the oversight programme.

> **Coverage**: The Secretary and 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, issuers would have to submit the test outcome to the Secretary, the regulator, the indenture trustee, the asset monitor and bondholders. Bonds issued under an approved programme would remain special-law-based even if the OC requirement is not met. An uncured failure of the OC requirement within a set time would constitute a default on covered bonds.

> **Limit**: Based on safety and soundness considerations and the financial condition of an issuer, the regulator would set a covered bond issuance limit as a percentage of total assets. A regulator could alter this limit as often as quarterly and if safety and soundness considerations or the issuer's financial condition would change. A cut of the limit would not affect an issuer's outstanding covered bonds.

> **Monitoring**: Issuers would have to appoint an independent asset monitor that verifies and reports at least annually to the Secretary, the regulator, the indenture trustee and bondholders whether a pool meets the 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**: Each regulator would be required to adopt a separate scheme of disclosure, registration and reporting obligations and exemptions for covered bonds. These different schemes should be as uniform and consistent as possible. Once a year, the 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 and Senate.

> **Default**: There are two scenarios: default on covered bonds before and after the issuer entering conservatorship, receivership, liquidation or bankruptcy (issuer default). Issuer default would not necessarily cause an acceleration of outstanding covered bonds.

> > **Default on covered bonds before issuer default**: The cover pool and the related covered bonds would be automatically transferred to a newly created separate estate.

> > **Default of the issuer (without FDIC involvement)**: The cover pool and the related covered bonds would be automatically transferred to a newly created separate estate.

> > **Default of the issuer (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 the transfer is made or the FDIC ceases further performance, the FDIC would meet an issuer's obligations under the covered bonds. If the FDIC would not complete the transfer within

4 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.

one year, ceases further performance or fails to meet an issuer's obligations under the covered bonds, the cover pool and covered bonds would be automatically transferred to a newly created separate estate.

The transferee 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. Investors would retain a claim against the issuer for any deficiency with respect to the covered bonds. The issuer, conservator, receiver, liquidating agent or bankruptcy trustee would retain a residual interest in the separate estate. The issuer would have to transfer to the estate all property of the estate that is in its possession or under its control, and may be required to continue servicing the cover pool for 120 days.

The regulator would give the Secretary, indenture trustee, residual interest holder and bondholders written notice of the creation of the estate. It would appoint a trustee for the estate and servicers or administrators for the pool. The servicers or administrators would actively manage the pool and would be required to maximise the proceeds and the value of a cover pool in resolution. They would be allowed to dispose of assets and raise funds on a secured or unsecured basis and on a priority, pari passu, or subordinated basis. The regulator would supervise the trustee and any servicer or administrator. It may 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 funds 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 United States Covered Bond Act.

> **Actions**: No court may take any action to restrain or affect the resolution of a separate estate, except at the request of the applicable 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.

Covered Bond Policy Statement & Best Practices Guide

On 9 July 2008, the FDIC approved the 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 Federal Reserve and the Securities and Exchange Commission. The Best Practices Guide introduces guidelines to promote the development of a standardised covered bond market. In July 2008, Bank of America, Citigroup, JPMorgan Chase Bank and Wells Fargo expressed their support for the FDIC and the US Treasury statements. They have shown interest in setting up programmes in accordance with or in aligning existing programmes to these statements (although this has not been completed).

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 securities that are non-deposit, recourse debt obligations of insured depository institutions (IDI) 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.

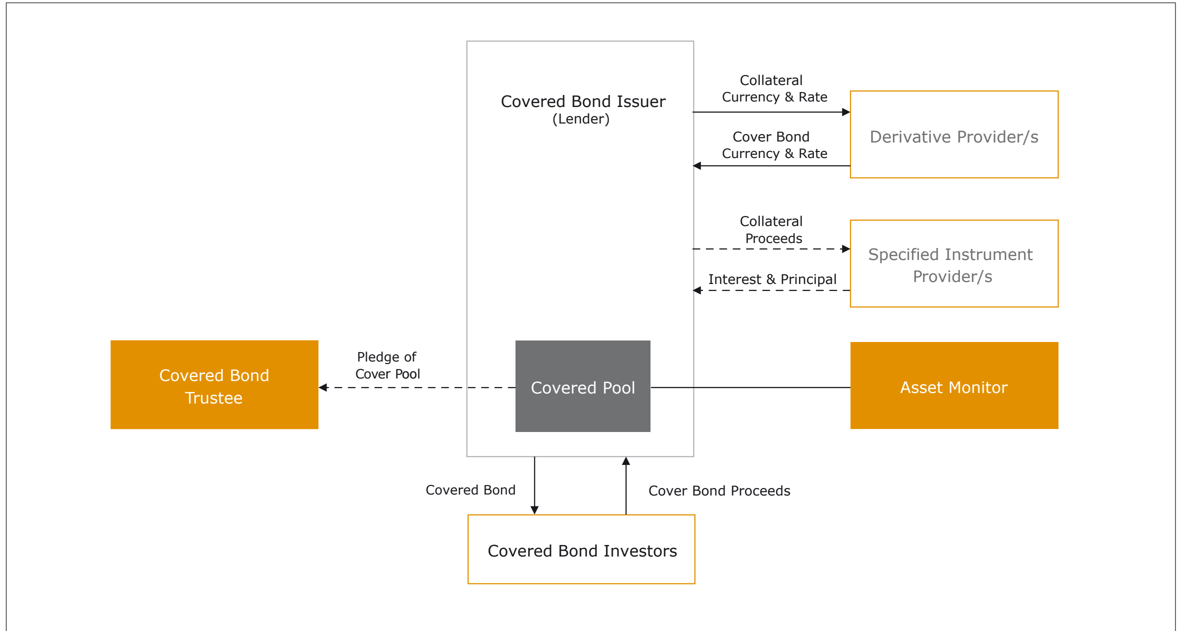
The policy statement must not be construed as waiving, limiting or otherwise affecting the rights or powers of the FDIC. Neither does it impose new responsibilities on the FDIC as conservator or receiver. The FDIC may consider changes to the policy statement as the US covered bond market develops. It 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.

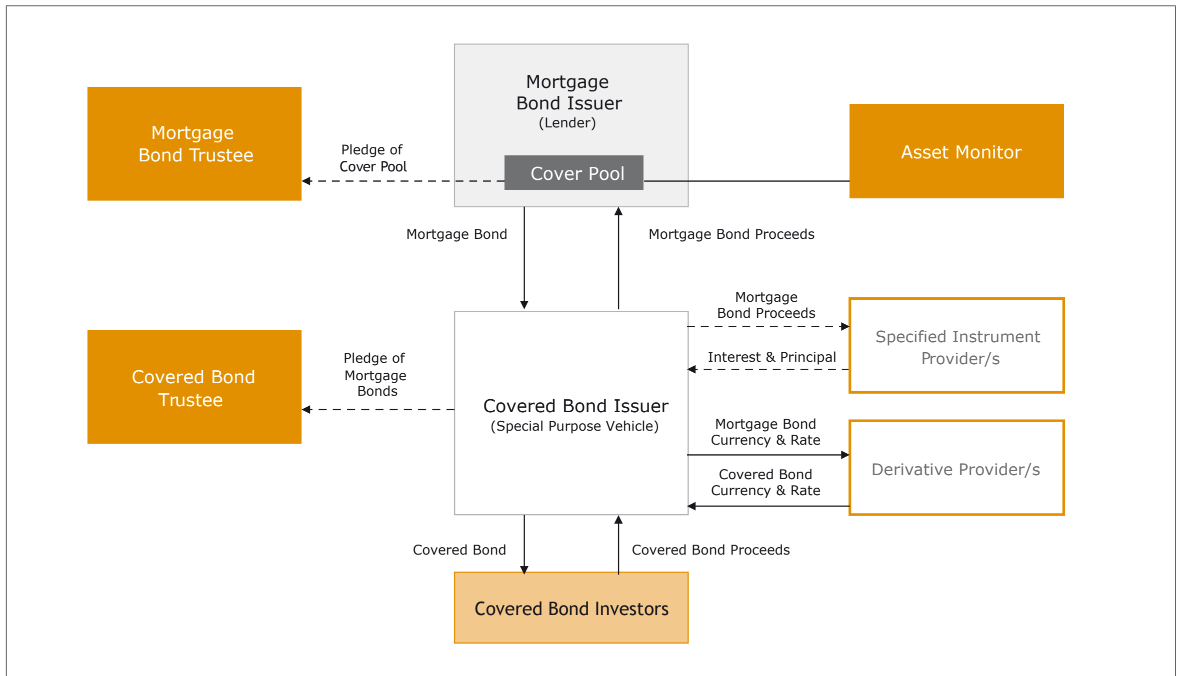
- **Issuer**: Issuers may be depository institutions and their subsidiaries, and bankruptcy-remote SPV. Pooled issuance is possible – i.e., multiple depository institutions could use a joint SPV to pool assets. The collateral has to be owned by the depository institution. Only well-capitalised entities 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.

> Exhibit A: Simplified Direct Issuance



Source: Best Practices Guide, Credit Suisse

> Exhibit B: Simplified SPV Issuance



Source: Best Practices Guide, Credit Suisse

- **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. Following issuer default 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.
- **Default**: 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.

The Best Practices Guide serves as a template for market participants and must not be construed to be dedicated legislation. Neither does it attempt to address any requirements imposed by other applicable US legislation, or provide or imply a government guarantee. The US Treasury expects the structure, collateral and other key terms of the product to evolve with the growth of this market in the US.

US lenders: SPV Issuance currently in practice

Importance of first priority perfected security interests

To date, US lenders use 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. There are other federal legislations and regulations implicated, including the Uniform Commercial Code, the Securities Act and the FDIA. The Uniform Commercial Code provides the basis to pledge collateral by creation of a first priority perfected security interest. Pledged collateral remains on the balance sheet of the entity granting the first priority perfected security interest.

> **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 covered bond collateral to a Covered Bond Indenture Trustee (CBIT) for the benefit of the secured creditors. The CBIT on behalf of the SPV holds each mortgage bond series as collateral for a covered bond series.

> **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 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 OCC. 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 was 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 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 taken into account. 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 default. 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 default.

> **PCT**: Upon an event of sponsor default and declaration of acceleration of the mortgage bonds by the MBIT but before an event of SPV default, 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 default.

Procedures upon an event of sponsor and/or SPV default

For example, if a sponsor becomes insolvent or is in an unsound condition, the applicable bureau of the US Treasury has the right to appoint the FDIC as conservator or receiver for the sponsor. In the event of sponsor default, 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: the FDIC affirms the bonds and meets the obligations of the sponsor under the mortgage bonds and/or seeks to transfer any of the sponsor's assets and liabilities to a new obligor, or it repudiates the covered bonds.

If the FDIC repudiates the covered bonds, the mortgage bonds become due and payable and an amount equal to actual direct compensatory damages has to be paid in full up to the value of the collateral. 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. If, after its appointment, the conservator or receiver for the sponsor remains in default for a set period, or if the FDIC as conservator or receiver for the sponsor repudiates the covered bonds, but does not pay the actual direct compensatory damages within a set period, the MBIT may exercise self-help remedies and enforce its security interest over the collateral. The exercise of self-help remedies is subject to approval by the FDIC.

Upon an event of sponsor default, the CBIT 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.

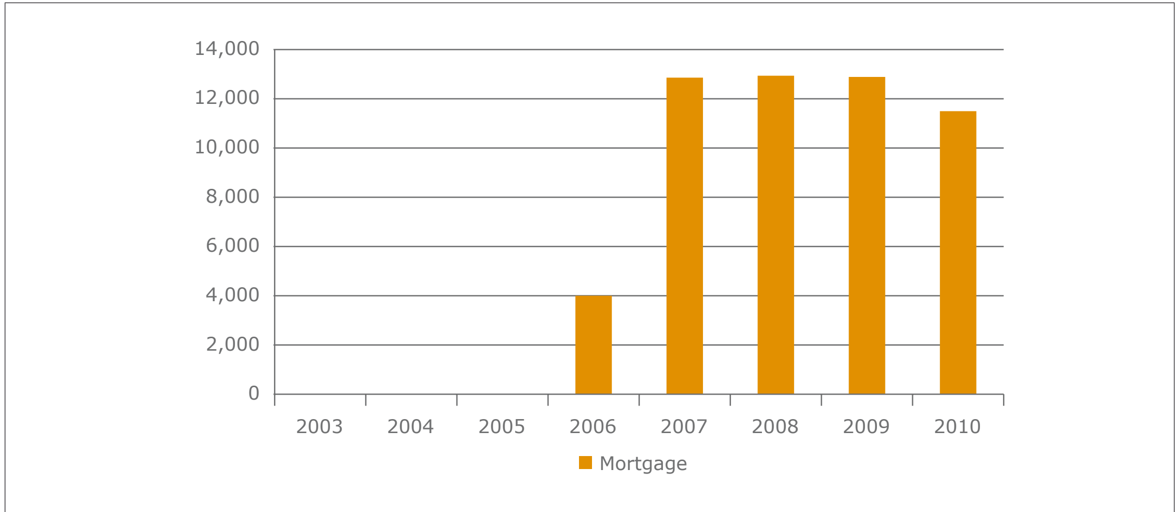
Following an event of SPV default, the CBIT can declare all outstanding covered bonds to be due and payable against the SPV at their early redemption amount plus accrued interest (Covered Bond Acceleration). The CBIT may enforce its security interest over the covered bond collateral, liquidate it and 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 because 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 CRD compliant without meeting UCITS 52(4). Thus, the bonds cannot benefit from special treatment in terms of risk weight.

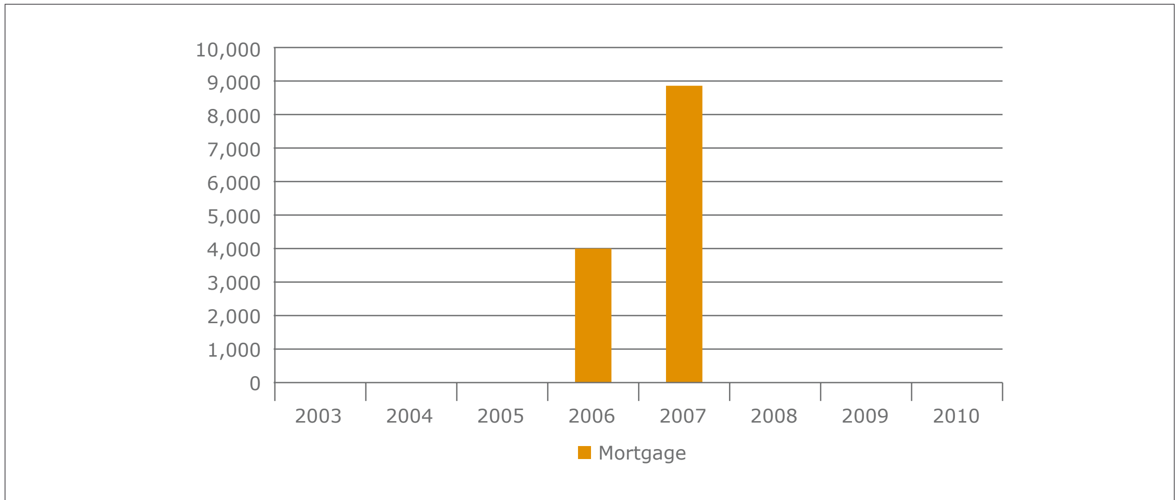
The Eurosystem accepts eligible assets as collateral for its credit operations. At present, outstanding EUR-denominated general-law-based US covered bonds are part of Liquidity Category IV.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2010, EUR M



Source: EMF/ECBC

CHAPTER 4 - RATING AGENCIES & METHODOLOGY

4.1 COVERED BOND RATINGS: STABILITY AFFECTED BY CHANGES IN CRITERIA AND SOVEREIGN DOWNGRADES

By Boudewijn Dierick, BNP Paribas
and ECBC Rating Agency Approaches Working Group Chairman

Contrary to last year, the covered bond market has not been shaken by changes in rating agency methodologies for covered bonds in the past 12 months. However, various events have directly or indirectly significantly impacted certain sectors of the covered bond market:

> Firstly, the number and magnitude of downgrades of ratings of issuing banks and related sovereigns impacted by the financial crisis.

> Secondly, changes in criteria of rating agencies for other sectors which are fully or partly applied to the covered bond market, like counterparty criteria.

> Lastly, adjustments in existing criteria or their application for covered bonds.

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.

These ongoing changes in methodologies may contradict with the expectation of issuers and investors who wish to see stability in ratings and methodologies that are specific for covered bonds. Lack of thorough reflection and discussion with market participants before applying new criteria is another often-heard comment while others would appreciate longer implementation periods to allow issuers to make adjustments to comply with new criteria. On the other hand, the market environment has been changing rapidly since the start of the crisis and it is no surprise that covered bond ratings have been affected by the flow of multiple-notch downgrades of banks and sovereigns in certain countries, especially in recent history.

In summary and as stated already in last year's Fact Book, all three rating agencies agree that the main risks are related to the issuer, the quality of the collateral and the asset-liability mismatch or liquidity risk, assuming the legal set up is robust.

Although none of the rating agencies have made any changes in their methodologies for covered bonds in the past 12 months, both Fitch and Standard & Poor's have published (proposals for) new counterparty criteria for covered bonds in the first half of 2011. At time of writing, Standard & Poor's is still undertaking its internal review of the comments they received from the market on their proposed counterparty methodology for covered bonds. This follows the application of similar criteria to the ABS market in H1 2011 after the publication of a counterparty criteria report in December 2010.

Moody's have not made any fundamental changes to its methodology which was initially published in June 2006. Developments in refinancing margins and asset performance continued to have limited impact on covered bond ratings thanks to strong issuer support. Covered bond downgrades were all caused by downgrades of the ratings of sovereigns and/or the issuers themselves as expected by Moody's in their 2011 outlook.

In the first half of 2011, Moody's has lowered the Timely Payment Indicators (TPI) for various programmes that were at the same time affected by sovereign downgrades. This created further downgrades for various programmes as the leeway between the covered bond rating and the issuer rating became smaller, especially for lower rated issuers. It recently also took rating action on certain Danish programmes following

the increase in volume of adjustable rate mortgages in underlying mortgage pools. One could question the value of TPIs if they are lowered jointly with downgrades of the issuer and/or country as it results in more rating linkage with issuers and country and specifically at lower rating levels where more leeway could be expected thanks to the quality of the underlying collateral and the strength of a legal framework. Liquidity risk seems to have become the dominating factor even in the rating process.

On 14 March 2011, Fitch published its covered bond counterparty criteria which has many similarities with the corresponding criteria for structured finance with categorisation in derivative, direct and indirect support In contrast, Fitch applies a less strict treatment to external counterparties for higher rated issuers and it allows slightly lower triggers for counterparties as long as the issuer is rated sufficiently high. This approach makes sense but the D-factors for most programmes were impacted by these new criteria as many swaps in covered bonds are provided by internal swap counterparties. At time of writing, Fitch was in the process of updating its D-factors and the resulting impact on OC-levels and ratings for covered bonds programs following the publication on 14 March 2011of their revised counterparty criteria.

Fitch also increased the D-factors for programmes that do not sufficiently mitigate commingling and payment interruption in case of an issuer default. Fitch published comments on the Australian and proposed US laws as well as on the rise of the use of covered bond funding by banks.

Standard & Poor's on 23 March 2011 published a request for comment on proposed covered bonds counterparty and supporting obligations methodology and assumptions. The proposed criteria expanded on the counterparty criteria for structured finance transactions as published in December 2010. Similar to Fitch, Standard & Poor's intends to favour programmes with external counterparties but considers the number of counterparties, their ratings and the rating of the issuer itself. If implemented, their criteria would introduce caps to the ratings of covered bonds with less than 10 external swap counterparties that would not make their swaps compliant with the counterparty criteria for structured finance as published in December 2010. At time of publication of this Fact Book, the final criteria were not yet published following the receipt of feedback from the market participants on the proposed criteria. Unless S&P amends the final methodology this could potentially impact the ratings of many outstanding covered bonds in the next 12 months.

Standard & Poor's also commented on the proposed Canadian and Australian legislations and indicated in a new criteria report that the maximum differential between non-sovereign issuers and the related EMU-sovereigns could be up to 6 notches going forward which supports the view that covered bond ratings can be higher and even more stable than the ratings of sovereigns.

Given this context, it is no surprise that various issuers and other market participants feel that the methodologies change too frequently and that those changes in methodologies are too extreme and affected by changes in other sectors which subsequently impact the covered bond market despite the resilience the asset class has shown compared to other markets during the crisis.

The added value that agencies can bring to the covered bond market is to introduce comparability and predictability by explaining how covered bond ratings could be impacted by changes in issuer and/or country ratings. However, it is a difficult task as it requires keeping in mind all the subtle differences between jurisdictions, laws, structures, housing markets and capture this in one rating. In recent years, the trend has actually been that raters are trying to standardise their methodologies with the aim to become more transparent, often at the expense of local differences. Hopefully, the number of moving factors impacting covered bond ratings will not further increase going forward. This, together with some stability in the ratings of sovereigns and issuers will further support the already high rating stability of covered bonds.

4.2 FITCH COVERED BONDS RATING METHODOLOGY

By Hélène M. Heberlein and Beatrice Mezza, Fitch Ratings

INTRODUCTION

Fitch covered bonds 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. **Static 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, assets 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 bonds 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.

Fitch introduced this rating approach in July 2006, and the first Discontinuity Factor was assigned in February 2007. Fitch criteria are subject to regular reviews. Among the most recent covered bond criteria developments, the agency is implementing a revised default risk analysis of cover pools constituting of granular commercial real estate loans and a refined approach towards counterparty risk in covered bonds.

Fitch Criteria for the Analysis of Covered Bonds Secured by Commercial Real Estate Loans

Among the nine German mortgage Pfandbriefe originally affected, Fitch has completed the analysis for seven programmes based on line-by-line data delivered by issuers. The Rating Watch Negative (RWN) was resolved and the rating affirmed at its previous level. However, the overcollateralisation supporting the rating generally rose and ranges from 19% to 27% for 'AAA' rated mortgage Pfandbriefe exposed to commercial real estate. Two programmes remain on RWN, pending the delivery and analysis of further data.

Fitch Covered Bonds Counterparty Criteria

Fitch guidelines are consistent with the agency's corresponding structured finance criteria, but allow for a differentiated treatment in recognition of the dual recourse nature of covered bonds. For instance, the definition of counterparties eligible to 'AA-' up to 'AAA' rated bonds is strictly the same: institutions rated at least 'A' and 'F1'. However, open interest and currency positions will not be stressed for issuers rated at least 'AA-' and 'F1+'. Also, minimum collateralisation expected to be posted upon swap counterparties becoming non eligible will vary depending on the issuer and the counterparty rating compared with the covered bonds rating, provided the counterparty is not an intra-group entity.

As a result of the criteria implementation, so far one programme has been downgraded due to counterparty exposure.

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 systemic and cover pool as well as issuer-specific aspects into account.

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. At one extreme, the covered bonds' probability of default will be equal to that of the institution, and in this case the Discontinuity Factor would be 100%. At the other extreme, with a Discontinuity Factor of 0%, the probability of default of the covered bonds could be completely independent of the issuer's creditworthiness, although this would be hard to achieve in practice: the institution benefiting from the covered bond funding is bound to influence the composition of the cover pool and take decisions about asset and liability management that will be dictated by its strategic choices.

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 maturity 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.

> **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, the 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.

> **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. Contractual covered bonds programmes get no benefit from oversight.

> **Adjustment for Counterparty Risk**: Fitch will tighten 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.

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

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 indicated in the above matrix, 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 covered bonds secondary market spreads as a starting point to calculate the corresponding refinancing costs. An additional margin that is dependent on the asset class and respective regional market is added to reflect the profit that a potential buyer would like to gain from the trade.

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.

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

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.

CONCLUSION

The IDR, Discontinuity Factor, 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 Factor 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 125 covered bonds programmes publicly rated by the agency at end of July 2011, 94 were rated 'AAA', the majority of which corresponding to a 'AA+' or 'AA' rating on a probability-of-default basis, and incorporating one or two notches for recovery given default.

The average Discontinuity Factor for all 99 mortgage covered bonds was 29.6%, 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 all 26 public sector covered bonds was 14.6%, 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.

Covered Bonds Surveillance

Fitch covered bonds surveillance platform constitutes a single, comprehensive source of periodic information on key covered bonds 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 the surveillance menu of www.fitchratings.com.

4.3 MOODY'S COVERED BOND RATING METHOD

By Juan Pablo Soriano, Nicholas Lindstrom and Jane Soldera, Moody's

SUMMARY

Moody's rating for a covered bond is determined after applying a two-step process:

> Moody's EL 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; and

> Timely Payment Indicator (TPI): may cap the rating arrived at using Moody's EL Model by applying a framework that 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 *issuer default*, ie. the removal of support from the issuer group.

Moody's method for rating covered bonds has not changed over the crisis. Moody's has always limited the amount of rating uplift for covered bonds over and above the issuer's rating. This is mainly due to the presence of refinancing risk, which we discuss further below.

MOODY'S EL MODEL – OVERVIEW

A Moody's covered bond rating is primarily determined by its expected loss under Moody's EL Model. This assumes there is recourse first to the issuer and then to the cover pool and therefore 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 value of the cover pool, and therefore any losses, will be determined assuming a stressed environment. The key factors affecting the value of the cover pool include:

> The credit quality of the collateral in the cover pool;

> Refinancing risk in the event that funds need to be raised to finance the cover pool following issuer default; and

> Any interest rate and currency risks to which the cover pool is exposed.

Moody's EL Model calculates the probability of issuer default (based on the issuer's senior unsecured rating), and the subsequent loss (if any) on the cover pool, on a month-by-month basis from issue to final maturity. The results are then summed and discounted back to present value to give the overall expected loss on the covered bond.

MOODY'S EL MODEL - ROLE OF THE ISSUER

During the life of a covered bond, Moody's EL Model calculates the probability of issuer default based on the senior unsecured rating of the issuer or, if the issuer is unrated, some other form of support provided by a rated parent or group entity. If the issuer is performing, there should be no loss to covered bondholders. Moody's EL Model also takes into account various issuer and issuer group-related benefits in addition to the senior unsecured rating of the issuer. 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 LTV loans with lower LTV loans, particularly where required by law. For this reason Moody's sees the role of the issuer as more important than that of a simple guarantor.

MOODY'S EL MODEL - VALUE OF THE COVER POOL

To avoid losses on covered bonds following issuer default, the value of the cover pool, including any overcollateralization, will need to be greater than the principal and interest payable on the bonds (taking into account other amounts ranking equal or prior). In Moody's analysis the three key factors affecting the value of the cover pool are described below.

(I) Credit quality of the cover pool

The credit quality of the cover pool is determined by calculating the amount of losses on cover pool assets that Moody's assumes will accrue after issuer default as a result of asset defaults or impairments. It is measured by the collateral score, which is conceptually equivalent to Aaa enhancement – so the lower the collateral score the better quality the pool. Factors which will determine the collateral score vary, but for mortgage loans they will normally include the state of the property market, range and distribution of loan-to-value ratios, the quality of the loan underwriting (in particular the calculation of whether the borrower can afford the loan), the seasoning of the pool and the type of loan product, eg. amortising vs. interest-only. Factors most relevant for public sector loans will include the credit strength of the public sector borrowers and concentration levels. Of course the quality of the cover pool may vary over time as issuers typically have discretion to add and remove assets, but Moody's recalculates the collateral score for most programmes on a quarterly basis to monitor this.

(II) Refinancing the cover pool

Following issuer default, the timely payment of principal under the covered bonds may rely on funds being raised against the cover pool. This is because the expected maturity of the assets in the cover pool is generally longer than that of the covered bonds. Moody's EL Model therefore assumes that funds must be raised against the cover pool, most likely 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 built into the overall enhancement modelled for a given rating level.

This enhancement is based on three factors:

(a) the level of discount (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.

Typically Moody's assumes the life of the refinancing risk, ie. the average remaining life of the cover pool at the time of issuer default, is a minimum of five years. The portion of the cover pool exposed to refinancing risk is normally considered to be a minimum of 50%. The refinancing margins are set by reference to each jurisdiction and then adjusted for individual programmes. Factors which influence the refinancing margins in Moody's analysis include the strength of the relevant legal framework for the covered bonds, the breadth and depth of the covered bond market and the quality of the collateral.

(II) 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 due to different durations of, and payment promises made on, the cover pool assets and the covered bonds. Under Moody's EL Model these potential mismatches are estimated by taking into account:

(a) the size of the 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 bonds;

(b) the portion of the assets with interest rate (or currency) mismatches; and

(c) in the case of interest rate risk, the average life of the mismatch based on the assets in the cover pool (typically assumed to be a minimum of five years at point of issuer default).

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 this time 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 has Moody's assumed that swaps used to hedge interest rate and currency risk completely remove these risks from a covered bond.

MOODY'S TIMELY PAYMENT INDICATORS ("TPIs")

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. TPIs range from "Very High" to "Very Improbable". 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. These are the factors Moody's considers when assigning TPIs.

TPIs operate to cap the rating of a covered bond to a certain number of notches above the issuer's rating. Moody's publishes a TPI Table setting out a framework for the maximum covered bond ratings for different issuer rating/TPI combinations – see Moody's rating methodology report referred to at the end of this chapter. As indicated at the beginning of this chapter, the rating cap under the TPI Table is likely to prevail if it is lower than the rating which is possible under Moody's EL Model.

Moody's has always been strongly of the view that following issuer default the single most important risk to timely payment for most covered bonds is the existence of refinancing risk (described above). This is the main driver when assessing TPIs. Refinancing Risk is highly volatile, which is why covered bonds which are subject to material refinancing risk cannot support Moody's highest ratings unless they are also backed by a highly-rated issuer. One important way in which Moody's assesses the TPI impact of refinancing risk for each jurisdiction is to consider covered bonds' systemic importance in that jurisdiction, and whether they would be likely to receive support from the government or market participants following an issuer default. Other factors relevant when Moody's assesses TPI levels include continuity of servicing and cash management, risk of termination of swaps, risk of acceleration of the covered bonds, enhancement levels, the issuer's ability to change the programme (in particular to add new assets and enter into new hedging arrangements) and sovereign risk.

In the last couple of years sovereign risk has become an increasingly important driver of TPI changes due to deteriorating sovereign creditworthiness in parts of Europe. In these countries (in particular Greece,

Ireland and Portugal) the stresses on the government and financial system may mean funding is less readily available to assist a covered bond programme to make timely payments to covered bondholders following issuer default.

Moody's mainly determines TPI on a jurisdiction-by-jurisdiction basis as many of the relevant factors are common within jurisdictions. TPIs may then be adjusted at the programme level to reflect particular features of a programme.

References:

> Moody's EMEA Covered Bond Monitoring Overview: Q1 2011 (updated quarterly)

> Moody's Rating Approach to Covered Bonds; 4 March 2010

> EMEA Covered Bonds: 2011 Outlook & 2010 Review; 17 January 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

4.4 STANDARD & POOR'S

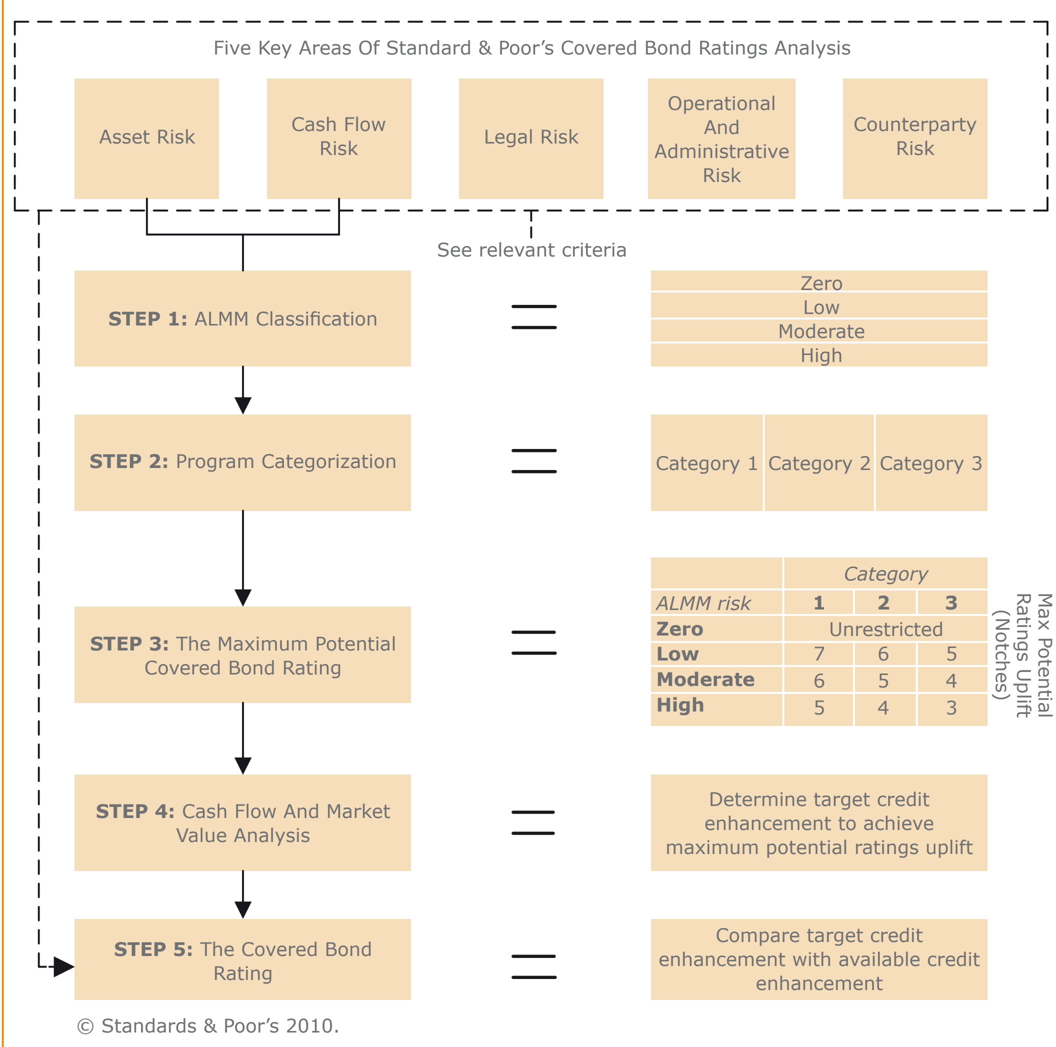
By Karen Naylor, Karlo Fuchs, Sabrina Miehs
and Nicolas Malaterre, Standard & Poor's

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 RatingsDirect 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 five main factors in its covered bond rating analysis, which are depicted in the following chart and described below.



Summary Of Revised Criteria For Assessing Asset-Liability Mismatch Risk In Covered Bonds
Five Key Areas Of Standard & Poor's Covered Bond Ratings Analysis
Asset Risk
Cash Flow Risk
Legal Risk
Operational And Administrative Risk
Counterparty Risk
See relevant criteria
STEP 1: ALMM Classification
Zero
Low
Moderate
High
STEP 2: Program Categorization
Category 1
Category 2
Category 3
STEP 3: The Maximum Potential Covered Bond Rating
Category
ALMM risk
1
2
3
Zero
Unrestricted
Low
7
6
5
Moderate
6
5
4
High
5
4
3
Max Potential Ratings Uplift (Notches)
STEP 4: Cash Flow And Market Value Analysis
Determine target credit enhancement to achieve maximum potential ratings uplift
STEP 5: The Covered Bond Rating
Compare target credit enhancement with available credit enhancement
© Standards & Poor's 2010.

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 in the summary chart. 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.

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. S&P currently reviews its counterparty criteria for covered bonds.

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 Johannes Rudolph, HSBC Trinkaus and
Sabine Winkler, Credit Suisse Securities (Europe) Limited

I. REVIEW OF COVERED BOND STATISTICS

The ECBC Statistics and Data Working Group collects and provides information on the outstanding volume and annual gross supply of covered bonds at year-end. Its aim is to provide complete covered bond market statistics. The statistics cover 25 jurisdictions as at the end of 2010.[1] The collation of statistics is possible thanks to the cooperation of the Working Group members, covered bond issuers and banking associations. Although there is plenty of covered bond data available, it is often difficult to evaluate its coverage and completeness.[2] For some countries, national specifics need to be considered.

> **Austria**: Consistent statistics are unavailable because the Österreichische Nationalbank stopped releasing covered bond related data in 2004. The central bank may resume providing data in 2011. 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. Austria's 2010 statistics only include the covered bonds of 14 issuers, as data of the other nine issuers was unavailable.

> **Canada**: Covered bonds backed by mortgages insured against borrower default by the Canada Mortgage and Housing Corporation are classed as mortgage covered bonds.

> **Czech Republic**: The Czech Republic's annual gross supply statistics include only new issues. Covered bonds launched and cancelled during the same year are not included in the annual gross supply statistics.

> **Denmark**: Denmark's covered bond statistics were revised in 2010. They are no longer distorted by a year-end effect – i.e., the reported total outstanding amount is now more in line with the actual total outstanding amount at year-end. The 2010 revision led to a downward correction of the country's covered bond statistics.

> **France**: Compagnie de Financement Foncier's cover pool includes public sector debt, mortgages and senior securitisation tranches. Crédit Foncier et Communal d'Alsace et Lorraine – Société de Crédit Foncier's cover pool includes mortgages and public sector debt. The covered bonds of both issuers are grouped into one 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.

> **Hungary**: Hungary's annual gross supply statistics include new issues and taps. Covered bonds launched and cancelled during the same year are not taken into account in the annual gross supply statistics.

1 These were Austria, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Luxembourg, New Zealand, Norway, Poland, Portugal, Slovakia, Spain, Sweden, Switzerland, Ukraine, the Netherlands, the UK and the US.

2 In accordance with applicable reporting standards, some issuers disclose outstanding covered bonds at their market value, but not at their par value. The International Financial Reporting Standards do not require issuers to disclose their covered bonds and the corresponding collateral.

> **Iceland**: Iceland's covered bond statistics are no longer included in the statistics because of the unavailability of reliable data. One issuer cancelled its covered bond programme and another is in the winding-up process.[3]

> **Italy**: Italy's covered bond statistics include covered bonds governed by Law No. 130 of 30 April 1999 (Law 130) and Cassa Depositi e Prestiti's covered bonds.

> **Latvia**: Latvia's annual gross supply statistics include only new issues. Covered bonds launched and cancelled during the same year are not taken into account in the annual gross supply statistics.

> **Slovakia**: Slovakia adopted the euro on 1 January 2009. Its 2009 and 2010 covered bond statistics do not distinguish between domestic currency and EUR-denominated covered bonds.

> **Spain**: Spain's covered bond statistics include only cédulas with an official listing in Spain's AIAF (Asociaciòn de Intermediarios de Activos Financieros). Cédulas without an official listing in the AIAF are not included in the statistics. Cédulas with an outstanding size of at least EUR1bn are classed as Jumbos, even though not all those securities meet all Jumbo criteria.

> **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).

> **Switzerland**: Limmat transactions governed by the Swiss Pfandbrief Act and launched by the Pfandbriefbank schweizerischer Hypothekarinstitute are classed as private placements.

The statistics distinguish between covered bonds secured by public sector debt, mortgages, ship loans and a mix thereof. In contrast to non-Jumbos, Jumbos typically have a minimum volume of EUR1bn, a fixed coupon payable once a year in arrears and (soft)-bullet redemption. They are supported by the commitment of at least five traders to quote continuous two-way prices during normal trading hours as long as there is sufficient liquidity in the respective Jumbo.

Covered bonds are divided into those distributed via private placement or public placement, 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 statistics regard bonds listed with an exchange as publicly placed. The exchange rate used to convert non-EUR-denominated bonds is the end-of-year rate published by the European Central Bank. A distinction is made between fixed-rate bonds and floating-rate bonds and bonds with another coupon structure.

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.

The statistics are skewed by country specifics (see above), exchange rate fluctuations and lenders' refunding, repurchase, cancellation and call activities. Because of inconsistent data disclosure or unavailability of information, there is uncertainty around the classification of several covered bonds or, in some cases, covered bonds cannot be classified at all. Consequently, the total or sum of each category (of a country's statistics or of the overall statistics) at year-end may differ.

3 For more details about Kaupthing Bank HF's covered bonds, refer to the issuer's monthly creditors' reports.

The statistics no longer include the weighted average time to maturity of the outstanding covered bonds from one country. They include now the number of issuers and of new issuers. 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.

II. COVERED BOND MARKET DEVELOPMENTS

At the end of 2010, the total outstanding volume of covered bonds was EUR 2,501 bn compared with EUR2,392bn at the end of 2009, representing 5% growth after 5% growth in 2009. In 2010, the Jumbo segment accounted for 51% of the total outstanding volume of covered bonds and 51% of annual gross supply. The total outstanding volume of EUR-denominated Jumbos was EUR 893 bn at the end of 2010 compared with EUR876bn at the end of 2009, representing 2% growth after 2% growth in 2009. The covered bond market continues to grow, especially outside Europe.

Cyprian lenders started using special-law-based covered bonds in 2011, after legislation came into effect in 2010. New Zealand entered the market in 2010. Ukraine exited the market in 2010, after the last outstanding covered bond was repaid in March. Markets inside and outside Europe conduct feasibility studies into the merits of the product as a funding instrument for lenders. In countries, such as Australia, Belgium, Canada, Japan, Mexico, New Zealand, South Korea and the US, market stakeholders are lobbying for covered bond legislation. The legislative procedures are at different stages in each country.

In their search for an optimal funding mix, lenders have turned, or are likely to turn, their attention towards covered bonds as a source of complementary liquidity. At the end of 2010, 300 issuers were competing for investor attention. At the end of 2009, there were 299 entities with at least one outstanding covered bond at year-end. In 2010, 22 entities joined the covered bond market and 21 left, due mainly to mergers or the repayment of last outstanding covered bonds. Of the new issuers in 2010, five were from Germany and four were from Italy. Of the five new issuers from Germany, two had exited the market in 2009 and re-joined the market in 2010.

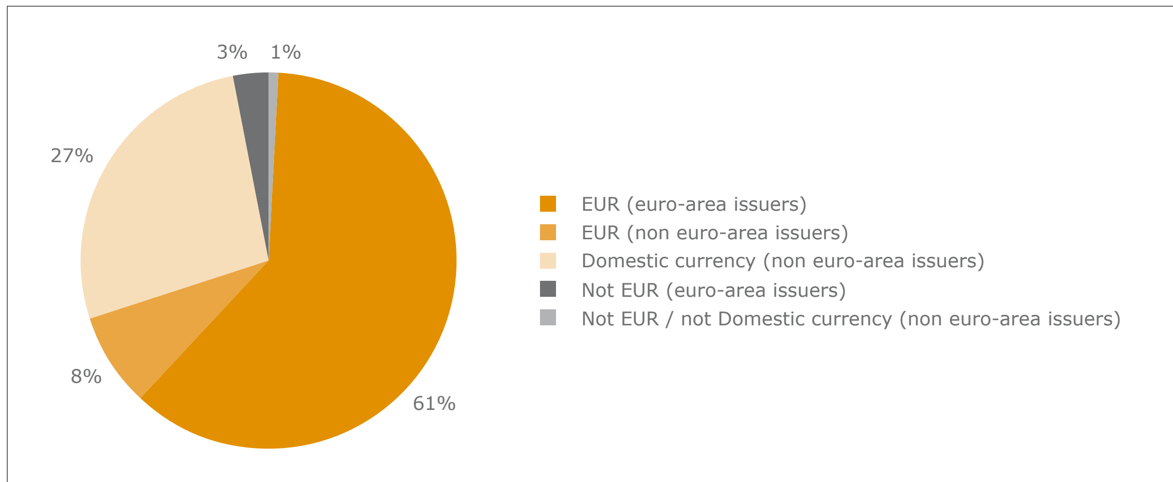
Of the total of 300 issuers, 265 had issued mortgage covered bonds, 101 public covered bonds, six had launched covered bonds backed by ship loans, and two had issued covered bonds backed by a pool of mixed collateral.[4] Most issuers (230) had one programme. Several issuers had more than one programme – i.e., 67 issuers used two covered bond products, and three issuers used three covered bond products to fund public sector debt, mortgages and ship loans. With 63 German, 59 Spanish, 23 Austrian, 22 UK, 22 Norwegian, 16 French and 10 Italian issuers, these countries represented over 70% of issuers in the overall covered bond market at the end of 2010.

With a total outstanding volume of EUR640bn at the end of 2010, Germany is by far the largest covered bond market, followed by Spain (EUR 362 bn), Denmark (EUR 339 bn), France (EUR 320 bn), the UK (EUR 209 bn) and Sweden (EUR 189 bn); these six captured 82% of the overall covered bond market. In 2010, the total outstanding volume of Canadian and Greek covered bonds experienced triple-digit growth. In countries, such as Finland, France, Italy, the Netherlands, Norway, Portugal, Sweden and

4 This excludes secured bonds launched by German issuers in accordance with the DG Bank Transformation Act of 1998 and the DSL Bank Transformation Act of 1999.

Switzerland, growth in covered bonds was in double digits. In jurisdictions, such as Germany (-11%), Hungary (-14%), Ireland (-19%), Latvia (-26%), Luxembourg (-9%), Poland (-12%), Slovakia (-5%) and the US (-11%), growth in covered bonds declined.

> Exhibit A: The importance of domestic currency-denominated covered bonds



Source: European Covered Bond Council

In 2010, gross supply of covered bonds reached EUR 613 bn compared with EUR 530 bn in 2009. About 87% (EUR 534 bn) of 2010 gross supply was placed publicly and 22% (EUR 562 bn) of the total outstanding volume of covered bonds at the end of 2010 was placed privately. Many issuers use domestic currency-denominated covered bonds. At the end of 2010, in Finland, Greece, Poland and Portugal, all the outstanding covered bonds were domestic currency-denominated. Simultaneously, EUR 2,175bn (87%) of the total outstanding volume of covered bonds was denominated in the issuers' domestic currency and EUR1,700bn (68%) was EUR-denominated.

In 2010, euro-area entities launched EUR 303 bn of covered bonds, of which EUR 290 bn were EUR-denominated. At the end of 2010, the total outstanding volume of EUR-denominated covered bonds of euro-area entities was EUR 1,497 bn. Only EUR 86 bn (3%) of the total outstanding volume of covered bonds of euro-area entities was non-EUR denominated. Compared with their peers, issuers from Finland, Greece, Portugal and Ukraine have not yet used covered bonds denominated in a currency other than the domestic currency. Apart from the euro, important currencies are DKK, GBP, SEK, USD, CHF and NOK.

Mortgage covered bonds dominated the market in 2010, accounting for 84% of gross supply and 72% of the total outstanding volume of covered bonds. All countries (except Luxembourg) included in the 2010 statistics were mortgage covered bond markets. Some 11 jurisdictions were also public covered bond markets. Denmark and Germany were the only ship mortgage covered bond markets and France was the only market with covered bonds secured by a pool of mixed collateral.[5] Even though several laws allow for a mixed cover pool, only a few issuers run a pool of mixed collateral. 2010 gross supply of covered bonds secured by a pool of mixed collateral was EUR 17 bn.

5 This excludes secured bonds launched by German issuers in accordance with the DG Bank Transformation Act of 1998 and the DSL Bank Transformation Act of 1999.

At the end of 2010, of the total outstanding volume of covered bonds, 20% were floating rate and 78% were fixed rate. Floating-rate covered bonds were in vogue in 2008, accounting for 45% of gross supply. In 2010, the portion of floating-rate covered bonds was below 20% of gross supply. Gross supply of fixed-rate covered bonds was over three and over four times that of floating-rate covered bonds in 2009 and 2010, respectively. In these years, the floating-rate covered bond market did not stand up to the fixed-rate covered bond market.

The market distinguishes between special-law-based and general-law-based covered bonds. The first are governed by dedicated legislation. At the end of 2010, general-law-based covered bonds existed in countries, such as Canada, France, Germany, Iceland, Italy, Mexico, New Zealand, South Korea, Switzerland, the Netherlands, the UK and the US. At the same time, the portion of general-law-based EUR-denominated Jumbos within the overall EUR-denominated Jumbo market was 10%. At the end of 1H11, their total outstanding volume was almost EUR 55 bn – i.e., about 6% of the overall EUR-denominated Jumbo market – compared with EUR 107 bn in 2007.

5.2 STATISTICS

5.2.1 TOTAL

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector	869714	858645	869924	884038	858773	774516	691096	607984
Outstanding CBs - Mortgage	584148	643687	745455	923289	1069825	1407311	1602963	1789739
Outstanding CBs - Ships	10087	9542	10586	11341	12167	16327	15151	14527
Outstanding CBs - Mixed Assets	34530	41350	50040	61930	80097	80631	82572	88693
Total Outstanding	**1498479**	**1553224**	**1676006**	**1880598**	**2020861**	**2278785**	**2391782**	**2500943**
Outstanding Jumbo	682671	745862	838717	966788	1048451	1158309	1242100	1265104
Outstanding non-Jumbo	805058	796612	837289	913810	972410	1120475	1149682	1235839
Sum	1487729	1542474	1676006	1880598	2020861	2278784	2391782	2500944
Total Outstanding Public Placement	1030751	1017513	1166260	1248021	1505113	1725482	1822932	1939149
Total Outstanding Private Placement	391109	446011	450067	477974	515748	553301	568850	561795
Sum	1421859	1463524	1616327	1725996	2020861	2278784	2391782	2500943
Denominated in EURO	1212927	1252336	1336544	1326319	1556014	1650815	1673160	1700268
Denominated in domestic currency	230340	242569	277283	342495	362173	511818	611412	677096
Denominated in other currencies	44461	47568	62178	57181	102674	116151	107210	123579
Sum	1487728	1542473	1676005	1725995	2020861	2278783	2391782	2500944
Outstanding fixed coupon	1241859	1261062	1378903	1504409	1737471	1748263	1843511	1948697
Outstanding floating coupon	155423	177148	177237	201488	251701	498601	516001	511903
Outstanding other	24578	25313	27225	20098	31688	31921	32270	40343
Sum	1421859	1463524	1583365	1725996	2020861	2278785	2391782	2500943
Number of Issuers	140	167	194	213	233	268	299	300
Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector	182482	162269	179523	173361	151091	128713	83614	75387
New Issues of CBs - Mortgage	205204	198078	273240	304384	285732	507082	428132	517139
New Issues of CBs - Ships	2421	1785	3579	3334	3143	6289	2221	3325
New Issues of CBs - Mixed Assets	9600	11150	13150	17263	23682	8549	15824	17261
Total Issuance	**399707**	**373282**	**469492**	**498342**	**463647**	**650633**	**529790**	**613112**
Issuance Jumbo	109327	112300	136847	194903	233116	222572	257184	310413
Issuance non-Jumbo	277949	249832	315690	303438	230531	428062	272606	302699
Sum	387276	362132	452537	498342	463647	650634	529790	613112
Total Issuance Public Placement	316385	294286	377324	384473	360965	507039	421532	533962
Total Issuance Private Placement	80362	78996	88363	113869	102683	143595	108259	79150
Sum	396747	373282	465687	498342	463647	650634	529790	613112
Denominated in EURO	283572	267724	284343	343990	332710	382806	302589	373336
Denominated in domestic currency	98710	96391	152467	125409	101148	251181	215370	204155
Denominated in other currencies	14593	9167	28876	28942	29789	16647	11830	35621
Sum	396876	373282	465686	498341	463647	650634	529789	613111
Issuance fixed coupon	319503	309181	375583	396247	374788	350876	404167	492389
Issuance floating coupon	50741	44735	67057	54233	83263	292729	120917	118375
Issuance other	10403	10765	13977	5828	5596	7028	4705	2348
Sum	380647	364682	456617	456308	463646	650633	529790	613112
Number of New Issuers	22	27	26	20	21	43	39	22

Source: EMF/ECBC

5.2.2 TOTAL 2010 STATISTICS BY TYPE OF ASSETS

COVERED BONDS OUTSTANDING 2010 in EUR million					
	Public Sector	Mortgage	Ships	Mixed Assets	TOTAL
Austria	19,555	7,645	0	0	27,200
Canada	0	18,003	0	0	18,003
Czech Republic	0	8,242	0	0	8,242
Denmark	0	332,505	6,722	0	339,227
Finland	0	10,125	0	0	10,125
France	75,548	156,239	0	88,693	320,480
Germany	412,090	219,947	7,805	0	639,842
Greece	0	19,750	0	0	19,750
Hungary	0	6,323	0	0	6,323
Ireland	36,550	29,037	0	0	65,587
Italy	10,092	26,925	0	0	37,017
Latvia	0	63	0	0	63
Luxembourg	28,889	0	0	0	28,889
Netherlands	0	40,764	0	0	40,764
New Zealand	0	1,247	0	0	1,247
Norway	1,837	70,178	0	0	72,015
Poland	126	511	0	0	636
Portugal	1,400	27,730	0	0	29,130
Slovakia	0	3,442	0	0	3,442
Spain	18,350	343,401	0	0	361,751
Sweden	0	188,750	0	0	188,750
Switzerland	0	62,046	0	0	62,046
United Kingdom	3,548	205,370	0	0	208,918
United States	0	11,497	0	0	11,497
Total	**607,984**	**1,789,739**	**14,527**	**88,693**	**2,500,943**

Source: EMF/ECBC

COVERED BONDS Issuance 2010 in EUR million					
	Public Sector	Mortgage	Ships	Mixed Assets	TOTAL
Austria	8,125	3,600	0	0	11,725
Canada	0	12,650	0	0	12,650
Czech Republic	0	724	0	0	724
Denmark	0	148,475	136	0	148,611
Finland	0	5,250	0	0	5,250
France	12,508	42,895	0	17,261	72,664
Germany	41,574	42,216	3,189	0	86,979
Greece	0	17,250	0	0	17,250
Hungary	0	542	0	0	542
Ireland	60	6,000	0	0	6,060
Italy	2,000	12,925	0	0	14,925
Latvia	0	0	0	0	0
Luxembourg	3,524	0	0	0	3,524
Netherlands	0	13,731	0	0	13,731
New Zealand	0	1,247	0	0	1,247
Norway	1,421	21,410	0	0	22,831
Poland	25	138	0	0	164
Portugal	250	11,610	0	0	11,860
Slovakia	0	1,179	0	0	1,179
Spain	5,900	51,916	0	0	57,816
Sweden	0	79,910	0	0	79,910
Switzerland	0	14,834	0	0	14,834
United Kingdom	0	28,636	0	0	28,636
United States	0	0	0	0	0
Total	**75,387**	**517,139**	**3,325**	**17,261**	**613,112**

Source: EMF/ECBC

5.2.3 AUSTRIA

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector	6750	6750	13038	15615	15200	17326	19617	19555
Outstanding CBs - Mortgage	4000	4000	4000	3880	4125	4973	5317	7645
Outstanding CBs - Ships								
Outstanding CBs - Mixed Assets								
Total Outstanding	**10750**	**10750**	**17038**	**19495**	**19325**	**22299**	**24934**	**27200**
Outstanding Jumbo			6000	6000	7000	8000	8000	13500
Outstanding non-Jumbo			11038	13495	12325	14298	16934	13700
Sum			17038	19495	19325	22298	24934	27200
Total Outstanding Public Placement				10235	10987	12931	12161	14100
Total Outstanding Private Placement				9260	8338	9367	12773	13100
Sum				19495	19325	22298	24934	27200
Denominated in EURO			15691	17703	17304	19664	24002	21510
Denominated in domestic currency								
Denominated in other currencies			1347	1792	2021	2634	932	5690
Sum			17038	19495	19325	22298	24934	27200
Outstanding fixed coupon			13497	17207	18111	19189	16593	17900
Outstanding floating coupon			3324	2062	1029	3110	6309	6600
Outstanding other			217	226	185	0	2032	2700
Sum			17038	19495	19325	22299	24934	27200
Number of Issuers	12	15	22	23	24	25	26	23
Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector	1802		3591	3110	3131	9361	2501	8125
New Issues of CBs - Mortgage	1029		214	2176	1959	1321	1442	3600
New Issues of CBs - Ships								
New Issues of CBs - Mixed Assets								
Total Issuance	**2831**		**3805**	**5286**	**5090**	**10682**	**3943**	**11725**
Issuance Jumbo				1000	1000	1000	1000	9725
Issuance non-Jumbo				4286	4090	9682	2943	2000
Sum				5286	5090	10682	3943	11725
Total Issuance Public Placement				1677	1531	3361	2599	9725
Total Issuance Private Placement				3609	3559	7321	1344	2000
Sum				5286	5090	10682	3943	11725
Denominated in EURO				4899	4861	10362	3943	10725
Denominated in domestic currency								
Denominated in other currencies				387	229	320	0	1000
Sum				5286	5090	10682	3943	11725
Issuance fixed coupon				3807	4577	8255	3252	10200
Issuance floating coupon				1478	490	2262	435	525
Issuance other				0	23	165	256	1000
Sum				5286	5090	10682	3943	11725
Number of New Issuers	1	3	7	1	1	1	1	0

Note: Data is tentative

5.2.4 CANADA

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector								
Outstanding CBs - Mortgage					2000	6574	7525	18003
Outstanding CBs - Ships								
Outstanding CBs - Mixed Assets								
Total Outstanding					**2000**	**6574**	**7525**	**18003**
Outstanding Jumbo					2000	6250	6250	4250
Outstanding non-Jumbo						324	1275	13753
Sum					2000	6574	7525	18003
Total Outstanding Public Placement					2000	6250	7201	18003
Total Outstanding Private Placement					0	324	324	0
Sum					2000	6574	7525	18003
Denominated in EURO					2000	6574	6574	4250
Denominated in domestic currency							496	1201
Denominated in other currencies							455	12552
Sum					2000	6574	7525	18003
Outstanding fixed coupon					2000	6250	6999	17763
Outstanding floating coupon						324	526	240
Outstanding other								
Sum					2000	6574	7525	18003
Number of Issuers					1	3	3	5
Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector								
New Issues of CBs - Mortgage					2000	4574	951	12650
New Issues of CBs - Ships								
New Issues of CBs - Mixed Assets								
Total Issuance					**2000**	**4574**	**951**	**12650**
Issuance Jumbo					2000	4250	0	0
Issuance non-Jumbo						324	951	12650
Sum					2000	4574	951	12650
Total Issuance Public Placement					2000	4250	951	12650
Total Issuance Private Placement						324	0	0
Sum					2000	4574	951	12650
Denominated in EURO					2000	4250	0	0
Denominated in domestic currency							496	638
Denominated in other currencies						324	455	12012
Sum					2000	4574	951	12650
Issuance fixed coupon					2000	4250	749	12650
Issuance floating coupon							202	0
Issuance other						324	0	0
Sum					2000	4574	951	12650
Number of New Issuers					1	2	0	2

5.2.5 CZECH REPUBLIC

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector								
Outstanding CBs - Mortgage	1638	1956	4452	5543	8245	8098	8186	8242
Outstanding CBs - Ships								
Outstanding CBs - Mixed Assets								
Total Outstanding	**1638**	**1956**	**4452**	**5543**	**8245**	**8098**	**8186**	**8242**
Outstanding Jumbo								
Outstanding non-Jumbo	1638	1956	4452	5543	8245	8098	8186	8242
Sum	1638	1956	4452	5543	8245	8098	8186	8242
Total Outstanding Public Placement	1537	1721	3710	4682	6639	6508	5444	5459
Total Outstanding Private Placement	100	235	742	861	1607	1590	2742	2783
Sum	1638	1956	4452	5543	8245	8098	8186	8242
Denominated in EURO				42	39	35	118	128
Denominated in domestic currency	1638	1956	4452	5501	8206	8064	8068	8114
Denominated in other currencies								
Sum	1638	1956	4452	5543	8245	8098	8186	8242
Outstanding fixed coupon	1572	1796	3619	4615	5894	5758	3759	3611
Outstanding floating coupon	66	160	833	928	1681	1271	3903	4068
Outstanding other					670	1070	523	563
Sum	1638	1956	4452	5543	8245	8098	8186	8242
Number of Issuers	5	5	8	8	9	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	738	724
New Issues of CBs - Ships								
New Issues of CBs - Mixed Assets								
Total Issuance	**666**	**744**	**2558**	**956**	**3514**	**939**	**738**	**724**
Issuance Jumbo								
Issuance non-Jumbo	666	744	2558	956	3514	939	738	724
Sum	666	744	2558	956	3514	939	738	724
Total Issuance Public Placement	565	610	2068	875	3359	939	187	705
Total Issuance Private Placement	100	135	490	81	155	0	551	19
Sum	666	744	2558	956	3514	939	738	724
Denominated in EURO				42	0	0	89	19
Denominated in domestic currency	666	744	2558	914	3514	939	650	705
Denominated in other currencies								
Sum	666	744	2558	956	3514	939	738	724
Issuance fixed coupon	666	650	1897	903	1328	55	76	420
Issuance floating coupon		94	661	53	1705	790	662	179
Issuance other					482	95	0	125
Sum	666	744	2558	956	3514	939	738	724
Number of New Issuers	1	0	3	0	1	0	0	0

5.2.6 DENMARK

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector					0	0	0	0
Outstanding CBs - Mortgage	204695	216133	246411	260367	244696	255140	319434	332505
Outstanding CBs - Ships	6915	6330	6915	6672	7754	7045	7197	6722
Outstanding CBs - Mixed Assets								0
Total Outstanding	**211610**	**222463**	**253326**	**267039**	**252450**	**262185**	**326631**	**339227**
Outstanding Jumbo	122126	136804	159665	180563	194157	189974	247205	258871
Outstanding non-Jumbo	89484	85659	93661	86476	58293	72211	79426	80356
Sum	211610	222463	253326	267039	252450	262185	326631	339227
Total Outstanding Public Placement	211610	222463	253326	267039	252450	260844	322198	334116
Total Outstanding Private Placement						1341	4433	5111
Sum	211610	222463	253326	267039	252450	262185	326631	339227
Denominated in EURO	17457	18315	18432	18743	19547	22520	37675	42848
Denominated in domestic currency	194153	204148	234894	248296	232903	238324	287317	294019
Denominated in other currencies						1341	1639	2360
Sum	211610	222463	253326	267039	252450	262185	326631	339227
Outstanding fixed coupon	193578	202936	209667	208623	178953	184636	254894	267075
Outstanding floating coupon	5735	7877	32729	48232	73497	77549	71737	72152
Outstanding other	12297	11650	10930	10184	0	0	0	0
Sum	211610	222463	253326	267039	252450	262185	326631	339227
Number of Issuers	8	8	8	8	9	9	9	9
Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector						0	0	0
New Issues of CBs - Mortgage	99727	95009	149708	114014	70955	103230	125484	148475
New Issues of CBs - Ships	318	139	1837	960	2515	235	935	136
New Issues of CBs - Mixed Assets								0
Total Issuance	**100045**	**95148**	**151545**	**114974**	**73470**	**103465**	**126419**	**148611**
Issuance Jumbo					61239	75100	100157	117729
Issuance non-Jumbo	100045	95148	151545	114974	12231	28365	26262	30882
Sum	100045	95148	151545	114974	73470	103465	126419	148611
Total Issuance Public Placement	100045	95148	151545	114974	73470	102124	125014	147933
Total Issuance Private Placement						1341	1405	678
Sum	100045	95148	151545	114974	73470	103465	126419	148611
Denominated in EURO	8455	5556	8850	8844	14415	13186	22255	24833
Denominated in domestic currency	91590	89591	142695	106130	59055	90279	101183	122374
Denominated in other currencies							2981	1404
Sum	100045	95148	151545	114974	73470	103465	126419	148611
Issuance fixed coupon	97916	91267	123590	93771	50757	89888	122851	133846
Issuance floating coupon	2128	3881	27955	21203	22713	13577	3568	14765
Issuance other	1	0	0	0	0	0	0	0
Sum	100045	95148	151545	114974	73470	103465	126419	148611
Number of New Issuers	0	0	0	0	1	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.

5.2.7 FINLAND

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector		0	0	0	0	0	0	0
Outstanding CBs - Mortgage		250	1500	3000	4500	5750	7625	10125
Outstanding CBs - Ships		0	0	0	0	0	0	0
Outstanding CBs - Mixed Assets		0	0	0	0	0	0	0
Total Outstanding	**0**	**250**	**1500**	**3000**	**4500**	**5750**	**7625**	**10125**
Outstanding Jumbo		0	1000	2000	3000	4000	5250	7250
Outstanding non-Jumbo		250	500	1000	1500	1750	2375	2875
Sum	0	250	1500	3000	4500	5750	7625	10125
Total Outstanding Public Placement		250	1500	3000	4500	5750	7625	10125
Total Outstanding Private Placement		0	0	0	0	0	0	0
Sum	0	250	1500	3000	4500	5750	7625	10125
Denominated in EURO		250	1500	3000	4500	5750	7625	10125
Denominated in domestic currency		0	0	0	0	0	0	0
Denominated in other currencies		0	0	0	0	0	0	0
Sum	0	250	1500	3000	4500	5750	7625	10125
Outstanding fixed coupon		0	1000	2250	3750	4750	6500	9250
Outstanding floating coupon		250	500	750	750	1000	1125	875
Outstanding other		0	0	0	0	0	0	0
Sum	0	250	1500	3000	4500	5750	7625	10125
Number of Issuers		1	2	2	3	3	3	4

Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector		0	0	0	0	0	0	0
New Issues of CBs - Mortgage		250	1250	1500	1500	1250	2125	5250
New Issues of CBs - Ships		0	0	0	0	0	0	0
New Issues of CBs - Mixed Assets		0	0	0	0	0	0	0
Total Issuance	**0**	**250**	**1250**	**1500**	**1500**	**1250**	**2125**	**5250**
Issuance Jumbo		0	1000	1000	1000	1000	1250	4000
Issuance non-Jumbo		250	250	500	500	250	875	1250
Sum	0	250	1250	1500	1500	1250	2125	5250
Total Issuance Public Placement		250	1250	1500	1500	1250	2125	5250
Total Issuance Private Placement		0	0	0	0	0	0	0
Sum	0	250	1250	1500	1500	1250	2125	5250
Denominated in EURO		250	1250	1500	1500	1250	2125	5250
Denominated in domestic currency		0	0	0	0	0	0	0
Denominated in other currencies		0	0	0	0	0	0	0
Sum	0	250	1250	1500	1500	1250	2125	5250
Issuance fixed coupon		0	1000	1250	1500	1000	2000	5000
Issuance floating coupon		250	250	250	0	250	125	250
Issuance other		0	0	0	0	0	0	0
Sum	0	250	1250	1500	1500	1250	2125	5250
Number of New Issuers		1	1	0	1	0	0	1

5.2.8 FRANCE

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector	31340	37600	42600	49660	56403	64756	71905	75548
Outstanding CBs - Mortgage	21079	26816	32133	43012	63555	119092	134757	156239
Outstanding CBs - Ships								0
Outstanding CBs - Mixed Assets	34530	41350	50040	61930	80097	80631	82572	88693
Total Outstanding	**86949**	**105766**	**124773**	**154602**	**200055**	**264479**	**289234**	**320480**
Outstanding Jumbo	64757	75307	80132	102577	102550	155318	173536	204913
Outstanding non-Jumbo	22192	30459	44641	52025	97505	109161	115698	115567
Sum	86949	105766	124773	154602	200055	264479	289234	320480
Total Outstanding Public Placement	21079	26083	61465		194593	223753	209116	236474
Total Outstanding Private Placement		733	20668		5461	40727	80118	84006
Sum	21079	26816	82133	0	200054	264479	289234	320480
Denominated in EURO	77109	94104	109236		165779	226922	256798	285501
Denominated in domestic currency						0	0	0
Denominated in other currencies	9840	11662	15537		34276	37558	32436	34979
Sum	86949	105766	124773	0	200055	264480	289234	320480
Outstanding fixed coupon	21079	26333	30465		174388	204729	236106	266080
Outstanding floating coupon					10502	48633	42600	43710
Outstanding other		483	1668		15165	11117	10528	10690
Sum	21079	26816	32133	0	200055	264479	289234	320480
Number of Issuers	5	5	5	6	7	10	14	16

Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector	6500	8600	9070	12134	15271	11354	13915	12508
New Issues of CBs - Mortgage	6181	5737	6397	12637	21670	59734	29373	42895
New Issues of CBs - Ships								0
New Issues of CBs - Mixed Assets	9600	11150	13150	17263	23682	8549	15824	17261
Total Issuance	**22281**	**25487**	**28617**	**42034**	**60623**	**79637**	**59112**	**72664**
Issuance Jumbo	10562	8640	7210	29471	33200	29130	32700	47943
Issuance non-Jumbo	2119	5697	8257	12563	27423	50507	26412	24721
Sum	12681	14337	15467	42034	60623	79637	59112	72664
Total Issuance Public Placement	17492	16611	16963	32437	52393	54352	43608	58469
Total Issuance Private Placement	4660	8877	11654	9597	8230	25285	15504	14195
Sum	22152	25487	28617	42034	60623	79637	59112	72664
Denominated in EURO	19774	21369	20637	34172	50700	73930	56155	64375
Denominated in domestic currency								0
Denominated in other currencies	2507	4119	7980	7862	9923	5708	2957	8289
Sum	22281	25488	28617	42034	60623	79637	59112	72664
Issuance fixed coupon	6052	12279	14904		57009	37158	50443	64503
Issuance floating coupon		1004	526		2614	42224	8519	7953
Issuance other		3605	4117		1000	255	150	208
Sum	6052	16887	19547	0	60623	79637	59112	72664
Number of New Issuers	0	0	0	1	1	3	4	2

5.2.9 GERMANY

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector	797492	760264	734713	720835	677656	578974	486406	412090
Outstanding CBs - Mortgage	256027	246636	237547	223306	206489	217367	225100	219947
Outstanding CBs - Ships	3172	3212	3670	4669	4413	9282	7954	7805
Outstanding CBs - Mixed Assets								
Total Outstanding	**1056691**	**1010112**	**975930**	**948810**	**888558**	**805623**	**719460**	**639842**
Outstanding Jumbo	413700	391400	372600	345640	312358	279176	233500	178818
Outstanding non-Jumbo	642991	618712	603330	603170	576200	526447	485960	461024
Sum	1056691	1010112	975930	948810	888558	805623	719460	639842
Total Outstanding Public Placement	672091	576463	567910	512621	427073	362461	317755	245056
Total Outstanding Private Placement	384600	433649	408020	436189	461485	443162	401705	394786
Sum	1056691	1010112	975930	948810	888558	805623	719460	639842
Denominated in EURO	1030959	985370	952485	922878	863594	778623	690510	620420
Denominated in domestic currency								
Denominated in other currencies	25732	24742	23445	25932	24964	27000	28950	19422
Sum	1056691	1010112	975930	948810	888558	805623	719460	639842
Outstanding fixed coupon	901004	838345	845386	823130	789338	689124	619364	546791
Outstanding floating coupon	144270	160693	120681	121754	90552	107522	90136	78105
Outstanding other	11417	11075	9863	3926	8668	8976	9959	14946
Sum	1056691	1010112	975930	948810	888558	805623	719460	639842
Number of Issuers	41	48	54	57	58	59	61	63

Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector	151690	131506	137235	129452	107913	89522	52251	41574
New Issues of CBs - Mortgage	57621	40773	33722	35336	26834	57345	56852	42216
New Issues of CBs - Ships	2103	1646	1742	2374	628	6054	1286	3189
New Issues of CBs - Mixed Assets								
Total Issuance	**211414**	**173925**	**172699**	**167162**	**135375**	**152921**	**110389**	**86979**
Issuance Jumbo	49725	44075	47950	42660	33105	27415	19275	16850
Issuance non-Jumbo	161689	129850	124749	124502	102270	125506	91114	70129
Sum	211414	173925	172699	167162	135375	152921	110389	86979
Total Issuance Public Placement	138958	109423	106895	76935	57973	67337	43507	38985
Total Issuance Private Placement	72456	64502	65804	90227	77402	85584	66882	47994
Sum	211414	173925	172699	167162	135375	152921	110389	86979
Denominated in EURO	203206	172085	163931	159340	131807	149137	107488	84459
Denominated in domestic currency								
Denominated in other currencies	8208	1840	8768	7822	3568	3784	2901	2520
Sum	211414	173925	172699	167162	135375	152921	110389	86979
Issuance fixed coupon	155531	130723	138259	143869	113085	111309	89605	62518
Issuance floating coupon	45685	36559	27077	18859	20099	40156	20091	23468
Issuance other	10198	6643	7363	4434	2191	1456	693	993
Sum	211414	173925	172699	167162	135375	152921	110389	86979
Number of New Issuers	3	7	6	4	2	4	5	5

5.2.10 GREECE

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector								
Outstanding CBs - Mortgage						5000	6500	19750
Outstanding CBs - Ships								
Outstanding CBs - Mixed Assets								
Total Outstanding	**0**	**0**	**0**	**0**	**0**	**5000**	**6500**	**19750**
Outstanding Jumbo							1500	1500
Outstanding non-Jumbo						5000	5000	18250
Sum	0	0	0	0	0	5000	6500	19750
Total Outstanding Public Placement						5000	6500	19750
Total Outstanding Private Placement								
Sum	0	0	0	0	0	5000	6500	19750
Denominated in EURO						5000	6500	19750
Denominated in domestic currency								
Denominated in other currencies								
Sum	0	0	0	0	0	5000	6500	19750
Outstanding fixed coupon							1500	1500
Outstanding floating coupon						5000	5000	18250
Outstanding other								
Sum	0	0	0	0	0	5000	6500	19750
Number of Issuers						3	3	4
Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector								
New Issues of CBs - Mortgage						5000	1500	17250
New Issues of CBs - Ships								
New Issues of CBs - Mixed Assets								
Total Issuance	**0**	**0**	**0**	**0**	**0**	**5000**	**1500**	**17250**
Issuance Jumbo							1500	
Issuance non-Jumbo						5000		17250
Sum	0	0	0	0	0	5000	1500	17250
Total Issuance Public Placement						5000	1500	17250
Total Issuance Private Placement								
Sum	0	0	0	0	0	5000	1500	17250
Denominated in EURO						5000	1500	17250
Denominated in domestic currency								
Denominated in other currencies								
Sum	0	0	0	0	0	5000	1500	17250
Issuance fixed coupon							1500	
Issuance floating coupon						5000		17250
Issuance other								
Sum	0	0	0	0	0	5000	1500	17250
Number of New Issuers						3	0	2

5.2.11 HUNGARY

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector								
Outstanding CBs - Mortgage	3568	4962	5072	5924	5987	7105	7375	6323
Outstanding CBs - Ships								
Outstanding CBs - Mixed Assets								
Total Outstanding	**3568**	**4962**	**5072**	**5924**	**5987**	**7105**	**7375**	**6323**
Outstanding Jumbo						1000	1050	0
Outstanding non-Jumbo	3568	4962	5072	5924	5987	6105	6325	6323
Sum	3568	4962	5072	5924	5987	7105	7375	6323
Total Outstanding Public Placement	2151	2993	3182	4188	4131	4955	6500	5581
Total Outstanding Private Placement	1417	1970	1890	1736	1856	2150	875	742
Sum	3568	4962	5072	5924	5987	7105	7375	6323
Denominated in EURO		350	540	1547	1784	2879	3799	2904
Denominated in domestic currency	3568	4612	4532	4377	4203	4209	3559	3419
Denominated in other currencies						17	17	0
Sum	3568	4962	5072	5924	5987	7105	7375	6323
Outstanding fixed coupon	3182	4556	4587	5214	5080	4086	6737	5713
Outstanding floating coupon	297	316	398	635	907	3019	638	610
Outstanding other	89	90	87	75	0	0	0	0
Sum	3568	4962	5072	5924	5987	7105	7375	6323
Number of Issuers	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
New Issues of CBs - Ships								
New Issues of CBs - Mixed Assets								
Total Issuance	**2961**	**2381**	**808**	**1418**	**331**	**3331**	**3209**	**542**
Issuance Jumbo						1000	0	0
Issuance non-Jumbo	2961	2381	808	1418	331	2331	3209	542
Sum	2961	2381	808	1418	331	3331	3209	542
Total Issuance Public Placement	2135	1815	618	1412	158	3091	3205	542
Total Issuance Private Placement	826	566	190	6	173	240	4	0
Sum	2961	2381	808	1418	331	3331	3209	542
Denominated in EURO		350	190	1007	291	1407	1102	300
Denominated in domestic currency	2961	2031	618	411	40	1907	2107	242
Denominated in other currencies						17	0	0
Sum	2961	2381	808	1418	331	3331	3209	542
Issuance fixed coupon	2779	2377	718	1168	116	2275	3200	477
Issuance floating coupon	177	0	90	250	215	1056	9	65
Issuance other	4	4	0	0	0	0	0	0
Sum	2961	2381	808	1418	331	3331	3209	542
Number of New Issuers	0	0	0	0	0	0	0	0

5.2.12 IRELAND

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector	12362	27204	40965	49914	51204	52613	50951	36550
Outstanding CBs - Mortgage		2000	4140	11900	13575	23075	29725	29037
Outstanding CBs - Ships								
Outstanding CBs - Mixed Assets								
Total Outstanding	**12362**	**29204**	**45105**	**61814**	**64779**	**75688**	**80676**	**65587**
Outstanding Jumbo	11490	25418	32607	39417	41440	41916	42113	38632
Outstanding non-Jumbo	872	3787	12499	22397	23339	33772	38563	26955
Sum	12362	29204	45105	61814	64779	75688	80676	65587
Total Outstanding Public Placement	11999	27278	35190	43557	43833	46224	45305	42473
Total Outstanding Private Placement	363	1926	9916	18257	20947	29464	35371	23114
Sum	12362	29204	45105	61814	64779	75688	80676	65587
Denominated in EURO	10881	26696	37452	52800	52328	60056	67626	55766
Denominated in domestic currency								
Denominated in other currencies	1481	2508	7654	9014	12451	15632	13050	9821
Sum	12362	29204	45105	61814	64779	75688	80676	65587
Outstanding fixed coupon	12027	28460	40717	55832	56094	48817	43717	40163
Outstanding floating coupon	335	631	2095	3028	5299	23294	36909	22311
Outstanding other	0	114	2294	2954	3386	3577	50	3113
Sum	12362	29204	45105	61814	64779	75688	80676	65587
Number of Issuers	2	3	3	4	4	5	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
New Issues of CBs - Ships								
New Issues of CBs - Mixed Assets								
Total Issuance	**12362**	**17047**	**15576**	**17475**	**11208**	**22171**	**17975**	**6060**
Issuance Jumbo	11490	14000	6907	12259	3883	7250	10250	2000
Issuance non-Jumbo	872	3047	8669	5216	7325	14921	7725	4060
Sum	12362	17047	15576	17475	11208	22171	17975	6060
Total Issuance Public Placement	11999	15285	8597	12508	5314	8250	10250	2650
Total Issuance Private Placement	363	1761	6980	4967	5894	13921	7725	3410
Sum	12362	17047	15576	17475	11208	22171	17975	6060
Denominated in EURO	10881	15816	10663	15035	6612	18741	17975	6060
Denominated in domestic currency								
Denominated in other currencies	1481	1231	4914	2440	4596	3430	0	0
Sum	12362	17047	15576	17475	11208	22171	17975	6060
Issuance fixed coupon	12027	16467	12033	15537	8183	4600	4175	200
Issuance floating coupon	335	466	1445	1101	2351	17240	13750	5860
Issuance other		114	2097	837	674	331	50	0
Sum	12362	17047	15576	17475	11208	22171	17975	6060
Number of New Issuers	2	1	0	1	0	1	1	0

5.2.13 ITALY

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector			4000	8063	8063	8063	9063	10092
Outstanding CBs - Mortgage						6500	14000	26925
Outstanding CBs - Ships								
Outstanding CBs - Mixed Assets								
Total Outstanding	**0**	**0**	**4000**	**8063**	**8063**	**14563**	**23063**	**37017**
Outstanding Jumbo			4000	8000	8000	9000	14500	24000
Outstanding non-Jumbo				63	63	5563	8563	13017
Sum	0	0	4000	8063	8063	14563	23063	37017
Total Outstanding Public Placement			4000	8000	8000	14500	23000	36925
Total Outstanding Private Placement				63	63	63	63	92
Sum	0	0	4000	8063	8063	14563	23063	37017
Denominated in EURO			4000	8000	8000	14500	23000	36925
Denominated in domestic currency								
Denominated in other currencies				63	63	63	63	92
Sum	0	0	4000	8063	8063	14563	23063	37017
Outstanding fixed coupon			4000	8063	8063	10063	15563	27100
Outstanding floating coupon						500	500	2825
Outstanding other						4000	7000	7092
Sum	0	0	4000	8063	8063	14563	23063	37017
Number of Issuers			1	1	1	4	6	10

Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector			4000	4063			3000	2000
New Issues of CBs - Mortgage						6500	7500	12925
New Issues of CBs - Ships								
New Issues of CBs - Mixed Assets								
Total Issuance	**0**	**0**	**4000**	**4063**	**0**	**6500**	**10500**	**14925**
Issuance Jumbo			4000	4000		1000	7500	10500
Issuance non-Jumbo				63		5500	3000	4425
Sum	0	0	4000	4063	0	6500	10500	14925
Total Issuance Public Placement			4000	4000		6500	10500	14925
Total Issuance Private Placement				63				
Sum	0	0	4000	4063	0	6500	10500	14925
Denominated in EURO			4000	4000		6500	10500	14925
Denominated in domestic currency								
Denominated in other currencies				63				
Sum	0	0	4000	4063	0	6500	10500	14925
Issuance fixed coupon			4000	4000		2000	7500	12600
Issuance floating coupon						500	0	2325
Issuance other				63		4000	3000	0
Sum	0	0	4000	4063	0	6500	10500	14925
Number of New Issuers			0	0	0	3	2	4

5.2.14 LATVIA

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector								
Outstanding CBs - Mortgage	35	54	60	63	90	90	85	63
Outstanding CBs - Ships								
Outstanding CBs - Mixed Assets								
Total Outstanding	**35**	**54**	**60**	**63**	**90**	**90**	**85**	**63**
Outstanding Jumbo								
Outstanding non-Jumbo	35	54	60	63	90	90	85	63
Sum	35	54	60	63	90	90	85	63
Total Outstanding Public Placement	35	54	60	63	90	90	85	63
Total Outstanding Private Placement								
Sum	35	54	60	63	90	90	85	63
Denominated in EURO	0	0	0	20	56	69	64	45
Denominated in domestic currency	35	36	38	34	28	17	17	14
Denominated in other currencies	0	18	21	8	6	4	4	4
Sum	35	54	60	63	90	90	85	63
Outstanding fixed coupon	26	27	26	21	15	26	26	27
Outstanding floating coupon	9	27	34	41	75	64	59	36
Outstanding other								
Sum	35	54	60	63	90	90	85	63
Number of Issuers	1	1	1	4	5	5	5	4
Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector	0	0	0	0				
New Issues of CBs - Mortgage	11	22	4	20	19	25	0	0
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**
Issuance Jumbo	0	0	0	0				
Issuance non-Jumbo	11	22	4	20	19	25	0	0
Sum	11	22	4	20	19	25	0	0
Total Issuance Public Placement	11	22	4	20	19	25	0	0
Total Issuance Private Placement	0	0	0	0				
Sum	11	22	4	20	19	25	0	0
Denominated in EURO	0	0	0	20	19	25	0	0
Denominated in domestic currency	11	3	4	0	0			
Denominated in other currencies	0	18	0	0	0			
Sum	11	22	4	20	19	25	0	0
Issuance fixed coupon	9	3	0	0	0	25	0	0
Issuance floating coupon	2	18	4	20	19			
Issuance other	0	0	0	0	0			
Sum	11	22	4	20	19	25	0	0
Number of New Issuers				3	1			

5.2.15 LUXEMBOURG

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector	16870	19627	24968	28360	33741	35467	31645	28889
Outstanding CBs - Mortgage				150	150	150	0	0
Outstanding CBs - Ships								
Outstanding CBs - Mixed Assets								
Total Outstanding	**16870**	**19627**	**24968**	**28510**	**33891**	**35617**	**31645**	**28889**
Outstanding Jumbo	5000	4000	2000	2000	2250	2250	2250	3000
Outstanding non-Jumbo	11870	15627	22968	26510	31641	33367	29395	25889
Sum	16870	19627	24968	28510	33891	35617	31645	28889
Total Outstanding Public Placement	12384	12358	16577	18833	21993	21295	18398	15659
Total Outstanding Private Placement	4486	7270	8391	9677	11898	14322	13247	13230
Sum	16870	19627	24968	28510	33891	35617	31645	28889
Denominated in EURO	9473	11032	10909	12319	16172	18147	16592	15826
Denominated in domestic currency								
Denominated in other currencies	7397	8595	14059	16191	17719	17470	15053	13063
Sum	16870	19627	24968	28510	33891	35617	31645	28889
Outstanding fixed coupon	11631	12236	15427	19077	22573	22267	21126	20390
Outstanding floating coupon	4465	5489	7376	7217	9210	11270	9355	7710
Outstanding other	774	1902	2165	2216	2108	2080	1164	789
Sum	16870	19627	24968	28510	33891	35617	31645	28889
Number of Issuers	3	3	3	3	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
New Issues of CBs - Mortgage				150	0	0	0	0
New Issues of CBs - Ships								
New Issues of CBs - Mixed Assets								
Total Issuance	**4528**	**5516**	**9611**	**9880**	**10052**	**3967**	**3083**	**3524**
Issuance Jumbo	750	0	0	0	250	0	0	750
Issuance non-Jumbo	3778	5516	9611	9880	9802	3967	3083	2774
Sum	4528	5516	9611	9880	10052	3967	3083	3524
Total Issuance Public Placement	3197	2870	6749	6798	4819	878	500	750
Total Issuance Private Placement	1331	2646	2862	3082	5233	3089	2583	2774
Sum	4528	5516	9611	9880	10052	3967	3083	3524
Denominated in EURO	2131	3589	2468	3628	5773	2639	2661	3260
Denominated in domestic currency								
Denominated in other currencies	2397	1927	7143	6252	4279	1328	422	264
Sum	4528	5516	9611	9880	10052	3967	3083	3524
Issuance fixed coupon	2828	3516	7511	8092	5425	1423	1526	1213
Issuance floating coupon	1500	1600	1700	1601	4448	2471	1530	2289
Issuance other	200	400	400	187	178	73	27	22
Sum	4528	5516	9611	9880	10051	3967	3083	3524
Number of New Issuers	0	0	0	0	2	0	0	0

5.2.16 NETHERLANDS

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector			0	0	0	0	0	0
Outstanding CBs - Mortgage			2000	7500	15727	20977	28367	40764
Outstanding CBs - Ships			0	0	0	0	0	0
Outstanding CBs - Mixed Assets			0	0	0	0	0	0
Total Outstanding	**0**	**0**	**2000**	**7500**	**15727**	**20977**	**28367**	**40764**
Outstanding Jumbo			2000	5500	11000	14000	20250	29150
Outstanding non-Jumbo			0	2000	4727	6977	8117	11614
Sum	0	0	2000	7500	15727	20977	28367	40764
Total Outstanding Public Placement			2000	6650	13817	18970	25306	34985
Total Outstanding Private Placement			0	850	1910	2007	3061	5779
Sum	0	0	2000	7500	15727	20977	28367	40764
Denominated in EURO			2000	6400	14319	19157	26525	37437
Denominated in domestic currency			0	0	0	0	0	0
Denominated in other currencies			0	1100	1408	1819	1842	3326
Sum	0	0	2000	7500	15727	20976	28367	40764
Outstanding fixed coupon			2000	7200	13725	17807	25370	38157
Outstanding floating coupon			0	0	1647	3120	2947	2546
Outstanding other			0	300	355	50	50	60
Sum	0	0	2000	7500	15727	20977	28367	40764
Number of Issuers			1	1	2	5	5	5
Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector			0	0	0	0	0	0
New Issues of CBs - Mortgage			2000	5500	8227	5608	7725	13731
New Issues of CBs - Ships			0	0	0	0	0	0
New Issues of CBs - Mixed Assets			0	0	0	0	0	0
Total Issuance	**0**	**0**	**2000**	**5500**	**8227**	**5608**	**7725**	**13731**
Issuance Jumbo			2000	3500	5500	3000	6250	9750
Issuance non-Jumbo			0	2000	2727	2608	1475	3981
Sum	0	0	2000	5500	8227	5608	7725	13731
Total Issuance Public Placement			2000	4650	7167	5118	6415	11164
Total Issuance Private Placement			0	850	1060	491	1310	2567
Sum	0	0	2000	5500	8227	5609	7725	13731
Denominated in EURO			2000	4400	7919	5191	7725	12407
Denominated in domestic currency			0	0	0	0	0	0
Denominated in other currencies			0	1100	308	418	0	1324
Sum	0	0	2000	5500	8227	5609	7725	13731
Issuance fixed coupon			2000	5200	6525	4033	7535	13654
Issuance floating coupon			0	0	1647	1575	190	77
Issuance other			0	300	55	0	0	0
Sum	0	0	2000	5500	8227	5608	7725	13731
Number of New Issuers			1	0	1	3	0	0

5.2.17 NEW ZEALAND

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector								0
Outstanding CBs - Mortgage								1247
Outstanding CBs - Ships								0
Outstanding CBs - Mixed Assets								0
Total Outstanding	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**1247**
Outstanding Jumbo								1000
Outstanding non-Jumbo								247
Sum	0	0	0	0	0	0	0	1247
Total Outstanding Public Placement								1000
Total Outstanding Private Placement								247
Sum	0	0	0	0	0	0	0	1247
Denominated in EURO								1000
Denominated in domestic currency								247
Denominated in other currencies								0
Sum	0	0	0	0	0	0	0	1247
Outstanding fixed coupon								1247
Outstanding floating coupon								0
Outstanding other								0
Sum								1247
Number of Issuers								1

Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector								0
New Issues of CBs - Mortgage								1247
New Issues of CBs - Ships								0
New Issues of CBs - Mixed Assets								0
Total Issuance	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**1247**
Issuance Jumbo								1000
Issuance non-Jumbo								247
Sum	0	0	0	0	0	0	0	1247
Total Issuance Public Placement								1247
Total Issuance Private Placement								0
Sum	0	0	0	0	0	0	0	1247
Denominated in EURO								1000
Denominated in domestic currency								247
Denominated in other currencies								0
Sum	0	0	0	0	0	0	0	1247
Issuance fixed coupon								1247
Issuance floating coupon								0
Issuance other								0
Sum	0	0	0	0	0	0	0	1247
Number of New Issuers								1

5.2.18 NORWAY

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector							751	1837
Outstanding CBs - Mortgage					6371	21924	53582	70178
Outstanding CBs - Ships								
Outstanding CBs - Mixed Assets								
Total Outstanding			**0**	**0**	**6371**	**21924**	**54333**	**72015**
Outstanding Jumbo					4500	12046	34280	42433
Outstanding non-Jumbo					1871	9877	20052	29582
Sum			0	0	6371	21924	54333	72015
Total Outstanding Public Placement					6371	17742	51621	67773
Total Outstanding Private Placement						4182	2712	4242
Sum			0	0	6371	21924	54333	72015
Denominated in EURO					4500	12847	17064	22022
Denominated in domestic currency					1433	8351	37269	45581
Denominated in other currencies					438	725	0	4413
Sum			0	0	6371	21924	54333	72016
Outstanding fixed coupon					5718	14750	17064	28808
Outstanding floating coupon					653	7174	37269	43207
Outstanding other								
Sum			0	0	6371	21924	54333	72015
Number of Issuers					3	7	22	22

Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector							751	1421
New Issues of CBs - Mortgage					6458	15660	30105	21410
New Issues of CBs - Ships								
New Issues of CBs - Mixed Assets								
Total Issuance			**0**	**0**	**6458**	**15660**	**30856**	**22831**
Issuance Jumbo					4500	7546	18964	12722
Issuance non-Jumbo					1958	8114	11892	10109
Sum			0	0	6458	15660	30856	22831
Total Issuance Public Placement					6458	12630	29271	21073
Total Issuance Private Placement					0	3030	1585	1758
Sum			0	0	6458	15660	30856	22831
Denominated in EURO					4500	8346	2044	10950
Denominated in domestic currency					1521	7042	28744	8087
Denominated in other currencies					438	272	67	3794
Sum			0	0	6458	15660	30855	22831
Issuance fixed coupon					5754	9020	2206	16143
Issuance floating coupon					704	6640	28649	6688
Issuance other								
Sum			0	0	6458	15660	30855	22831
Number of New Issuers					2	4	15	1

5.2.19 POLAND

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector					131	137	139	126
Outstanding CBs - Mortgage	160	220	558	453	676	561	583	511
Outstanding CBs - Ships								
Outstanding CBs - Mixed Assets								
Total Outstanding	**160**	**220**	**558**	**453**	**807**	**698**	**722**	**636**
Outstanding Jumbo								
Outstanding non-Jumbo	160	220	558	453	807	698	722	636
Sum	160	220	558	453	807	698	722	636
Total Outstanding Public Placement	91	91	265	339	725	627	710	631
Total Outstanding Private Placement	69	129	293	114	82	71	12	5
Sum	160	220	558	453	807	698	722	636
Denominated in EURO	37	62	62	62	56	56	4	0
Denominated in domestic currency	111	115	440	357	726	617	711	636
Denominated in other currencies	11	43	56	34	25	25	7	0
Sum	159	220	558	453	807	698	722	636
Outstanding fixed coupon	4	4	4	4	1	1	4	0
Outstanding floating coupon	156	216	554	450	806	697	718	636
Outstanding other								
Sum	160	220	558	453	807	698	722	636
Number of Issuers	1	1	2	2	2	3	3	3

Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector					131	24	0	25
New Issues of CBs - Mortgage	123	63	224	52	206	197	88	138
New Issues of CBs - Ships								
New Issues of CBs - Mixed Assets								
Total Issuance	**123**	**63**	**224**	**52**	**337**	**222**	**88**	**164**
Issuance Jumbo								
Issuance non-Jumbo	123	63	224	52	337	222	88	164
Sum	123	63	224	52	337	222	88	164
Total Issuance Public Placement	91	0	174	52	337	222	88	164
Total Issuance Private Placement	32	63	50	0	0	0		
Sum	123	63	224	52	337	222	88	164
Denominated in EURO	23	25	0	0	0	0		
Denominated in domestic currency	100	7	211	52	337	222	88	164
Denominated in other currencies		31	12	0	0	0		
Sum	123	63	223	52	337	222	88	164
Issuance fixed coupon								
Issuance floating coupon	123	63	224	52	337	222	88	164
Issuance other								
Sum	123	63	224	52	337	222	88	164
Number of New Issuers	0	0	1	0	0	1	0	0

5.2.20 PORTUGAL

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector						150	1150	1400
Outstanding CBs - Mortgage				2000	7850	15270	20270	27730
Outstanding CBs - Ships								0
Outstanding CBs - Mixed Assets								0
Total Outstanding	**0**	**0**	**0**	**2000**	**7850**	**15420**	**21420**	**29130**
Outstanding Jumbo				2000	6500	12150	17150	17900
Outstanding non-Jumbo					1350	3270	4270	11230
Sum	0	0	0	2000	7850	15420	21420	29130
Total Outstanding Public Placement				2000	7850	15420	21420	29090
Total Outstanding Private Placement								40
Sum	0	0	0	2000	7850	15420	21420	29130
Denominated in EURO				2000	7850	15420	21420	29130
Denominated in domestic currency								0
Denominated in other currencies								0
Sum	0	0	0	2000	7850	15420	21420	29130
Outstanding fixed coupon				2000	6500	12150	18150	17980
Outstanding floating coupon					1350	3100	2925	10805
Outstanding other						170	345	345
Sum	0	0	0	2000	7850	15420	21420	29130
Number of Issuers				1	2	5	6	7

Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector						150	1000	250
New Issues of CBs - Mortgage				2000	5850	7420	6000	11610
New Issues of CBs - Ships								0
New Issues of CBs - Mixed Assets								0
Total Issuance	**0**	**0**	**0**	**2000**	**5850**	**7570**	**7000**	**11860**
Issuance Jumbo				2000	4500	5650	6000	3130
Issuance non-Jumbo					1350	1920	1000	8730
Sum	0	0	0	2000	5850	7570	7000	11860
Total Issuance Public Placement				2000	5850	7570	7000	11820
Total Issuance Private Placement								40
Sum	0	0	0	2000	5850	7570	7000	11860
Denominated in EURO				2000	5850	7570	7000	11860
Denominated in domestic currency								0
Denominated in other currencies								0
Sum	0	0	0	2000	5850	7570	7000	11860
Issuance fixed coupon				2000	4500	5650	6000	3080
Issuance floating coupon					1350	1750	825	8780
Issuance other						170	175	0
Sum	0	0	0	2000	5850	7570	7000	11860
Number of New Issuers				1	1	3	1	1

5.2.21 SLOVAKIA

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector								
Outstanding CBs - Mortgage	510	1052	1583	2214	2738	3576	3608	3442
Outstanding CBs - Ships								
Outstanding CBs - Mixed Assets								
Total Outstanding	**510**	**1052**	**1583**	**2214**	**2738**	**3576**	**3608**	**3442**
Outstanding Jumbo								
Outstanding non-Jumbo	510	1052	1583	2214	2738	3576	3608	3442
Sum	510	1052	1583	2214	2738	3576	3608	3442
Total Outstanding Public Placement	436	953	1435	1731	2111	2676	2900	1790
Total Outstanding Private Placement	73	100	148	482	627	900	708	1652
Sum	510	1052	1583	2214	2738	3576	3608	3442
Denominated in EURO				280	510	1189	3516	3350
Denominated in domestic currency	510	1052	1583	1934	2161	2296		
Denominated in other currencies					68	92	92	92
Sum	510	1052	1583	2214	2738	3576	3608	3442
Outstanding fixed coupon	510	1052	1223	1405	1666	1992	1845	1571
Outstanding floating coupon			360	809	1073	1584	1762	1871
Outstanding other								
Sum	510	1052	1583	2214	2738	3576	3608	3442
Number of Issuers	6	8	9	9	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
New Issues of CBs - Ships								
New Issues of CBs - Mixed Assets								
Total Issuance	**355**	**549**	**584**	**676**	**803**	**1414**	**707**	**1179**
Issuance Jumbo								
Issuance non-Jumbo	355	549	584	676	803	1414	707	1179
Sum	355	549	584	676	803	1414	707	1179
Total Issuance Public Placement	289	516	482	296	380	565	224	424
Total Issuance Private Placement	66	33	101	380	423	849	483	755
Sum	355	549	584	676	803	1414	707	1179
Denominated in EURO				280	230	679	707	1179
Denominated in domestic currency	355	549	584	396	505	711		
Denominated in other currencies					68	24	0	0
Sum	355	549	584	676	803	1414	707	1179
Issuance fixed coupon	355	549	223	227	539	902	529	349
Issuance floating coupon			360	449	264	512	178	830
Issuance other								
Sum	355	549	584	676	803	1414	707	1179
Number of New Issuers	0	2	1	0	0	0	0	0

5.2.22 SPAIN

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector	4900	7200	9640	11590	16375	17030	16030	18350
Outstanding CBs - Mortgage	57111	94707	150213	214768	266959	315055	336750	343401
Outstanding CBs - Ships								
Outstanding CBs - Mixed Assets								
Total Outstanding	**62011**	**101907**	**159853**	**226358**	**283334**	**332085**	**352780**	**361751**
Outstanding Jumbo	60598	98683	155463	220058	268723	309503	312686	317556
Outstanding non-Jumbo	1413	3224	4390	6300	14611	22582	40094	44195
Sum	62011	101907	159853	226358	283334	332085	352780	361751
Total Outstanding Public Placement	62011	101907	159853	226358	283334	332085	352780	361751
Total Outstanding Private Placement								
Sum	62011	101907	159853	226358	283334	332085	352780	361751
Denominated in EURO	62011	101907	159853	226358	283334	332085	352780	361751
Denominated in domestic currency								
Denominated in other currencies								
Sum	62011	101907	159853	226358	283334	332085	352780	361751
Outstanding fixed coupon	61921	100417	153588	212878	238273	261480	291235	309751
Outstanding floating coupon	90	1490	6265	13480	45061	70606	61545	52000
Outstanding other								
Sum	62011	101907	159853	226358	283334	332085	352780	361751
Number of Issuers	50	61	65	67	69	66	68	59
Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector	5600	1600	2440	5150	5060	1670	500	5900
New Issues of CBs - Mortgage	28502	37835	57780	69890	51801	54187	43580	51916
New Issues of CBs - Ships								
New Issues of CBs - Mixed Assets								
Total Issuance	**34102**	**39435**	**60220**	**75040**	**56861**	**55857**	**44080**	**57816**
Issuance Jumbo	31800	36335	58780	69230	50955	42510	31108	36620
Issuance non-Jumbo	2302	3100	1440	5810	5906	13347	12972	21196
Sum	34102	39435	60220	75040	56861	55857	44080	57816
Total Issuance Public Placement	34102	39435	60220	75040	56861	55857	44080	57816
Total Issuance Private Placement								
Sum	34102	39435	60220	75040	56861	55857	44080	57816
Denominated in EURO	34102	39435	60220	75040	56861	55857	44080	57816
Denominated in domestic currency								
Denominated in other currencies								
Sum	34102	39435	60220	75040	56861	55857	44080	57816
Issuance fixed coupon	33312	38635	55545	66125	35870	21957	37480	50891
Issuance floating coupon	790	800	4675	8915	20991	33900	6600	6925
Issuance other								
Sum	34102	39435	60220	75040	56861	55857	44080	57816
Number of New Issuers	14	11	4	2	2	1	4	1

Source: AIAF

5.2.23 SWEDEN

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector								
Outstanding CBs - Mortgage				55267	92254	117628	133903	188750
Outstanding CBs - Ships								
Outstanding CBs - Mixed Assets								
Total Outstanding	**0**	**0**	**0**	**55267**	**92254**	**117628**	**133903**	**188750**
Outstanding Jumbo				5283	11114	40100	45941	35785
Outstanding non-Jumbo				49984	81140	77528	87962	152965
Sum	0	0	0	55267	92254	117628	133903	188750
Total Outstanding Public Placement				54781	90780	115259	130049	184276
Total Outstanding Private Placement				486	1474	2369	3855	4474
Sum	0	0	0	55267	92254	117628	133903	188750
Denominated in EURO				5283	13171	21126	25787	35697
Denominated in domestic currency				49474	77436	93374	103809	144969
Denominated in other currencies				510	1648	3128	4308	8085
Sum	0	0	0	55267	92254	117628	133903	188750
Outstanding fixed coupon				55029	88944	112648	126116	172693
Outstanding floating coupon				21	3046	4259	7169	16013
Outstanding other				217	265	721	619	45
Sum	0	0	0	55267	92254	117628	133903	188750
Number of Issuers				3	6	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
New Issues of CBs - Ships								
New Issues of CBs - Mixed Assets								
Total Issuance	**0**	**0**	**0**	**17569**	**36638**	**43488**	**53106**	**79910**
Issuance Jumbo				5283	5875	16721	14480	16494
Issuance non-Jumbo				12286	30762	26767	38626	63417
Sum	0	0	0	17569	36638	43488	53106	79910
Total Issuance Public Placement				17482	36084	42631	50402	79000
Total Issuance Private Placement				87	554	856	2704	910
Sum	0	0	0	17569	36638	43488	53106	79910
Denominated in EURO				5283	7085	10975	6705	20797
Denominated in domestic currency				11794	28417	31490	44354	55117
Denominated in other currencies				492	1135	1023	2047	3997
Sum	0	0	0	17569	36638	43488	53106	79910
Issuance fixed coupon				17560	35779	39135	47375	68023
Issuance floating coupon				2	752	4353	5376	11888
Issuance other				7	107	0	354	0
Sum	0	0	0	17569	36638	43488	53106	79910
Number of New Issuers				3	3	1	0	0

5.2.24 SWITZERLAND

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010
Total Covered Bonds Outstanding								
Outstanding CBs - Pfandbriefe	30326	29941	29010	29395	29013	36180	43283	58046
Outstanding CBs - Structured							3000	4000
Total Outstanding	**30326**	**29941**	**29010**	**29395**	**29013**	**36180**	**46283**	**62046**
Outstanding Jumbo							3000	7000
Outstanding non-Jumbo	30326	29941	29010	29395	29013	36180	43283	55046
Sum	30326	29941	29010	29395	29013	36180	46283	62046
Total Outstanding Public Placement	30326	29941	29010	29395	29013	34917	39431	55456
Total Outstanding Private Placement						1263	6852	6590
Sum	30326	29941	29010	29395	29013	36180	46283	62046
Denominated in EURO							3000	7000
Denominated in domestic currency	30326	29941	29010	29395	29013	36180	43283	55046
Denominated in other currencies								
Sum	30326	29941	29010	29395	29013	36180	46283	62046
Outstanding fixed coupon	30326	29941	29010	29395	29013	36180	46283	62046
Outstanding floating coupon								
Outstanding other								
Sum	30326	29941	29010	29395	29013	36180	46283	62046
Number of Issuers	2	2	2	2	2	2	3	4

Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Pfandbriefe	3027	2755	4171	4967	4559	5316	9414	10834
New Issues of CBs - Structured							3000	4000
Total Issuance	**3027**	**2755**	**4171**	**4967**	**4559**	**5316**	**12414**	**14834**
Issuance Jumbo							3000	4000
Issuance non-Jumbo	3027	2755	4171	4967	4559	5316	9414	10834
Sum	3027	2755	4171	4967	4559	5316	12414	14834
Total Issuance Public Placement	2500	2342	3940	4047	4559	4053	6236	14834
Total Issuance Private Placement	527	413	231	920	0	1263	6178	0
Sum	3027	2755	4171	4967	4559	5316	12414	14834
Denominated in EURO							3000	4000
Denominated in domestic currency	3027	2755	4171	4967	4559	5316	9414	10834
Denominated in other currencies								
Sum	3027	2755	4171	4967	4559	5316	12414	14834
Issuance fixed coupon	3027	2755	4171	4967	4559	5316	12414	14834
Issuance floating coupon								
Issuance other								
Sum	3027	2755	4171	4967	4559	5316	12414	14834
Number of New Issuers	0	0	0	0	0	0	1	1

Note: from 2008 only Limmat bonds are considered as "Private Placements"

5.2.25 UNITED KINGDOM

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector	0	0	0	0	0	0	3439	3548
Outstanding CBs - Mortgage	5000	14959	26778	50548	81964	204278	201096	205370
Outstanding CBs - Ships	0	0	0	0	0	0	0	0
Outstanding CBs - Mixed Assets	0	0	0	0	0	0	0	0
Total Outstanding	**5000**	**14959**	**26778**	**50548**	**81964**	**204278**	**204535**	**208918**
Outstanding Jumbo	5000	14250	23250	43750	61000	60689	60750	68049
Outstanding non-Jumbo	0	709	3528	6798	20964	143589	143785	140869
Sum	5000	14959	26778	50548	81964	204278	204535	208918
Total Outstanding Public Placement	5000	14959	26778	50548	81964	204278	204535	206868
Total Outstanding Private Placement	0	0	0	0	0	0	0	2049
Sum	5000	14959	26778	50548	81964	204278	204535	208918
Denominated in EURO	5000	14250	24384	44884	69672	76697	70683	76884
Denominated in domestic currency	0	709	2335	3127	4704	118937	125491	122353
Denominated in other currencies	0	0	60	2536	7588	8644	8361	9681
Sum	5000	14959	26778	50548	81964	204278	204535	208918
Outstanding fixed coupon	5000	14959	24689	48467	76515	78613	71668	81586
Outstanding floating coupon	0	0	2089	2081	4563	125505	132867	127332
Outstanding other	0	0	0	0	886	160	0	0
Sum	5000	14959	26778	50548	81964	204278	204535	208918
Number of Issuers	1	3	5	8	8	19	22	22

Issuance (in EUR million)								
Total Covered Bonds Issuance								
New Issues of CBs - Public Sector	0	0	0	0	0	0	3439	0
New Issues of CBs - Mortgage	5000	9959	11819	23770	31874	121030	30431	28636
New Issues of CBs - Ships	0	0	0	0	0	0	0	0
New Issues of CBs - Mixed Assets	0	0	0	0	0	0	0	0
Total Issuance	**5000**	**9959**	**11819**	**23770**	**31874**	**121030**	**33870**	**28636**
Issuance Jumbo	5000	9250	9000	20500	17250	0	3750	17200
Issuance non-Jumbo	0	709	2819	3270	14624	121030	30120	11436
Sum	5000	9959	11819	23770	31874	121030	33870	28636
Total Issuance Public Placement	5000	9959	11819	23770	31874	121030	33870	26587
Total Issuance Private Placement	0	0	0	0	0	0	0	2049
Sum	5000	9959	11819	23770	31874	121030	33870	28636
Denominated in EURO	5000	9250	10134	20500	24788	7763	5535	21871
Denominated in domestic currency	0	709	1626	745	1841	113267	28335	5747
Denominated in other currencies	0	0	60	2525	5245	0	0	1018
Sum	5000	9959	11819	23770	31874	121030	33870	28636
Issuance fixed coupon	5000	9959	9730	23770	28424	2618	3750	20541
Issuance floating coupon	0	0	2089	0	2564	118253	30120	8095
Issuance other	0	0	0	0	886	159	0	0
Sum	5000	9959	11819	23770	31874	121030	33870	28636
Number of New Issuers	1	2	2	3	0	11	4	1

5.2.26 UNITED STATES

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Total Covered Bonds Outstanding								
Outstanding CBs - Public Sector								
Outstanding CBs - Mortgage				4000	12859	12937	12888	11497
Outstanding CBs - Ships								
Outstanding CBs - Mixed Assets								
Total Outstanding	**0**	**0**	**0**	**4000**	**12859**	**12937**	**12888**	**11497**
Outstanding Jumbo				4000	12859	12937	12888	11497
Outstanding non-Jumbo								
Sum	0	0	0	4000	12859	12937	12888	11497
Total Outstanding Public Placement				4000	12859	12937	12888	11497
Total Outstanding Private Placement								
Sum	0	0	0	4000	12859	12937	12888	11497
Denominated in EURO				4000	11500	11500	11500	10000
Denominated in domestic currency					1359	1437	1388	1497
Denominated in other currencies								
Sum	0	0	0	4000	12859	12937	12888	11497
Outstanding fixed coupon				4000	12859	12937	12888	11497
Outstanding floating coupon								
Outstanding other								
Sum	0	0	0	4000	12859	12937	12888	11497
Number of Issuers				1	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	**0**	**0**	**0**	**4000**	**8859**	**0**	**0**	**0**
Issuance Jumbo				4000	8859			
Issuance non-Jumbo								
Sum	0	0	0	4000	8859	0	0	0
Total Issuance Public Placement				4000	8859			
Total Issuance Private Placement								
Sum	0	0	0	4000	8859	0	0	0
Denominated in EURO				4000	7500			
Denominated in domestic currency					1359			
Denominated in other currencies								
Sum	0	0	0	4000	8859	0	0	0
Issuance fixed coupon				4000	8859			
Issuance floating coupon								
Issuance other								
Sum	0	0	0	4000	8859	0	0	0
Number of New Issuers				1	1	0	0	0

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