ECBC

EUROPEAN COVERED BOND **FACT BOOK**

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ECBC

European Covered Bond Council

The Covered Bond Voice of the European Mortgage Federation

EUROPEAN MORTGAGE FEDERATION

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Contact Details

Luca Bertalot
Secretary General
lbertalot@hypo.org

Paloma Repullo Conde
Economic Adviser
prepullo@hypo.org

Maria Pavlova
Junior Policy Adviser
mpavlova@hypo.org

Sophie Blave
Administrative Assistant
sblave@hypo.org

EUROPEAN MORTGAGE FEDERATION – EUROPEAN COVERED BOND COUNCIL (EMF-ECBC)
Avenue de Cortenbergh 71
B-1000 Brussels
Tel: +32 2 285 40 30

LIST OF EDITORS

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

Luca Bertalot
Secretary General
EUROPEAN COVERED BOND COUNCIL
lbertalot@hypo.org

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

Maria Pavlova
Junior Policy Adviser
EUROPEAN COVERED BOND COUNCIL
mpavlova@hypo.org

LIST OF CONTRIBUTORS

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

FOREWORD

Carsten Tirsbæk Madsen
Chairman
EUROPEAN COVERED BOND COUNCIL
ctm@brf.dk

Luca Bertalot
Secretary General
EUROPEAN COVERED BOND COUNCIL
lbertalot@hypo.org

CHAPTER 1
KEY THEMES OF THE YEAR

Wolfgang Kälberer
Chairman of the ECBC Fact Book Working Group
Head of Brussels Office
ASSOCIATION OF GERMAN PFANDBRIEF BANKS – vdp
kaelberer@pfandbrief.de

Florian Eichert
Chairman of the ECBC Statistics & Data Working Group
Senior Covered Bond Analyst – Credit Research
CRÉDIT AGRICOLE CIB
florian.eichert@ca-cib.com

Frank Will
Chairman of the ECBC EU Legislation Working Group
Head of Covered Bond Research
HSBC TRINKAUS & BURKHARDT
frank.will@hsbc.de

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

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

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

Julian Kreipl
Credit Analyst
LANDESBANK BADEN-WÜRTTEMBERG – LBBW
julian.kreipl@lbbw.de

Maureen Schuller
Head of Covered Bond Strategy
ING BANK N.V.
maureen.schuller@ingbank.com

Jean-David Cirotteau
Director – Senior Analyst Structured Finance
SOCIÉTÉ GÉNÉRALE
jean-david.cirotteau@sgcib.com

Cristina Costa
Senior Covered Bond Analyst
SOCIÉTÉ GÉNÉRALE
cristina.costa@sgcib.com

Matthias Melms
Senior Covered Bond Analyst; Director - Fixed Income Research
NORDDEUTSCHE LANDESBANK - NORD/LB - GERMANY
matthias.melms@nordlb.de

Florian Hillenbrand
Director, Senior Covered Bond Analyst
UNICREDIT
florian.hillenbrand@unicredit.de

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

Ralf Berninger
Co-Head Investor Relations
CAISSE FRANÇAISE DE FINANCEMENT LOCAL
ralf.berninger@sfil.fr

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

Ralf Burmeister
Senior Portfolio Manager
DEUTSCHE ASSET & WEALTH MANAGEMENT

Nathalie Aubry-Stacey
Director/Market Practice and Regulatory Policy
INTERNATIONAL CAPITAL MARKET ASSOCIATION
Nathalie.aubry-stacey@icmagroup.org

CHAPTER 2
GENERIC SECTION

Ralf Grossmann
Chairman of the ECBC Technical Issues Working Group
Head of Covered Bond - Origination
SOCIETE GENERALE
ralf.grossmann@sgcib.com

Otmar Stöcker
Managing Director
ASSOCIATION OF GERMAN PFANDBRIEF BANKS - vdp
stoecker@pfandbrief.de

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

Fritz Engelhard
Covered Bond Strategist
BARCLAYS
fritz.engelhard@barclays.com

Florian Eichert
Chairman of the ECBC Statistics & Data Working Group
Senior Covered Bond Analyst – Credit Research
CREDIT AGRICOLE CIB
florian.eichert@ca-cib.com

Stephan Dorner
Covered Bond Analyst – Credit Research
CREDIT AGRICOLE CIB
stephan.dorner@ca-cib.com

Richard Kemmish
CONSULTANT
richardkemmish@outlook.com

Jan King
Senior Covered Bond Analyst
ROYAL BANK OF SCOTLAND
jan.king@rbs.com

Frank Will
Chairman of the ECBC EU Legislation Working Group
Head of Covered Bond Research
HSBC TRINKAUS & BURKHARDT
frank.will@hsbc.de

Rondeep Barua
Associate
BANK OF AMERICA MERRILL LYNCH
rondeep.barua@baml.com

Jerry Marlatt
Senior of Counsel
MORRISON & FOERSTER LLP
jmarlatt@mofo.com

CHAPTER 3
THE ISSUER'S PERPECTIVE

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

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

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

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

BULGARIA
Yolanda Hristova
Manager Capital Markets
UNICREDIT BULBANK
yolanda.hristova@unicreditgroup.bg

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

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

CHILE
Antonio Procopio
ALM Markets Executive
BANCO SANTANDER CHILE
aprocopio@santander.cl

Emiliano Muratore
Managing Director / Head of ALM
BANCO SANTANDER CHILE
emurator@santander.cl

Patricia Perez
Head of Markets - ALM
BANCO SANTANDER CHILE
pperezpa@santander.cl

CYPRUS
Ioannis Georgiou
Head of Liquidity Management & Group Funding
BANK OF CYPRUS
yiannis.georgiou@bankofcyprus.com

CZECH REPUBLIC
Libor Ondřich
Asset Liability Management Specialist
UNICREDIT BANK CZECH REPUBLIC AND SLOVAKIA, A.S.
libor.ondrich@unicreditgroup.cz

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

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

FINLAND
Timo Ruotsalainen
Head of Treasury and IR, AKTIA BANK PLC
Managing Director, AKTIA REMB PLC
tel: +358 10 247 7211; mob: +358 50 386 1753

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

FRANCE
Francis Gleyze
Chief Executive Officer of CIF Euromortgage
CREDIT IMMOBILIER DE FRANCE GROUP
francis.gleyze@creditimmobilierdefrance.com

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

Cristina Costa
Senior Covered Bond Analyst
SOCIÉTÉ GÉNÉRALE
cristina.costa@sgcib.com

Boudewijn Dierick
Head of Flow ABS and Covered Bond Structuring
BNP PARIBAS
boudewijn.dierick@uk.bnpparibas.com

Diane Jammaron
CIB Legal Paris
BNP PARIBAS
diane.jammaron@bnpparibas.com

Jennifer Levy
Senior Covered Bond Analyst
NATIXIS
jennifer.levy@natixis.com

GERMANY
Wolfgang Kälberer
Head of Brussels Office
ASSOCIATION OF GERMAN PFANDBRIEF BANKS - VDP
kaelberer@pfandbrief.de

Otmar Stöcker
Managing Director
ASSOCIATION OF GERMAN PFANDBRIEF BANKS - VDP
stoecker@pfandbrief.de

GREECE
Alexander Metallinos
Partner
KARATZAS & PARTNERS LAW FIRM
a.metallinos@karatza-partners.gr

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

ICELAND
Eiríkur Magnús Jensson
Head of Funding
ARION BANK
eirikur.jensson@arionbanki.is

Kristín Erla Jónsdóttir
Funding manager
ARION BANK
kristin.erla.jonsdottir@arionbanki.is

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

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

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

LATVIA
Mr Aivars Graudiņš
Vice President
ASSOCIATION OF LATVIAN COMMERCIAL BANKS
aivars.graudins@bankasoc.lv

LUXEMBOURG
Reinolf Dibus
Member of the Board of Directors & Managing Director
HYPOTHEKENBANK FRANKFURT INTERNATIONAL S.A.
reinolf.dibus@hypothekenbankfrankfurt.com

Frank Will
Head of Covered Bond Research
HSBC TRINKAUS & BURKHARDT
frank.will@hsbc.de

THE NETHERLANDS
Thijs Naeije
Secured Funding
ABN AMRO BANK N.V.
thijs.naeije@nl.abnamro.com

Kees Westermann & Miranda Gossen
Advocaten
RUTGERS & POSCH
kees.westermann@rutgersposch.com
miranda.gossen@rutgersposch.com

NEW ZEALAND
Geoff Martin
Head of Funding
KIWIBANK
geoff.martin@kiwibank.co.nz

Frank Will
Head of Covered Bond Research
HSBC TRINKAUS & BURKHARDT
frank.will@hsbc.de

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

Torkil Wiberg
Analyst - Economics and Capital Markets
FINANCE NORWAY – FNO
torkil.wiberg@fno.no

PANAMA
Frank Will
Head of Covered Bond Research
HSBC TRINKAUS & BURKHARDT
frank.will@hsbc.de

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

Piotr Cyburt
CEO
mBANK HIPOTECZNY
piotr.cyburt@mhipoteczny.pl

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

ROMANIA
Irina Neacsu
Business development director
BANCA COMERCIALA CARPATICA
irina.neacsu@carpatica.ro
in the name of Romanian Banking Association

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

RUSSIA
Tim Lassen
Director for foreign legal affairs
"PFP-GROUP" LTD., Moscow
Russian Federation
timlassen@msk.pfpg.ru

SINGAPORE
Colin YS Chen
Managing Director and Head - Structured Debt Solutions
DBS BANK Ltd.
colinchen@dbs.com

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

SLOVAKIA
Viktória Múčková
Mortgage Trustee
CSOB
muckovaviktoria@gmail.com

Jaroslav Sobolič
Financial Markets Sales Section
CSOB
jsobolic@csob.sk

SLOVENIA
Damjana Lavrič
Deputy General Manager
NOVA LJUBLJANSKA BANKA D.D., LJUBLJANA
damjana.lavric@nlb.si

Matjaž Grčar
Senior Area Manager
NOVA LJUBLJANSKA BANKA D.D., LJUBLJANA
matjaz.grcar@nlb.si

Maja Koritnik
Senior Adviser
NOVA LJUBLJANSKA BANKA D.D., LJUBLJANA
maja.koritnik@nlb.si

SOUTH KOREA
Hoin Lee
Senior Foreign Attorney
KIM & CHANG
Hoin.lee@kimchang.com

Frank Will
Head of Covered Bond Research
HSBC TRINKAUS & BURKHARDT
frank.will@hsbc.de

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

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

SWITZERLAND
Robert Horat
Chief Executive Officer
PFANDBRIEFBANK SCHWEIZERISCHER HYPOTHEKARINSTITUTE AG
robert.horat@pfandbriefbank.ch

UBS INVESTMENT BANK

TURKEY
Ozlem Gokceimam
Manager / Head of Structured Finance
GARANTI BANK
ozlemgokc@garanti.com.tr

Serdar Sari
Supervisor / Structured Finance
GARANTI BANK
serdarsari2@garanti.com.tr

UNITED KINGDOM
John Millward
Director, Structured Finance
HSBC BANK PLC
john.millward@hsbcgroup.com

Jussi Harju
Senior Covered Bond Analyst
BARCLAYS CAPITAL
jussi.harju@barclays.com

UNITED STATES
Anne Caris
Director-Covered Bond Analyst
BANK OF AMERICA MERRILL LYNCH
anne.caris@baml.com

Jerry Marlatt
Senior of Counsel
MORRISON & FOERSTER LLP
jmarlatt@mofo.com

CHAPTER 4
RATING AGENCIES & METHODOLOGY

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

DBRS
Vito Natale
Senior Vice President, EU Covered Bonds
DRBS
vnatale@dbrs.com

Claire Mezzanotte
Group Managing Director
DBRS
cmezzanotte@dbrs.com

FITCH
Carmen Muñoz
Senior Director
FITCH RATINGS
carmen.munoz@Fitchratings.com

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

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

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

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

STANDARD & POOR'S
Roberto Paciotti
Managing Director - Analytical Manager Covered Bonds
STANDARD & POOR'S
roberto.paciotti@standardandpoors.com

Bernd Ackermann
Senior Director
STANDARD & POOR'S
bernd.ackermann@standardandpoors.com

CHAPTER 5
COVERED BOND STATISTICS

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

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

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

Katarzyna Kapeller
Head Office Treasury
RAIFFEISEN BANK INTERNATIONAL AG
katarzyna.kapeller@rbinternational.com

BELGIUM
Maureen Schuller
Head of Covered Bond Strategy
ING BANK N.V.
maureen.schuller@ingbank.com

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

Rondeep Barua
Associate
BANK OF AMERICA MERRILL LYNCH
rondeep.barua@baml.com

CYPRUS
Ioannis Georgiou
Head of Liquidity Management & Group Funding
BANK OF CYPRUS
yiannis.georgiou@bankofcyprus.com

CZECH REPUBLIC
Stepan Nyvlt
Head of Debt Origination / Structuring & Bond Sales
UNICREDIT BANK CZECH REPUBLIC AND SLOVAKIA, A.S.
stepan.nyvlt@unicreditgroup.cz

DENMARK
Kaare Christensen
Senior Economist
ASSOCIATION OF DANISH MORTGAGE BANKS
kc@rkr.dk

FINLAND
Timo Ruotsalainen
Head of Treasury and IR, AKTIA BANK PLC
Managing Director, AKTIA REMB PLC
tel: +358 10 247 7211; mob: +358 50 386 1753

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

FRANCE
Boudewijn Dierick
Head of Flow ABS and Covered Bond Structuring
BNP PARIBAS
boudewijn.dierick@uk.bnpparibas.com

GERMANY
Swen Prilla
Referent Kapitalmarkt
ASSOCIATION OF GERMAN PFANDBRIEF BANKS - VDP
prilla@pfandbrief.de

GREECE
Dimitris Spathakis
Asset & Liability Management
PIRAEUS BANK
spathakisd@piraeusbank.gr

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

ICELAND
Eiríkur Magnús Jensson
Head of Funding
ARION BANK
eirikur.jensson@arionbanki.is

Kristín Erla Jónsdóttir
Funding manager
ARION BANK
kristin.erla.jonsdottir@arionbanki.is

IRELAND
Gavin Purtill
Manager
IBF - IRISH BANKING FEDERATION / ACS IRELAND
gavin.purtill@ibf.ie

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

LATVIA
Matthias Melms
Senior Covered Bond Analyst; Director - Fixed Income Research
NORDDEUTSCHE LANDESBANK - NORD/LB - GERMANY
matthias.melms@nordlb.de

LUXEMBOURG
Matthias Melms
Senior Covered Bond Analyst; Director - Fixed Income Research
NORDDEUTSCHE LANDESBANK - NORD/LB - GERMANY
matthias.melms@nordlb.de

THE NETHERLANDS
Maureen Schuller
Head of Covered Bond Strategy
ING BANK N.V.
maureen.schuller@ingbank.com

NEW ZEALAND
Frank Will
Head of Covered Bond Research
HSBC TRINKAUS & BURKHARDT
frank.will@hsbc.de

NORWAY
Torkil Wiberg
Analyst - Economics and Capital Markets
FINANCE NORWAY – FNO
torkil.wiberg@fno.no

PANAMA
Frank Will
Head of Covered Bond Research
HSBC TRINKAUS & BURKHARDT
frank.will@hsbc.de

POLAND
Agnieszka Nierodka
Chief Economist
POLISH MORTGAGE CREDIT FOUNDATION
a.nierodka@ehipoteka.pl

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

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

SLOVAKIA
Viktória Múčková
Mortgage Trustee
CSOB
muckovaviktoria@gmail.com

Jaroslav Sobolič
Financial Markets Sales Section
CSOB
jsobolic@csob.sk

SOUTH KOREA
Frank Will
Head of Covered Bond Research
HSBC TRINKAUS & BURKHARDT
frank.will@hsbc.de

SPAIN
Lorena Mullor
Manager
SPANISH MORTGAGE ASSOCIATION - AHE
lorena.mullor@ahe.es

Irene Peña Cuenca
Senior Economist
SPANISH MORTGAGE ASSOCIATION - AHE
ipcuenca@ahe.es

SWEDEN
Christian Nilsson
Senior Adviser, Statistics and Reporting
ASSOCIATION OF SWEDISH COVERED BOND
ISSUERS (ASCB)
christian.nilsson@swedishbankers.se

SWITZERLAND
Francesco Dissera
Executive Director - Debt Capital Markets
UBS LIMITED
francesco.dissera@ubs.com

Robert Horat
Chief Executive Officer
PFANDBRIEFBANK SCHWEIZERISCHER
HYPOTHEKARINSTITUTE AG
robert.horat@pfandbriefbank.ch

TURKEY
Gencay Gedik
Associate, Structured Finance, Financial Institutions
GARANTI BANK
gencayge@garanti.com.tr

UNITED KINGDOM
Chris Fielding
Executive Director
REGULATED COVERED BOND COUNCIL – UKRCBC
chris.fielding@ukrcbc.org

Michael Weigerding
Covered Bond Research
COMMERZBANK
michael.weigerding@commerzbank.com

UNITED STATES
Anne Caris
Director-Covered Bond Analyst
BANK OF AMERICA MERRILL LYNCH
anne.caris@baml.com

TABLE OF CONTENTS

CHAPTER 5 - COVERED BOND STATISTICS 511

FOREWORD

The covered bond is at the heart of the financial tradition of Europe, playing a central role in funding strategies for the last two centuries. The strategic importance of covered bonds as a long-term funding tool is now recognised at a global level. Major jurisdictions including Australia, Brazil, Canada, Chile, India, Japan, Mexico, Morocco, New Zealand, Panama, Peru, Singapore, South Korea and the United States, are either in the process of adopting covered bond legislation or are investigating the introduction of covered bonds. This year's Fact Book provides comprehensive coverage of these new legislative frameworks and developments, and shows how the ECBC is developing its role as the principal voice of covered bonds, not just in Europe but globally.

During the recent years of market turmoil, covered bonds demonstrated a strong degree of resilience. Throughout the crisis, they played a pivotal role in bank wholesale funding, providing lenders with a cost-effective and reliable long-term funding instrument for mortgage and public-sector loans. Industry continues to build on the lessons learnt from the financial crisis while maintaining a focus on the essential features and qualities that have made the asset class such a success story. The ECBC believes that the quality of the asset class will continue to be the basis of our strength in the future.

The resilience of covered bonds is based on key safety features. Strict legal and supervisory frameworks, asset segregation, and a dynamic cover pool maintaining the quality of the collateral are all essential characteristics which ensure bondholders' protection and market confidence.

The success of covered bonds also lies in the industry's capacity to respond to the challenges of the current crises and its ability to share best market practices. This allows a continuous fine-tuning of European covered bond legislation and facilitates a strong level of transparency of the asset class. The instrument has enabled member states in Europe to continue to channel private sector funds to housing markets and maintain efficient lending activity without an additional increase of burden for taxpayers or public debt. Covered bonds provide essential funding for housing finance, providing banks with a long-term funding instrument that avoids asset and liability mismatches. Furthermore, the on-balance sheet nature of covered bonds is an efficient and simple alternative to complex originate-to-distribute products ensuring financial stability.

Covered bonds are an effective tool to channel long-term financing for high quality assets at reasonable costs. They improve banks' ability to borrow and lend and, hence, represent a stable source of funding for key banking functions, such as housing loans and public infrastructure. In this respect, we believe that covered bonds represent a key funding tool for the future European banking industry.

Lending capacity, funding flexibility and long term financing are key issues at the centre of the current economic and legislative debate in Europe and at global level. The covered bond industry shares the objectives of the current legislative developments underway in Europe.

The commitment to contribute to European efforts to enhance financial stability and transparency has led the covered bond industry to launch a quality Label. The Covered Bond Label was developed by the European issuer community working in close cooperation with investors and regulators, and in consultation with all major stakeholders such as the European Commission and the European Central Bank. The Label is based on the Covered Bond Label Convention, which defines the core characteristics required for a covered bond programme to qualify for the Label.

The Covered Bond Label and its transparency platform (www.coveredbondlabel.com) are operational since January 2013, providing detailed covered bond market data, comparable cover pool information and legislative details on the various national legal frameworks designed to protect bondholders. As of August 2014, 81 labels were granted to 70 issuers from 13 European Member States, covering over €1.3 trillion of covered bonds outstanding.

In this context, covered bond issuers from these 13 different jurisdictions have come together to develop a National Transparency Template. This provides cover pool information in a harmonised format on the basis of guidelines agreed at European level. The format allows for both the recognition of national specificities and the comparability of information required to facilitate investors' due diligence.

The critical mass achieved by this initiative is a clear sign that the industry sees the need to respond to the requirements of new classes of investors by providing higher levels of transparency to aid investment decisions. It is also important to highlight the progress that has been made in recent years in terms of collating and distributing relevant macro-level information on the covered bond sector:

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

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

In conclusion, the European Covered Bond Council believes that the quality of the asset class is the basis of our strength in the future. More work needs to be done, but we believe that the initiatives underway will strengthen the asset class and facilitate the convergence of market and supervisory best practice in the covered bond markets. The increased recognition by policymakers and regulators of the central role that the asset class plays for the banking system and also for financial stability reinforces the need for an appropriate regulatory framework for covered bonds at European and International levels.

FACTBOOK

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

Chapter II provides a detailed explanation of covered bond fundamentals, including reviews of some of the current European regulatory changes that are bound to have a direct, significant impact on covered bonds, mainly the Capital Requirements Directive and Regulation (CRD IV and CRR), Solvency II and MiFIR. This chapter also includes articles outlining the repo treatment of covered bonds by central banks; investigating the relationship between covered bonds and other asset classes such as senior unsecured and government bonds; and describing the USD & GBP denominated covered bond markets.

Chapter III presents an overview of the legislation and markets in 37 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 would like extend our appreciation to the Chairmen of the ECBC "Fact Book" and "Statistics & Data" Working Groups, Mr Wolfgang Kälberer and Mr Florian Eichert respectively, as well as to all Fact Book contributors, whose efforts have once again produced an outstanding edition of the ECBC Fact Book.

Carsten Tirsbæk Madsen
ECBC Chairman

Luca Bertalot
EMF-ECBC Secretary General

ECBC
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 2014, 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 ECBC and the EMF are currently in the process of re-integrating under a common umbrella entity, the "Covered Bond & Mortgage Council". The intention is to further develop synergies, share market best practices, achieve convergence across the whole value chain of this Industry, and, at the same time, to act as a market catalyst in origination and funding techniques.

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

ECBC STRUCTURE

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

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

ECBC WORKING GROUPS

> **The EU Legislation Working Group**, chaired by Mr Frank Will, has over the past 8 years been closely following the debate on the Capital Requirements Directive (CRD) and has been successfully lobbying at EU level to obtain treatment that recognises the low risk profile of the instrument. In this respect, the group has drafted and passed comments to the European Institutions.

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

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

> **The Working Group on Statistics and Data**, chaired by Mr Florian Eichert, is responsible for collecting and publishing complete and up-to-date information on issuing activities and volumes outstanding of covered bonds in all market segments. With over 30 different covered bond jurisdictions and numerous issuers, the collection of data is of utmost importance, particularly given that the ECBC data is increasingly viewed as the key source of covered bond statistics.

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

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

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 amongst the different covered bonds stakeholders, in working as a catalyst in defining the common features that characterise the asset class and in facilitating improvements in market practices, transparency and liquidity.

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

Luca Bertalot,
EMF-ECBC Secretary General

ECBC MEMBERS

ABN Amro

Aktia Real Estate Mortgage Bank plc

Allen & Overy

Allied Irish Banks Plc. - AIB

Asociación de Intermediarios de Activos - AIAF

Asociación Hipotecaria Española - AHE

Association of Danish Mortgage Banks - Realkreditrådet

Association of Hungarian Mortgage Banks – Magyar Jelzálogbank Egyesület

Association of Swedish Covered Bond Issuers –ASCB

AXA Bank Europe SCF

Banca Popolare di Milano - BPM

Banco Espírito Santo - BES

Bank of America Merrill Lynch

Bank of Ireland Mortgages Bank

Bankia

Banque Fédérale des Banques Populaires – BPCE

Barclays

Barclays Germany

Bayerische Landesbank - Bayern LB

Belfius Bank

Bloomberg LP

BNP Paribas

BNP Paribas Fortis

BRFKredit A/S

Caisse Centrale du Crédit Immobilier de France – 3CIF

Caisse de Refinancement de l'Habitat – CRH

Caixa Geral de Depósitos S.A.

Canada Mortgage and Housing Corporation - CMHC

Citigroup Global Markets Germany

Clifford Chance LLP

Commerzbank Securities

Crédit Agricole Corporate & Investment Bank

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

Crédit Foncier de France

Crédit Mutuel - CIC Home Loan SFH

Crédit Mutuel Arkéa

Credit Suisse

Danish Ship Finance

Danske Bank

DBRS Ratings Limited

Depfa ACS Bank

Deutsche Bank AG

DLR Kredit A/S

DnB NOR Bolligkreditt

Dutch Association of Covered Bond Issuers - DACB

DZ Bank

EAA Covered Bond Bank Plc.

Eurex Bonds

EuroMTS

European AVM Alliance - EAA

Finance Norway - FNO

Fitch Ratings Ltd

GOH Portugal

Goldman Sachs

Grupo BBVA

Gruppo Banca Carige

HSBC Bank Plc.

ICAP Deutschland GmbH

ING Group

Intesa Sanpaolo

Irish Banking Federation - ACS Ireland

Italian Banking Association - Associazione Bancaria Italiana - ABI

JP Morgan

KBC Bank

Korea Housing Finance Corporation - KHFC

La Banque Postale Home Loan SFH

Landesbank Baden-Württemberg – LBBW

Linklaters LLP

Lloyds Banking Group

Luxembourg Bankers’ Association - ABBL

Moody’s

Morgan Stanley Bank AG

Nationwide Building Society

Natixis

Nederlandse Vereniging van Banken - NVB

NIBC Bank N.V.

Nomura International Plc.

Norddeutsche Landesbank Girozentrale

Nordea Hypotek

Nykredit A/S

OP Mortgage Bank

pbb Deutsche Pfandbriefbank AG

Pfandbrief & Covered Bond Forum Austria

Pfandbriefbank schweizerische Hypothekarinstitute

Realkredit Danmark A/S

Realkreditforeningen

Royal Bank of Canada - RBC

Royal Bank of Scotland - RBS

Santander UK Plc.

SEB AG

SNS Reaal Bank NV

Société de Financement Local

Société Générale Corporate & Investment Banking

Société Générale Société de Crédit Foncier - SG SCF

Standard & Poor’s

Svenska Handelsbanken – Stadshypotek

TD Bank Group

TXS GmbH

UBI Banca

UBS

UK Regulated Covered Bond Council - UKRCBC

UniCredit Group

Verband Deutscher Pfandbriefbanken e.V. - vdp

White & Case LLP

August 2014

COVERED BOND · LABEL ·

COVERED BOND LABEL

The Covered Bond Label is a quality Label which responds to a market-wide request for common qualitative and quantitative standards and for an enhanced level of transparency and comparability in the European covered bond market. The Label:

> Establishes a clear perimeter for the asset class and highlights the core standards and quality of covered bonds;

> Increases transparency;

> Improves access to information for investors, regulators and other market participants;

> Has the additional objective of improving liquidity in covered bonds;

> Positions the covered bond asset class with respect to the regulatory challenges (CRD IV, Solvency II, redesign of ECB repo rules, etc.).

The Covered Bond Label was founded by the EMF-ECBC in 2012 and it was developed by the European issuer community, working in close cooperation with investors and regulators, and in consultation with all major stakeholders. It became fully operational on the 1st of January 2013, with the first Labels being effective since then.

As of August 2014, visitors can find 13 National Transparency Templates, 70 issuer Profiles and information on 81 labelled cover pools with issuance data on over 4,000 covered bonds amounting to a total face value of over 1.3 trillion EUR.

The Label is based on the Covered Bond Label Convention (see below), which defines the core characteristics required for a covered bond programme to qualify for the Label. This definition of the required characteristics is complemented by a transparency tool developed at national level based on the "Guidelines for National Transparency Templates".

2014 Covered Bond Label Convention

Covered bonds are debt securities, backed by mortgage, public sector or ship assets, and characterised by a twofold bondholders' protection mechanism rooted in a dedicated covered bond legal framework.

In more details:

I Legislation safeguards

a) The CB programme is embedded in a dedicated national CB legislation;

b) The bond is issued by -or bondholders otherwise have full recourse, direct or indirect[1], to- a credit institution which is subject to public regulation and supervision;

c) The obligations of the credit institution in respect of the cover pool are supervised by public supervisory authorities.

II Security features intrinsic to the CB product

a) Bondholders have a dual claim against:

i. The issuing credit institution as referred to in point I b);

ii. A cover pool of financial assets[2] (mortgage, public sector or ship assets), ranking senior to the unsecured creditors.

1 Including pooling models consisting only of covered bonds issued by credit institutions.

2 The financial assets eligible for the cover pool (including substitution assets and derivative instruments) and their characteristics are defined in the national covered bond legislation which complies with the requirements of Article 52(4) of the UCITS Directive and Article 129 of the CRR, as well as those articles which specify its implementation. A phase-in period of up to 1 year from the 1st of January 2014 is granted to issuers where the national implementation of CRR in their home country requires a longer implementation period.

b) The credit institution has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times.

c) Issuers are committed to providing regular information enabling investors to analyse the cover pool, following the guidelines developed at national level.

For further information on the Covered Bond Label Convention, visit www.coveredbondlabel.com

LABELLED COVER POOLS

AUSTRIA

UniCredit Bank Austria AG Credit Public Sector

UniCredit Bank Austria AG Credit Mortgage

DENMARK

BRFKredit a/s Capital Center E

Danish Ship Finance General Capital Center

Danske Bank A/S Cover Pool D - Denmark

Danske Bank A/S Cover Pool I - International

Danske Bank A/S Cover Pool C – Commercial

DLR Kredit A/S Capital Centre B

Nordea Kredit Capital Center 1

Nordea Kredit Capital Center 2

Nykredit Capital Centre E

Nykredit Capital Centre H

Realkredit Danmark A/S Capital Centre S

Realkredit Danmark A/S Capital Centre T

FINLAND

Danske Bank Plc Pool 1

Nordea Bank Finland cover pool

OP Mortgage Bank, Pool B

FRANCE

AXA Bank Europe SCF

BNP Paribas Home Loan SFH

BNP Paribas Public Sector SCF

BPCE Home Loan SFH

Caisse de Refinancement de l’Habitat

Caisse Française de Financement Local

Compagnie de Financement Foncier

Credit Agricole Home Loan SFH

Credit Agricole Public Sector SCF

Crédit Mutuel - CIC Home Loan SFH

Crédit Mutuel Arkéa Home Loans SFH

Crédit Mutuel Arkéa Public Sector SCF

HSBC SFH (France)

La Banque Postale Home Loan SFH

SG Credit Public Sector SCF

SG Credit Home Loan SFH

GERMANY

NORD/LB

UniCreditBank AG HVB Mortgage

UniCreditBank AG HVB Public

IRELAND

AIB Mortgage Bank ACS (Asset Covered Securities)

Bank of Ireland Mortgages ACS (Asset Covered Securities)

ITALY

Banca Carige S.p.A. Credit Home/Commercial Loan

Intesa Sanpaolo S.p.A. CB Ipotecario S.r.l.

Intesa Sanpaolo S.p.A. CB Pubblico S.r.l.

UniCredit BpC Mortgage s.r.l.

NETHERLANDS

ABN AMRO Cover Pool

ING Bank

SNS Cover pool

NIBC Conditional Pass-Through Covered Bond Programme

NORWAY

DNB Boligkreditt mortgage cover pool

Eika Boligkreditt AS cover pool

Nordea Eiendomskreditt cover pool

SpareBank 1 Boligkreditt (Spabol)

PORTUGAL

BPI Mortgage Cover Pool

BCP Residential Mortgages

Banco Espírito Santo Mortgage Cover Pool

Banco Santander Totta, S.A.

Caixa Economica Montepio Geral

Caixa Geral de Depósitos Mortgage Cover Pool

SPAIN

Banco de Sabadell, S.A.

Banco Popular Español

Santander Mortgage Covered Bonds

Bankia Mortgage

Bankinter, S.A.

BBVA Covered Bond Programme

BBVA Public Sector Covered Bond Programme

Mortgages Loans Caixabank S.A.

Public Loans CaixaBank S.A.

Kutxabank S.A.

Unicaja Banco Mortgage Covered Bonds

SWEDEN

Länsförsäkringar Hypotek AB

Nordea Hypotek cover pool

SEB Cover Pool

Stadshypotek Swedish Pool

Stadshypotek Norwegian Pool

Swedbank Mortgage cover pool

The Swedish Covered Bond Corporation

UK

Abbey National Treasury Services plc

Clydesdale Bank €10 billion Global Covered Bond Programme

Coventry Building Society – 1006

Lloyds Bank plc EUR60bn Global Covered Bond Programme

Nationwide Covered Bond LLP

RBS Covered Bond programme

YBS Covered Bonds

CHAPTER 1 - KEY THEMES OF THE YEAR

1.1 INTRODUCTION

By Wolfgang Kälberer, Chairman of the ECBC Fact Book Working Group

After more than five years of crisis scenario, the quality and safety of covered bonds and the attractiveness of covered bond investments have been resolutely confirmed. Against this background and at the beginning of a new European Parliament legislative term together with a new mandate of the European Commission, this is the ideal moment to take stock of the current European framework for covered bonds by way of an introductory note and to consider some expectations for the immediate regulatory future.

Of course, the main purpose of the 2014 edition of the European Covered Bond Council (ECBC) Fact Book is to provide all market participants with a full update on all covered bond relevant issues in the usual way. This 2014 edition notably covers bail-in (see article 1.5), asset encumbrance (see article 1.4), long-term financing of the European economy (see article 1.7), regulatory issues (see articles 1.2 and 2.2), as well as the state of play of the market (see articles 1.3, 1.6, 1.8 and 1.9) and investor perspectives (see articles 1.10, 1.11 and 1.12). Particular consideration is given to the European Banking Authority's (EBA) Report on Covered Bond Frameworks and Capital Treatment published on 1 July 2014 (see Generic Section).

WHERE DO WE STAND?

It is worthwhile noting that the pillar of the European covered bond framework, i.e. the definition of a covered bond laid down by Article 52(4) of the UCITS Directive, remained unchanged for more than 25 years. The cross-reference to this piece of legislation of many other covered bond provisions in legislation at EU and national level, survived multiple market cycles since the late 1980's, as well as the most recent financial crisis.

Similarly, the preferential risk-weight of covered bonds stipulated within the Capital Requirements Regulation (CRR) (Regulation N° 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms) was last year confirmed in by Article 129 CRR. The principle of preferential risk treatment of covered bonds has been enshrined in European banking legislation since 1989. The European legislators have even improved the approach, as the credit assessment is now related to the covered bond itself and no longer to the issuing institution.

The new Solvency II rules relating to insurance undertakings provide for a specific regime for covered bonds by way of the Solvency Capital Requirement (SCR) rules. This is of particular importance as the insurance industry holds a major share of the European covered bond investment markets. The SCR provisions introduce a preferential treatment for this asset class according to the Market Risk Module, which allocates favourable spread risk and concentration risk factors to covered bonds compared to other bonds and loans. As a result, these investments by insurance companies benefit from significantly lower capital allocation, thereby consolidating the important role of the insurance industry for the covered bond market.

Very recently, the European Bank Recovery and Resolution Directive (BRRD) excluded covered bonds from the bail-in tool, meaning that credit claims of covered bond holders cannot be written off or converted into shares. This unequivocal exclusion from the bail-in is of fundamental importance as any doubts in this respect would have had an immediate impact on the bankruptcy remoteness of the instrument, undermining the 'raison d'être' of covered bonds.

The protection of covered bonds from bail-in was a very important achievement and reflected the obvious aim of the European legislators to draft legislation in line with the high level of security of the instrument. Overall, the BRRD provisions have a positive effect on covered bond ratings as banks are made more crisis-resilient. This should lead to an improvement in issuers' ratings with corresponding benefits for covered bond ratings.

Another important aspect providing for further growth potential for the European covered bond market segment is the recognition of covered bonds as high-quality liquid assets (HQLA) for Liquidity Coverage Ratio (LCR) purposes. Indeed, in accordance with the Basel Committee's recommendations, the European Commission is likely to confirm the LCR eligibility of covered bonds through a delegated act which is expected to be published at the end of September 2014. It is expected that covered bonds could even be recognised – under certain requirements – as extremely HQLA under Level 1. The LCR eligibility of covered bonds directly translates their high liquidity and credit performances during the crisis into European legislation.

Furthermore, the new Single Supervisory Mechanism (SSM) will reinforce the special covered bond supervision which is required by Article 52(4) of the UCITS Directive. In the medium term, this supervision is expected to remain within the remit of national banking supervisory authorities. This approach will allow the European Central Bank (ECB) to progressively increase its covered bond know-how without weakening the special supervision of this asset class by national supervisors which is increasingly proving to be appreciated by investors as an important safety feature.

Finally, asset encumbrance has so far escaped from the scope of regulatory initiatives. There are good reasons not to legislate in this area as evidence shows that covered bond driven asset encumbrance levels in Europe amount to only 15% on average. Moreover, asset encumbrance triggered by covered bonds heavily depends on underlying business models, which range from specialised banks and special purpose vehicles to commercial banks. There is enough evidence to support the focus of the European authorities on transparency and information on overall asset encumbrance levels. In this context, the EBA released a draft Implementing Technical Standard (ITS) on reporting of asset encumbrance on 30 October 2013, which is to be applied from January 2015 after approval by the European Commission. The EBA also published guidance on disclosure of asset encumbrance on 27 June 2014 to be transformed into an ITS in 2016.

The post-crisis stock-taking exercise brings us to the very positive conclusion that the current regulatory treatment of covered bonds appears consistent and recognises the specific security features of the product through a tailor-made preferential supervisory regime. This also applies to the Banking Union framework in which the covered bond rules are based on the UCITS definition and are in line with the rationale of the instrument without weakening the quality of the day-to-day supervision.

WHERE ARE WE GOING?

Moving-forward, the challenge will be to preserve the preferential supervisory regime of covered bonds, whilst at the same time ensuring room for product innovation and rendering the instrument even more beneficial for the real economy. A strengthening of supervisory rules and the further integration of covered bond markets are now on the agenda of the European policy makers.

In view of these objectives, the ECBC launched a quality Label, i.e. the Covered Bond Label, in January 2013, with the ultimate purpose of enhancing the recognition of the covered bonds asset class by highlighting the security and quality that it provides. The legal basis for the Label is the Covered Bond Label Convention which lays down the key characteristics required for a given covered bond programme to qualify for the Label and which provides guidelines for setting up National Transparency Templates (NTTs). Each Label issuer is currently disclosing a wide range of asset level information through these NTTs, which are comparable on a country-by-country basis and that also to show compliance with the transparency requirements outlined in Article 129(7) CRR.

As a recognition of these efforts, the EBA published a report on "EU Covered Bond Frameworks and Capital Treatment" on 1 July 2014, where it acknowledged that "the 14 national transparency templates [...] constitute a valuable starting point for the harmonisation of covered bond disclosure standards" (p. 97). Additionally, the preferential risk-weight of covered bonds laid down in Article 129 CRR was considered, in principle, to be appropriate. Nevertheless, the EBA proposed to complement the qualifying criteria with additional requirements improving the robustness of the instrument in the area of liquidity risk mitigation, legal over-collateralization, the role of the competent authority and disclosure requirements.

Regarding the eligibility of cover assets for preferential treatment, the EBA shared the view that the derogation to the 10% limit for senior MBS units should be removed, that aircraft liens should not be admitted but that guaranteed residential loans should be included in Article 129 CRR.

In addition to these recommendations, the EBA drafted 'Principles of Best Practice' aimed at bringing about convergence in covered bond frameworks towards common standards of safety and robustness in a number of crucial areas. Any future changes to covered bond legislation at national or European level should take these principles into account.

It is now up to the European Commission to shape the upcoming debate on further integration of European covered bond market. In its Communication on Long-Term Financing of the European Economy from March 2014, the Commission pointed out that there is currently no single, harmonised covered bond framework in place. The launch of a feasibility study on the merits of introducing an EU framework for covered bonds is expected for 2015.

In this context, it will be crucial to properly calibrate the harmonisation process. A full technical harmonisation of national covered bond regimes would be detrimental to the market which is characterised by very heterogeneous national legal frameworks. With this in mind, it is clear that any regulatory initiative at European level must be restricted to a 'principles based harmonisation' where only a certain number of structural covered bond features can be addressed.

The EBA's best practice principles will certainly influence this debate or even be the basis for all upcoming assessments. As long-term financing of the European economy has a strong SME-connotation, the Commission's assessments might also cover the advantages and disadvantages of expanding cover pool eligibility to other asset classes than the traditional ones. Indeed, product innovation could be beneficial to the covered bond asset class. On the other hand, it is crucial to avoid any dilution of the covered bond instrument in order to safeguard its traditional profile and preferential regulatory treatment as outlined above. These two aspects are not exclusive. Ring-fencing of the traditional covered bond could be complemented by creating other types of 'asset covered securities' based on covered bond techniques, providing both instruments are clearly distinguished and subject to different regimes.

1.2 COVERED BONDS IN REGULATION

By Frank Will, HSBC & ECBC EU Legislation Working Group Chairman,
and Florian Eichert, Crédit Agricole & ECBC Statistics and Data Working Group Chairman

In Europe, regulators and lawmakers have acknowledged the strengths of the covered bond product and the important role it plays in the financing of the real economy and the public sector. Hence covered bonds benefit from a favourable treatment in various regulations ranging from the low risk-weighting under the Capital Requirements Regulation (CRR) to the exemption of the bailing-in rules under the EU Bank Recovery and Resolution Directive (BRRD) to the expected Level 1 categorisation for highly-rated covered bonds. Interestingly, this special treatment is no longer limited to European regulators. In 2013, the Basel Committee of Banking Supervision (BCBS) finally started to grant a more favourable treatment to certain covered bonds. Moreover, over the last few years, the number of non-European central banks that accept covered bonds as eligible repo collateral has risen.

I. EUROPEAN REGULATION AND COVERED BONDS

1. Expected LCR treatment

According to the Liquidity Coverage Requirement (LCR), credit institutions should hold sufficient liquid assets to withstand net liquidity outflows under gravely stressed conditions over a period of 30 days. Covered bonds will be one of the asset classes that qualify as liquid assets under the European LCR rules. Extremely high quality covered bonds (EHQCB) are expected to be categorised as Level 1 assets, subject to a haircut of at least 7% and a 70% cap. According to the latest draft as of July 2014, these covered bonds have to be (i) UCITS or CRR compliant and backed by a pool of homogeneous assets; (ii) the transparency requirements laid down in Article 129(7) CRR must be met; (iii) the issue size is at least EUR 500 m (or the equivalent in domestic currency); (iv) the covered bonds have a rating of at least credit quality step 1 (AA- or better)[1]; and (v) the cover pool must have at all times an overcollateralisation level of at least 2%.

High quality covered bonds (HQCB) should qualify as Level 2A assets and would be subject to a haircut of at least 15% and a cap of 40%. Again, the bonds have to be (i) UCITS or CRR compliant and backed by a pool of homogeneous assets; (ii) must meet the transparency requirement laid down in Article 129(7) CRR; (iii) must have an issue size of at least EUR 250 m (or the equivalent in domestic currency); (iv) the covered bonds have a rating of at least credit quality step 2 (A- or better)[2]; and (v) the cover pool must have at all times an overcollateralisation level of at least 7%.

Covered bonds issued by non-EU credit institutions would be subjected to a haircut of at least 15% and a cap of 40%, if they have a national covered bond law and if investors have a preferential claim against the cover pool in the case of issuer default. The supervisory and regulatory arrangements applied in the third country must be at least equivalent to those applied in the European Union (EU). The covered bonds must be backed by a pool of homogeneous assets and the transparency requirements laid down in Article 129(7) CRR must be met. The covered bonds must have a rating of at least credit quality step 1 (AA- or higher)[1] and the overcollateralization is at least 7%.

Timeframe: Due to the technical complexity of the matter and the prolonged consultation process with stakeholders and national experts until the end of June 2014, the initial implementation deadline of 31 December 2014 will be delayed and the European Commission envisages now that it shall apply from an unspecified date in 2015, most probably 1 October 2015. The Liquidity Coverage Requirements will be phased-in from 2015 to 2018 according to the following schedule[3]:

1 Or the equivalent credit quality step in the case of a short-term rating or, in the absence of a rating, they are assigned a 10% risk-weight.
2 Or the equivalent credit quality step in the case of a short-term rating or, in the absence of a rating, they are assigned a 20% risk-weight.
3 However, EU member states can require that domestically authorised institutions maintain a higher LCR up to 100% until the binding minimum standard is fully introduced at the rate of 100%.

> 60% of the LCR in 2015 (most likely from October 2015);

> 70% as from 1 January 2016;

> 80% as from 1 January 2017;

> 100% as from 1 January 2018.

2. EBA's assessment of the covered bond risk-weighting under CRR

In June 2014, the European Banking Authority (EBA) said that the preferential risk-weighting of covered bonds is "in principle appropriate" given historical default statistics and the dual recourse character of the product. However, it advised to strengthen the covered bond frameworks by introducing further criteria for their preferential treatment. In particular, the EBA recommends that the additional qualifying criteria should cover minimum regulatory over-collateralisation, liquidity risk mitigation, and special public supervision. In addition, it advises that the disclosure requirements for preferential capital treatment currently foreseen in the CRR should be further clarified through the development of binding technical standards. Finally, the EBA has concluded that residential guaranteed loans should be maintained within the scope of the preferential risk-weight treatment. However, it recommends not to include aircraft liens in the scope and not to renew the derogation on the use of residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) as cover assets beyond December 2017. The European Commission will take a final decision regarding the preferential treatment of covered bonds by December 2014.

3. EBA's best practice principles and the harmonisation of covered bond laws

In June 2014, the EBA also published the best practice principles for covered bonds. The principles were based on the results of a comprehensive study conducted by the EBA and national regulators and are viewed as a first step into a broader harmonisation of the various covered bond laws in Europe. The EBA expects the national regulators and lawmakers to take its recommendations on board when changing the national covered bond laws. According to the best practice principles, key features of covered bonds are: (i) the dual recourse character; (ii) the effective asset segregation; (iii) the bankruptcy remoteness; and (iv) the independence of the cover pool administrator after issuer default. Additional aspects include:

> only one primary asset class, i.e. no mixed assets;

> regulatory limits on the cover pool composition for bonds backed by residential and commercial real estate loans;

> not only commercial real estate but also residential property values should be re-valued once a year. A breach of the loan-to-value (LTV) limit after re-valuation, however, should not make such a loan ineligible for the cover pool;

> legal minimum over-collateralisation;

> liquid asset buffer.

4. Bank Recovery and Resolution Directive (BRRD)

In April 2014, the European Parliament adopted the Bank Recovery and Resolution Directive (BRRD) setting a common framework across all 28 EU countries on how to deal with troubled banks. The BRRD will come into force on 1 January 2015, the bail-in tool will be available from 2016, two years earlier than initially planned. According to Article 44 BRRD, secured liabilities including covered bonds and liabilities in the form of financial instruments used for hedging purposes, which form an integral part of the cover pool and which, according to national law, are secured in a way similar to covered bonds, shall not be subject to write down or conversion. The member states shall ensure that all secured assets related to a covered bond cover pool remain unaffected, segregated and with enough funding. However, the BRRD also states that the scope of the bail-in tool shall not prevent, where appropriate, the exercise of the bail-in powers to any part of a secured liability or a liability for which collateral has been pledged that exceeds the value of the assets, pledge, lien or collateral against which it is secured.

II. BASEL COMMITTEE ON BANKING SUPERVISION (BCBS) AND COVERED BONDS

1. Liquidity Coverage Ratio (LCR)

The Basel II framework does not mention covered bonds and, in contrast to the European CRR, does not grant any special treatment to covered bonds which are more or less treated as senior unsecured bank debt under the Basel II's Standardised Approach. In January 2013, the BCBS changed its stance and mentioned covered bonds for the first time in a legal framework. Under Basel's LCR rules, covered bonds are defined in line with Article 52(4) UCITS without the requirement that the issuer has to be based in the EU. According to the BCBS, covered bonds "are bonds issued and owned by a bank or mortgage institution and are subject by law to special public supervision designed to protect bond holders. Proceeds deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of the validity of the bonds, are capable of covering claims attached to the bonds and which, in the event of the failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest."[4] The LCR rules set additional conditions. The covered bonds:

> are not issued by the submitting bank itself (i.e. no retained covered bonds);

> are rated at least AA- (second-highest rating);

> are traded in large, deep and active repo/cash markets with a low level of concentrations;

> have proven record as a reliable source of liquidity (repo or sale): max. 10% price drop over 30-day period of stress.

Covered bonds meeting these criteria qualify as Level 2A assets under the Basel LCR rules and are subject to a 15% haircut and a 40% cap.

2. Large exposures

In April 2014, the BCBS published its large exposures framework, which will be applicable to all internationally active banks by 2019. There will not be any grandfathering for existing exposures and national regulators can require banks to report before that date.

According to the Basel framework, large exposures need to be reported if they are at least 10% of a bank's eligible capital. The general exposure limit to a single counterparty is 25% of the tier-1 capital. A tighter limit of 15% applies to exposures between global systemically important banks (G-SIBs). In order to qualify the covered bonds must fulfil the following criteria:

> Issued by a **bank** or **mortgage institution**;

> Subject by law to **special public supervision**;

> In case of issuer default, covered bond investors have **priority claim on cover assets**

> **Eligible assets** are:

> claims on, or guaranteed by, sovereigns, central banks, public sector entities or supras;

> residential mortgages (max risk weight of 35% / max LTV of 80%);

> commercial real estate loans (max risk weight of 100% / max LTV of 60%);

> substitution assets plus hedging instruments;

4 Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools, BCBS, January 2013.

> **Nominal over-collateralisation** of at least 10%. If not mandatory by law, issuer needs to disclose publicly on a regular basis compliance with the 10% minimum OC requirement;

> Calculation of maximum loan-to-value (LTV) for residential and commercial real estate loans is based on **objective market value** and must be **frequently re-evaluated**.

Covered bonds satisfying the above criteria will have an exposure value of no less than 20% of the nominal value of the bank's covered bond holdings. The counterparty to which the exposure value is assigned is the issuing bank. Covered bonds that do not satisfy the criteria will have an exposure value of 100%.

The major differences between Basel's new large exposure rules and current treatment in the EU are: (1) For some countries such as Germany and Denmark, the Basel rules mean a shift from full exemption to a minimum exposure value of 20%; (2) Basel's eligible collateral definition does not include internal (R)MBS, guaranteed home loans, ship and aircraft loans; and Basel requires at least annual revaluation of mortgage loans. Under the CRR, commercial real estate loans need to be re-evaluated every year, but residential mortgages only every three years. The new Basel framework will only apply from 2019 onwards, which gives EU regulators plenty of time to implement it into EU law. We expect that they will consider the specifics of the European market and will use a covered bond definition in line with UCITS or CRR.

III. CONCLUSION

Covered bonds have been the regulators' darling throughout the sovereign crisis. Having banks put their balance sheet behind the lending they do and thus get their skin into the game had been the dogma for much of the last years. The product thus managed to keep the beneficial treatment in existing regulation and on top of that carve-out a very positive treatment in new regulatory frameworks such as the BRRD or the CRD IV / CRR package on topics such as the LCR and NSFR.

Securitisation on the other end has been the villain of the financial crisis. In recent months, however, a certain number of initiatives have been taken to unlock the securitisation market. While the European Central Bank announced an ABS purchase programme, ABS have started to get more beneficial treatment for LCR purposes, for example and they have been mentioned by the European Commission as one way to finance the European SME sector. At the same time, regulators are starting to discuss the minimum requirements for covered bonds to continue to benefit from preferential regulatory treatment. Higher minimum OC requirements or the introduction of liquid asset buffers have been mentioned in the EBA recommendations to the European Commission on minimum requirements for beneficial risk-weight treatment going forward. The European Market Infrastructure Regulation (EMIR) on the other hand includes a 2% legal minimum OC for covered bonds to benefit from a carve-out on central clearing of derivatives.

While we caution to move to far into the direction of securitization, a product that is far more diverse than covered bonds, less deep and liquid trading-wise and with a smaller and less heterogeneous investor base, tightening eligibility criteria for covered bonds is something that will benefit covered investors in the long-run. Full harmonization of covered bond structures across the EU is a fairly unrealistic goal and fortunately regulators seem to acknowledge this. But there are areas in the covered bond market where closer harmonization can be sensible (minimum OC levels or transparency, for example). We have already seen various countries starting to tighten their respective covered bond frameworks anticipating the new regulatory landscape. The French have raised their minimum OC level from 2% to 5%, while the Dutch will likely go from 0% to 5% and introduce a liquid asset buffer requirement for Dutch hard bullet covered bond programmes.

What is still hindering the evolution is the fact that we do not have a common understanding of where regulators want to go with minimum standards and harmonization at this point. We have minimum requirements that are not the same across regulatory dossiers. The list of requirements is longer on some topics than on others and even seemingly similar requirements such as minimum OC still come in different shades. Requirements range from a nominal legal minimum of 2% in EMIR to voluntary OC of 10% in the proposed Basel large exposure rules. For frameworks to evolve and become ready to deal with the new requirements national legislators need certainty. They need to know what the ultimate target is and, ideally, that target is harmonized across regulatory frameworks as well. It would be far from ideal if banks are burdened with different requirements and minimum standards for different regulatory purposes. The goal of European regulators seems to be higher standardization and tougher minimum requirements for covered bonds to continue to benefit from positive regulatory treatment the product has achieved in the last years. Well, practice what you preach. Harmonization can and should also be something European politicians and regulators focus on.

1.3 COVERED BONDS IN A POST-CRISIS SCENARIO

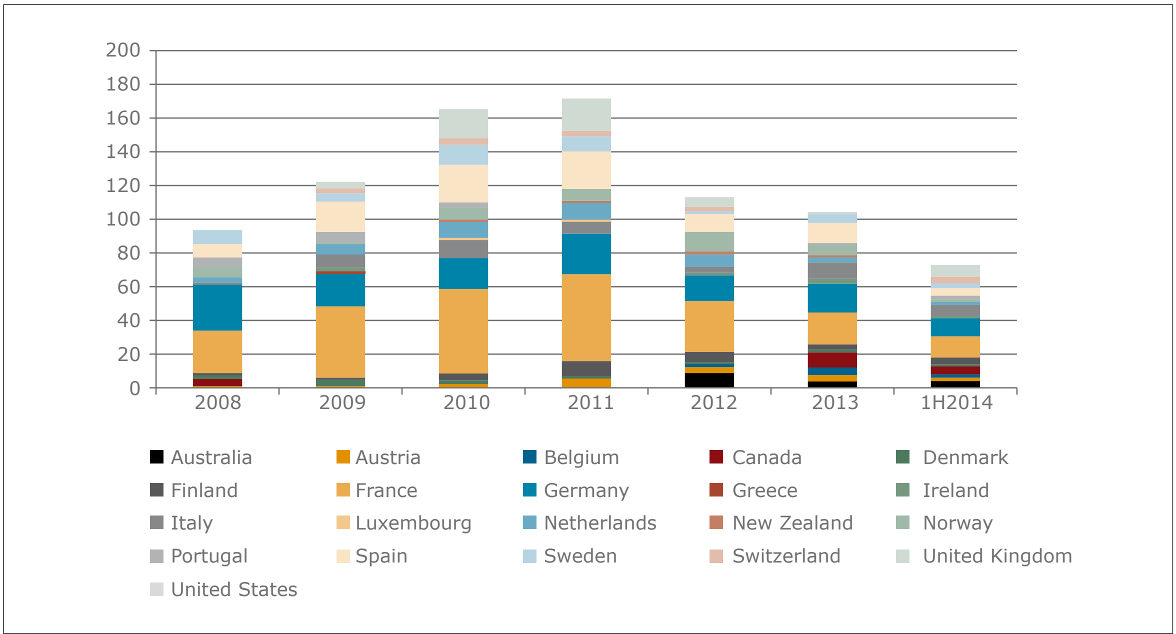
By Anne Caris, Bank of America Merrill Lynch and Heiko Langer, BNP Paribas

Throughout the global financial crisis, the covered bond market saw an unprecedented expansion. Market growth could be seen both in the number of banks that issue covered bonds as well as in the broadening range of investors that buy covered bonds.

During the crisis, covered bonds saved many European banks' funding bases and supported their franchise value, e.g. growing residential mortgages, an activity which continued even at the height of the crisis. As such, covered bonds have proven to be an instrumental defensive funding tool for European banks, notably given:

> **Market access:** the covered bond market remained open throughout the crisis as illustrated by the hike in EUR new issuance (gross) between 2009 and 2011 (see Figure 1 below), even though higher execution risks resulted in smaller sizes and shorter maturities. Non-peripheral banks were the main beneficiaries but the strongest peripheral names also managed to tap the covered bond market, in some cases at spread levels inside sovereign bonds. The characteristics and good track record of the product translated into lower market volatility versus bank senior unsecured, for example (see volatility calculations across asset classes in appendix).

> Figure 1: EUR-denominated benchmark issuance by country (EUR bn) [1]



Source: BofA Merrill Lynch Global Research; [1] Excluding FRNs, public deals only

> **ECB repos & support:** funding requirements which could not be placed with private investors (including from weaker European banks) were typically fulfilled through the European Central Bank (ECB) repo facilities. Favourable haircuts for sovereign and covered bonds supported active issuance of "retained" covered bonds. Some programmes by peripheral issuers were even especially established for ECB repo purposes. The two covered bond purchase programmes launched by the ECB also supported market confidence[1] in the product.

1 ECB's first covered bond purchase programme was launched between July 2009-June 2010 (total size of €60bn, fully used) and the second one was between November 2011-October 2012 (€40bn, not fully used).

> **A split Rates/Credit investor base:** covered bonds benefited from their broad investor base, which evolved according to market conditions throughout the crisis. For example, when "Rates" investors stopped buying peripheral covered bonds during the most volatile periods, "Credit" investors stepped in, especially domestic ones but also US/UK hedge funds. Instead, "Rates" investors prioritised non-peripheral covered bonds, even exiting sovereign bonds in some cases. Higher ratings for covered bonds vs. sovereign/bank bonds also attracted investors which could not buy non-investment grade or borderline investment paper (this is less the case nowadays).

For investors, covered bonds offered a higher degree of stability during the crisis compared to senior unsecured bank bonds. This stability manifested itself through lower spread volatility and less severe rating pressure. When the banking crisis developed into a sovereign debt crisis, covered bonds also showed greater stability than most peripheral government bond markets. As a result of this stability, covered bonds have been granted a certain degree of preferential treatment in various regulations that have been drafted, amended or adopted as a reaction to the crisis.

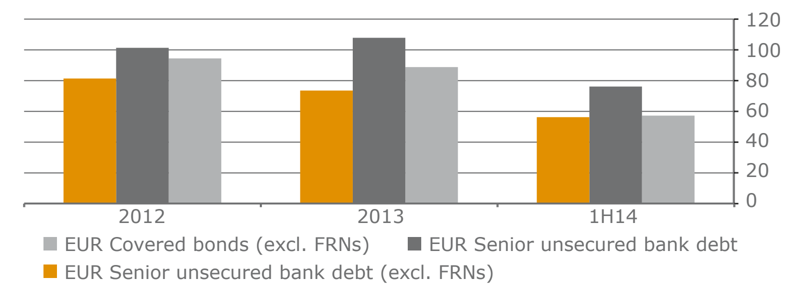
I. THE ISSUER PERSPECTIVE

Since 2012, EUR new issuance (gross) has dropped significantly from EUR150bn+ levels to EUR100bn+, with net negative supply ranging between EUR50bn and EUR60bn on an annual basis. This might raise questions about whether there is something wrong with the covered bond product, or whether it has become obsolete in less volatile times. While covered bonds remain attractive to investors for a number of reasons, as detailed below, they also remain an important market for banks, being:

> **A stable source of funding for banks:** issuance volumes have been normalising in recent years but there is nothing necessarily alarming in that respect. This is actually positive, with banks having been able to diversify their funding bases, e.g. through senior unsecured, securitisation, customer deposits. European banks' funding needs have also decreased as they have been deleveraging and/or restructuring. However, covered bonds are still at the core of management funding strategies, even though senior unsecured debt issuance has been revived, e.g. to take advantage of easier market access or for collateral management purposes, especially in peripheral countries (see Figure 2 below).

Banks have been actively diversifying their funding sources, benefiting from complementary investor bases. Furthermore, new entrants or returning issuers are visible, confirming the attractiveness of the product, which is spreading globally with the ongoing emergence of new legislation, e.g. in Asia. It is also important for issuers to maintain a covered bond curve as well as some collateral for repo purposes for rainy days, as market liquidity can dry up very quickly, as seen during the crisis. Customer deposits can also be volatile in stressed situations.

> Figure 2: New benchmark issues by European banks only (EUR bn) [1]

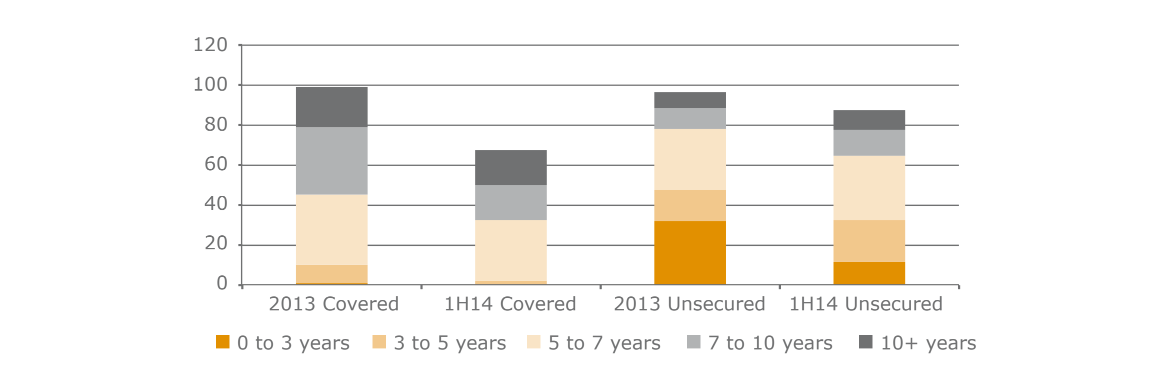


Source: BofA Merrill Lynch Global Research; [1] Public deals only

> **A competitive source of funding supporting banks' franchises:** covered bonds can actually strengthen the franchise of a bank by financing long-term and low-margin mortgage and public sector loans more efficiently. The product has typically offered longer maturities vs. senior unsecured or securitisation even though they somewhat decreased during the crisis, a trend which has now reverted, with new issues being typically 7+ years (see Figure 3 below). Furthermore, the differential in ASW spreads between senior unsecured and covered bonds has been very much in favour of the latter in both peripheral and non-peripheral markets (see Figure 4 below).

That said, the efficiency of the product also depends on the level of over-collateralisation required by rating agencies, which has been material in some cases during the crisis. This is less the case nowadays notably due to improved market confidence. But possible critical downgrades of bank ratings as rating agencies incorporate the Banking Resolution and Recovery Directive (BRRD) in their methodology could renew pressures in that respect. On the positive side, the higher de-linkage between bank and covered bond ratings will be an important offsetting factor. Conditional pass-through structures could be another way to maintain the product efficiency, but the depth of the market for these new covered bond structures has yet to be proven.

> FIGURE 3: COVERED BOND AND SENIOR UNSECURED EUR NEW ISSUES BY MATURITY



Source: BofA Merrill Lynch Global Research; [1] Public deals only

> **A non-bail-in-able product embedded in banks' regulation:** in May 2014 the Council of the European Union adopted the final text of the BRRD, which confirmed the exclusion of secured funding from bail-in including UCITS 52(4)-compliant covered bonds. While covered bonds are not risk-free, they become "super" senior to senior unsecured debt, similar to guaranteed deposits or other secured funding. This further backs the robustness of the product, which has benefited from preferential regulatory treatment in terms of capital charges and for banks' liquidity purposes. Aside from favourable repo haircuts with the ECB, covered bonds are indeed a major pillar of Basel's Liquidity Coverage Ratio (LCR) in Europe (this is not the case in other jurisdictions, however, e.g. the US).

Such preferential regulation, which is being tightened to ensure that only high-quality/plain-vanilla covered bonds are targeted, can be expected to remain a key driver of future issuance. Banks are likely to further diversify their liquidity portfolios into covered bonds as they tend to offer a spread pick-up over sovereign bonds, for example, even though we have seen some exceptions. In addition, countries like Denmark have a shortage of sovereign bonds, thus substituting them with covered bonds. That said, demand across different covered bond markets will vary depending on the final regulatory criteria and value opportunities.

While the above are important tailwinds for covered bond issuance, the product also faces major headwinds.

First, growth in residential mortgage lending remains negative or is down with no real sign of material improvement in the foreseeable future given prudent credit underwriting criteria from banks but also weak household demand due to soft/declining house prices (with few exceptions). Therefore, for the majority of covered bond markets, new issuance should still mainly be driven by refinancing rather than net positive mortgage lending. Public sector lending has also declined significantly post-crisis.

Second, since 2013, European regulators have been more focused on asset encumbrance. For now, the focus seems to be more on higher transparency for stress testing or resolution purposes rather than introducing hard limits, which is positive as asset encumbrance is not just about quantitative metrics: important qualitative factors, such as business models and ALM, must be taken into consideration. A study by the IMF published last year[2] also showed that covered bonds are not necessarily the main encumbrance driver. Nonetheless, this has created some degree of uncertainty, making banks more careful about encumbering their balance sheets.

II. THE INVESTOR PERSPECTIVE

If we assume that the worst of the crisis is now behind us, the question whether covered bonds will manage to retain their strong appeal to investors in a post-crisis scenario, is a valid one. The increasing risk appetite of market participants combined with a low yield environment, which pushes investors towards potentially higher yielding assets, clearly increases the competition that covered bonds face from other asset classes. Specifically, unsecured bank debt as well as peripheral government bonds have managed to regain significant investor appeal as the financial crisis has abated. While it makes sense that assets with a riskier profile perform better in a recovering market environment, it would be a mistake to assume that we are merely going through a reversion of the intensifying phase of the crisis which would leave us exactly where we started from. Important parameters, which have an impact on the value of covered bonds for investors, have changed during the crisis or as a result of the crisis.

The Bail-in concept is one of the most significant game changers to come out of the financial crisis. Burden-sharing of unsecured creditors of a failing bank in order to avoid, or at least lower, potential cost for the tax payer increases the value of the protection that covered bonds offer to their investors. One can argue that banks have become more stable in recent years due to generally higher capitalisation levels and stricter supervision (e.g. stress tests) and that this may reduce the risk of another systemic crisis. On the other hand, the risk that burden-sharing will be applied to creditors in the case of an isolated insolvency event is higher than before the crisis, especially for systemically less important banks. For investors who want to protect themselves against such a scenario, covered bonds are still an attractive alternative even in an environment of improved systemic stability. The strong performance of senior unsecured bank bonds, due to the increasing risk appetite of market participants and overall spread compression in the market means that the give up in yield that investors have to accept when buying covered bonds instead of senior unsecured bonds has decreased. The fact that covered bonds require less sacrifice in extra yield now than during the midst of the crisis adds further to their attractiveness in a post-crisis scenario.

2 IMF Global Financial Stability Report (October 2013).

> Figure 4: Asset Swap Margin difference between iBoxx EUR Banks Senior and iBoxx EUR Covered

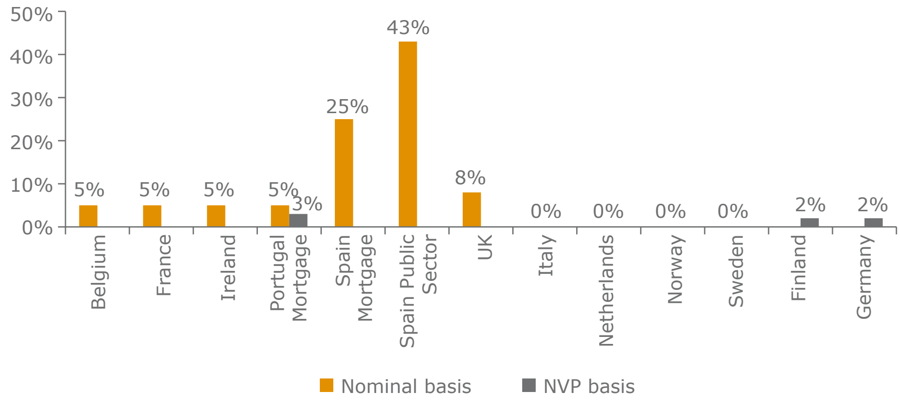
Source: iBoxx, BNP Paribas

Looking at the structural features of covered bonds, a number of improvements have occurred since the outbreak of the crisis which resulted in higher safety standards for covered bonds. One key driver behind structural improvements has been tighter rating requirements that were implemented by the rating agencies as the crisis unfolded. Greater focus on liquidity risk has led to tighter asset-liability matching requirements. Through the more severe stress scenarios that the rating agencies were applying when assessing refinancing risk, covered bond issuers were incentivised to keep mismatches between the cover pool and the outstanding covered bonds at a minimum. The implementation of pre-maturity tests, which ultimately result in the creation of liquidity buffers within the cover pool upon the breach of certain trigger events, is another instrument that was increasingly used to reduce refinancing risk and help issuers to achieve higher covered bond ratings.

Another structural feature that has improved the stability of covered bonds is over-collateralization, which has significantly increased in recent years. To some extent higher over-collateralization was required to compensate for deteriorating collateral quality or lower issuer ratings and thus may be regarded as neutral for the bondholder. Over-collateralization has, however, also increased as the rating agencies increased their focus on liquidity and counterparty risk, which constitutes an increase in investor protection as these risks were previously not, or less strongly, considered within rating methodologies.

Stricter requirements from the rating agencies were not the only driver of structural improvements. Higher over-collateralization levels and stricter asset-liability matching criteria have also been adopted in a number of regulatory frameworks. While the regulatory requirements, especially in the case of over-collateralization, often remain below the levels that rating agencies demand for achieving the highest ratings, investors still benefit from legally enshrined security features as they also remain in place when rating considerations are less important, e.g. in the case of a wind down of the issuer. On the other hand, having stricter rating requirements enabled regulators to tighten covered bond frameworks without putting issuers, who already comply due to stricter rating requirements, under additional stress.

> FIGURE 5: LEGAL MINIMUM OVER-COLLATERALIZATION LEVELS IN EUROPE



Source: Moody's

Transparency is another area where covered bonds have improved. Before the crisis disclosure of cover pool information was largely voluntary (with some exceptions) and very heterogeneous. Significant differences could be found in the level of detail of disclosed data as well as in reporting frequency between issuers from various countries. While issuers improved their disclosure standards to various degrees on an individual basis in recent years, a major step towards standardisation and comparability of cover pool disclosure was achieved with the creation of the Covered Bond Label by the EMF/European Covered Bond Council (ECBC) in 2013. Through the Covered Bond Label's website, market participants can access information on 81 cover pools. A further step towards a more standardised disclosure regime was taken with the introduction of the CRD IV/ CRR package, which contains some disclosure standards covered bonds must meet in order to be eligible for preferential regulatory treatment. Although there is undoubtedly room for further improvement of disclosure standards, especially with regards to comparability of disclosed data, we would argue that we have reached a level of transparency that is noticeably superior to the one prevailing before the crisis.

Even though covered bonds benefitted from preferential regulatory treatment before the financial crisis, mainly through lower risk-weightings and higher investment limits for certain institutional investors, the preferential treatment of covered bonds has been an important factor in the changing regulatory landscape during the course of the crisis. Apart from the exemption from bail-in mentioned above, the inclusion of covered bonds as eligible assets for the Liquidity Coverage Requirement (LCR) has been of key importance. LCR eligibility helped to further establish covered bonds with bank investors, which are likely to generate a stable level of demand going forward as maturing assets within the LCR pool will have to be replaced on an ongoing basis. The regulatory recognition of covered bonds has also helped to further expand investor demand to regions outside of Europe, such as the Asian Pacific Area. While the increased importance of bank investors within the covered bond market is likely to support secondary market liquidity, the typical buy and hold investor base (such as insurance companies, for which Solvency II provides a preferential treatment of covered bonds) is equally important for the market as it adds stability and extends demand for covered bonds into longer maturities. Although preferential regulatory treatment also plays a significant part in supporting demand in a post-crisis environment, it should not be the main reason to invest but rather be seen as a reconfirmation of the high security standards and the good track record of the product itself.

III. CONCLUSION

Covered bonds continue to be a strategic product for both issuers and investors even in a more benign market environment. Changing regulation and lessons learned during the crisis have changed the perception of covered bonds as a funding tool and an investment instrument. Ongoing developments (e.g. in terms of regulation or innovation) are critical to the efficiency and future success of the covered bond market. So is the current expansion globally.

IV. APPENDIX: VOLATILITY CALCULATIONS & METHODOLOGY

Weekly spread data are used for a number of asset classes from BofAML's own databases and from BofAML Bond Indices, with breakdowns by country where available. Where possible, bonds in the 3-5yr maturity range are used. From the spread levels, prices and returns based on generic simplifying assumptions across asset classes are estimated, and volatility is calculated as the standard deviation of logarithmic returns. Volatility is reported as an annualised rate. The footnote to Figure 6 includes further detail on the data used in both.

> Figure 6: Annualised volatility by sector, 2001 to Apr-14

		2001-2007						
		CB	**Bank**	**Sovs**	**AAA RMBS**	**A RMBS**		
United Kingdom 3-5 years	UK	-	0.9%	0.8%	0.5%	0.8%		
France 3-5 years	France	0.5%	0.7%	0.6%	-	-		
Germany 3-5 years	Germany	0.4%	0.6%	0.5%	-	-		
Netherlands 3-5 years	Netherlands	-	0.5%	0.5%	0.5%	1.0%		
Spain 3-5 years	Spain	0.6%	1.0%	0.5%	0.4%	0.9%		
Sweden 3-5 years	Sweden	-	-	1.0%	-	-		
Italy 3-5 years	Italy	-	-	0.4%	0.6%	0.7%		
		HY	**HG**	**QG**	**AAA CLO**	**A CLO**	**AAA Auto**	**A Auto**
Europe 3-5 years	Europe	5.1%	1.2%	0.5%	0.5%	1.4%	0.4%	0.6%

		2008-2009						
		CB	**Bank**	**Sovs**	**AAA RMBS**	**A RMBS**		
United Kingdom 3-5 years	UK	1.5%	5.6%	2.6%	3.4%	12.8%		
France 3-5 years	France	1.3%	2.5%	1.4%	-	-		
Germany 3-5 years	Germany	1.3%	1.0%	1.4%	-	-		
Netherlands 3-5 years	Netherlands	2.1%	1.1%	1.9%	2.9%	8.3%		
Spain 3-5 years	Spain	1.3%	3.9%	2.0%	5.7%	10.1%		
Sweden 3-5 years	Sweden	1.3%	2.1%	1.5%	-	-		
Italy 3-5 years	Italy	1.4%	1.6%	2.5%	3.4%	10.2%		
		HY	**HG**	**QG**	**AAA CLO**	**A CLO**	**AAA Auto**	**A Auto**
Europe 3-5 years	Europe	8.8%	2.4%	1.1%	5.0%	14.5%	2.7%	13.2%

> Figure 6: Annualised volatility by sector, 2001 to Apr-14

		2010-2014 YTD						
		CB	Bank	Sovs	AAA RMBS	A RMBS		
United Kingdom 3-5 years	UK	0.8%	2.4%	1.1%	1.6%	4.9%		
France 3-5 years	France	1.1%	2.7%	2.0%	-	-		
Germany 3-5 years	Germany	0.4%	0.8%	1.1%	-	-		
Netherlands 3-5 years	Netherlands	0.7%	1.1%	1.4%	1.3%	4.5%		
Spain 3-5 years	Spain	2.9%	5.3%	7.4%	5.8%	10.1%		
Sweden 3-5 years	Sweden	0.4%	1.6%	1.2%	-	-		
Italy 3-5 years	Italy	2.4%	4.2%	6.5%	3.8%	7.0%		
		HY	HG	QG	AAA CLO	A CLO	AAA Auto	A Auto
Europe 3-5 years	Europe	5.0%	1.5%	1.2%	1.8%	8.0%	0.8%	3.4%

		H1 2013						
		CB	Bank	Sovs	AAA RMBS	A RMBS		
United Kingdom 3-5 years	UK	0.5%	1.5%	0.7%	0.7%	1.2%		
France 3-5 years	France	0.7%	1.6%	0.8%	-	-		
Germany 3-5 years	Germany	0.3%	0.7%	1.0%	-	-		
Netherlands 3-5 years	Netherlands	0.7%	1.6%	0.8%	0.8%	1.4%		
Spain 3-5 years	Spain	3.5%	3.9%	5.1%	3.2%	7.3%		
Sweden 3-5 years	Sweden	0.4%	1.0%	1.2%	-	-		
Italy 3-5 years	Italy	2.0%	3.6%	5.0%	3.0%	5.2%		
		HY	HG	QG	AAA CLO	A CLO	AAA Auto	A Auto
Europe 3-5 years	Europe	4.1%	1.4%	0.8%	1.9%	6.7%	0.4%	0.7%

		H2 2013						
		CB	Bank	Sovs	AAA RMBS	A RMBS		
United Kingdom 3-5 years	UK	0.5%	0.9%	0.6%	0.3%	0.6%		
France 3-5 years	France	0.2%	0.8%	0.7%	-	-		
Germany 3-5 years	Germany	0.2%	0.5%	0.6%	-	-		
Netherlands 3-5 years	Netherlands	0.3%	0.6%	0.6%	0.4%	0.7%		
Spain 3-5 years	Spain	1.4%	2.3%	3.2%	1.6%	5.0%		
Sweden 3-5 years	Sweden	0.2%	0.8%	0.5%	-	-		
Italy 3-5 years	Italy	0.7%	2.0%	3.3%	1.3%	2.9%		
		HY	HG	QG	AAA CLO	A CLO	AAA Auto	A Auto
Europe 3-5 years	Europe	2.1%	0.7%	0.7%	1.2%	3.1%	0.1%	0.4%

> Figure 6: Annualised volatility by sector, 2001 to Apr-14

		2014 YTD						
		CB	Bank	Sovs	AAA RMBS	A RMBS		
United Kingdom 3-5 years	UK	0.1%	0.6%	0.5%	0.2%	0.8%		
France 3-5 years	France	0.1%	1.0%	0.7%	-	-		
Germany 3-5 years	Germany	0.2%	0.4%	0.6%	-	-		
Netherlands 3-5 years	Netherlands	0.2%	0.5%	0.5%	0.4%	0.8%		
Spain 3-5 years	Spain	0.9%	1.1%	3.5%	1.9%	2.2%		
Sweden 3-5 years	Sweden	0.2%	0.4%	0.4%	-	-		
Italy 3-5 years	Italy	0.4%	1.6%	2.7%	1.2%	2.1%		
		HY	HG	QG	AAA CLO	A CLO	AAA Auto	A Auto
Europe 3-5 years	Europe	2.6%	0.6%	0.4%	0.4%	2.3%	0.2%	0.2%

		2011						
		CB	Bank	Sovs	AAA RMBS	A RMBS		
United Kingdom 3-5 years	UK	0.9%	3.3%	1.1%	0.8%	2.3%		
France 3-5 years	France	1.5%	4.3%	3.1%	-	-		
Germany 3-5 years	Germany	0.4%	0.8%	1.3%	-	-		
Netherlands 3-5 years	Netherlands	0.6%	1.1%	1.9%	0.9%	1.9%		
Spain 3-5 years	Spain	2.3%	6.2%	8.8%	3.6%	6.2%		
Sweden 3-5 years	Sweden	0.4%	2.6%	1.0%	-	-		
Italy 3-5 years	Italy	3.0%	6.3%	9.1%	4.3%	7.4%		
		HY	HG	QG	AAA CLO	A CLO	AAA Auto	A Auto
Europe 3-5 years	Europe	7.2%	2.0%	1.4%	1.7%	9.3%	0.5%	1.5%

		2012						
		CB	Bank	Sovs	AAA RMBS	A RMBS		
United Kingdom 3-5 years	UK	1.0%	2.1%	1.6%	1.0%	2.2%		
France 3-5 years	France	1.2%	2.7%	2.5%	-	-		
Germany 3-5 years	Germany	0.5%	0.9%	1.2%	-	-		
Netherlands 3-5 years	Netherlands	0.9%	1.0%	1.8%	0.8%	1.8%		
Spain 3-5 years	Spain	3.3%	6.7%	9.5%	4.6%	12.5%		
Sweden 3-5 years	Sweden	0.5%	1.6%	1.4%	-	-		
Italy 3-5 years	Italy	2.7%	4.7%	7.5%	5.2%	9.8%		
		HY	HG	QG	AAA CLO	A CLO	AAA Auto	A Auto
Europe 3-5 years	Europe	4.3%	1.8%	1.4%	2.2%	5.8%	0.5%	0.7%

> Figure 6: Annualised volatility by sector, 2001 to Apr-14

		2013						
		CB	**Bank**	**Sovs**	**AAA RMBS**	**A RMBS**		
United Kingdom 3-5 years	UK	0.5%	1.2%	0.6%	0.5%	1.0%		
France 3-5 years	France	0.5%	1.2%	0.7%	-	-		
Germany 3-5 years	Germany	0.2%	0.6%	0.8%	-	-		
Netherlands 3-5 years	Netherlands	0.5%	1.2%	0.7%	0.6%	1.1%		
Spain 3-5 years	Spain	2.6%	3.2%	4.2%	2.5%	6.2%		
Sweden 3-5 years	Sweden	0.3%	0.9%	0.9%	-	-		
Italy 3-5 years	Italy	1.5%	2.9%	4.2%	2.3%	4.3%		
		HY	**HG**	**QG**	**AAA CLO**	**A CLO**	**AAA Auto**	**A Auto**
Europe 3-5 years	Europe	3.3%	1.1%	0.8%	1.6%	5.2%	0.3%	0.5%

Source: BofA Merrill Lynch Global Research

Notes: For structured finance, AAA/A refers to bonds originally rated AAA/A. UK RMBS refers to UK Prime RMBS. The structured spread series aim to reflect spreads for bonds with 5yr WAL, though in some cases (such as for AAA CLO and AAA auto ABS) the data may reflect shorter WAL bonds given the lack of available longer duration paper. The majority of the remaining data is based on BofAML Bond Indices as follows: HNE0 (Euro Non-Financial High Yield Index) is used for high yield European bonds; EN02 (EMU Corporates, Non-Financial, 3-5 yr) is used for high grade European bonds; EQ02 (EMU Quasi-Governments, 3-5 years) is used for European quasi-government bonds; 3-5yr government bond indices are used for the UK (G2L0), France (G2F0), Germany (G2D0), Netherlands (G2N0), Spain (G2E0), Sweden (G2W0) and Italy (G2I0); bank senior unsecured spread volatility is based on data from EB3A (Euro Corporates, Banking, Senior (IG)); Euro covered bond indices are used for the UK (ECVU), France (ECFV), Germany (ECDV), Spain (ECVS), Sweden (ECVN - this is a Nordic Issuers Index) and Italy (ECVI) while data for the Netherlands is based on a subset of the ECV0 index

1.4 FACTORS AFFECTING ASSET ENCUMBRANCE

By Alexandra Schadow and Julian Kreipl, LBBW

LOSS OF CONFIDENCE AND THE NEED FOR SECURITY

Looking back, over the course of the financial crisis financial institutions have had their unsecured access to the capital market restricted, substantially so in some cases, due to the pronounced loss of confidence. Amid such a setting investors attempt to minimize risk and demand corresponding collateral for their investments. This leads to a substantial increase in interest not only in collateralized transactions. The assessment of risk is also reflected in the amount of collateral demanded. This applies to repo transactions on the interbank market and derivatives transactions as much as it does to refinancing by the central banks. In addition, covered bonds - which are considered as crisis-proof, have become more attractive to investors. These methods designed to ensure refinancing are vital or even necessary for survival in some cases. At the same time, via the collateral itself and the excess cover or haircuts demanded they have ensured that the necessary assets are tied up to protect a select group of investors when a crisis occurs. Asset encumbrance has, however, moved increasingly into the focus of market participants, as there are fears that it might, in the event of insolvency, result in structural subordination of non-collateralized creditors. This aspect gained additionally in importance as a result of the BRRD's bail-in provisions. However, the question as to how much of a bank's assets are encumbered could not be clarified initially. This was due to the lack of transparency regarding which of the bank's assets are tied up - with one exception. Covered bonds and their cover pools could be determined exactly; hence the focus was initially on this asset class. It is worth mentioning here that at the end of 2012 in Europe covered bonds totaling EUR 2.8trn were outstanding. Assuming an average surplus cover of 10%, around EUR 3.1trn in tied-up assets would be required. At the same time, the International Capital Market Association (ICMA) reported a EUR 5.5trn volume of repo transactions at the end of 2013; here, too, with an average assumed haircut of approx. 5%, assets totaling EUR 5.8trn would be needed. In addition, the European Central Bank (ECB) at the end of 2013 reported EUR 2.3trn in assets deposited with the Bank for bank funding. As we see it, this shows quite clearly that an overall view of all potential sources of asset encumbrance is necessary. This requires an exact definition of the term.

DEFINITION OF ASSET ENCUMBRANCE

A concise definition is necessary to ensure that a term is clear and accepted. In the course of the discussion of this topic the Bank for International Settlements (BIS) and the European Systemic Risk Board (ESRB) provided initial definitions of asset encumbrance. Specific mandates were then issued to the European Banking Authority (EBA) in the wake of the Capital Requirements Regulation (CRR). First, the EBA was mandated to develop reporting templates for all forms of asset encumbrance and that this information should be included in an implementing technical standard (ITS) (see Article 100 CRR). Secondly, it was mandated to draft a guideline for the disclosure of information on unencumbered assets (see Article 443 CRR). The final proposal for regulatory reporting has already been communicated to the European Commission for decision and is due to be implemented in the course of 2014, the guidelines for disclosure of information on unencumbered assets have been published at the end of June 2014. These texts are based on a standard definition of what asset encumbrance actually means. The EBA defines asset encumbrance as follows: "An asset shall be treated as encumbered if it has been pledged or if it is subject to any form of arrangement to secure, collateralise or credit enhance any transaction from which it cannot be freely withdrawn" (see Annex XVII, 1.7 of the EBA final draft implementing technical standards on asset encumbrance reporting under Article 100 CRR). Generally speaking, all on-balance sheet and off-balance sheet items must be included. In addition, a clear distinction is made between liabilities settled off the balance sheet via financial vehicles (SPVs) and true-sale securitzations and on-balance-sheet refinancing activities. Transactions via SPVs require additional analysis to establish whether the parent has pledged guarantees or liabilities that can be liquidated. These in turn lead to the tie-up of assets. This standard basis for the evaluation of tied-up assets that are not available to all creditors in the event of insolvency constitutes a major step toward the goal of making all tied-up assets transparent.

DRIVERS OF ASSET ENCUMBRANCE

There are a whole range of potential financing types that can have a major influence on the asset encumbrance of individual banks as a result of the demand for collateral. The EBA sets out the following categories:

> Secured financing transactions, e.g. securities lending or repo operations;

> Collateralization agreements, e.g. in connection with derivatives transactions;

> Financial guarantees that are collateralized;

> Collateral placed at clearing systems or CCPs;

> Collateral for central bank facilities;

> Underlying assets from securitization structures;

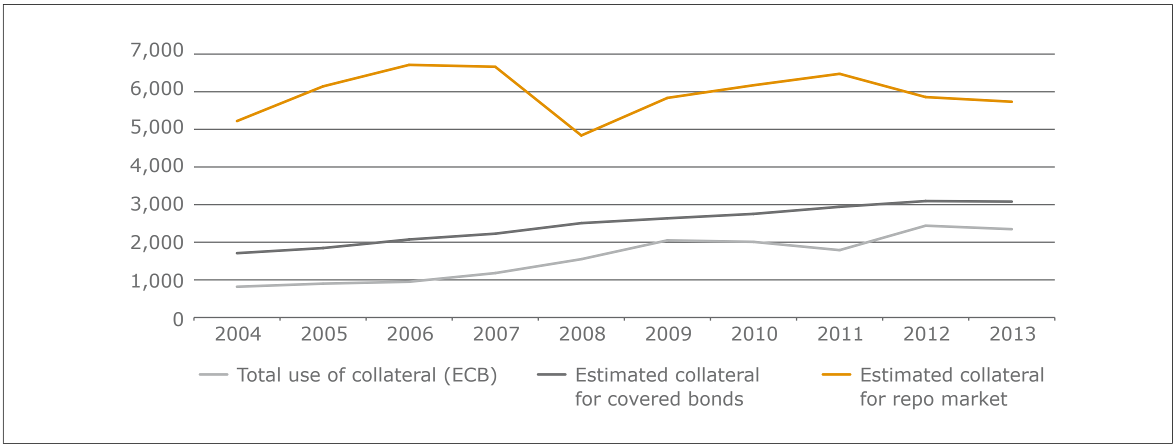
> Assets in cover pools used for covered bond issuance.

However, which of these drivers assume the main role in asset encumbrance depends to a great extent on the individual bank. Alongside the type of business model, it depends on the creditworthiness, the refinancing habits and on the economic setting. For example, during the financial crisis there was a steep increase in central bank facilities. Banks with a low credit rating, in particular, were able to secure their refinancing in this way.

All of the named financing types have one thing in common, however: the liabilities are matched by collateral which in some cases substantially exceeds the liabilities themselves. Covered bonds usually require a minimum surplus cover, on top of which the rating agencies have surplus cover requirements that need to be met to ensure a specific rating. These surplus cover requirements increase asset encumbrance. However, the same applies to the collateral requirements for the derivatives business, interbank repo business and ECB funding. The counterparties secure the borrowers' risks by means of haircuts on the assets required. In addition, the lenders can adjust haircuts upward, depending on the market's assessment. This factor also increases asset encumbrance.

While the outstanding volume of covered bonds has shown a very steady trend, the interbank repo business, in particular, and ECB funding have recorded substantially more pronounced fluctuations in the wake of the financial crisis. By way of example, we compare below the development of cover pool volume in the case of an average estimated surplus cover of 10%, the collateral deposited with the ECB and the estimated collateral amount for the repo business.

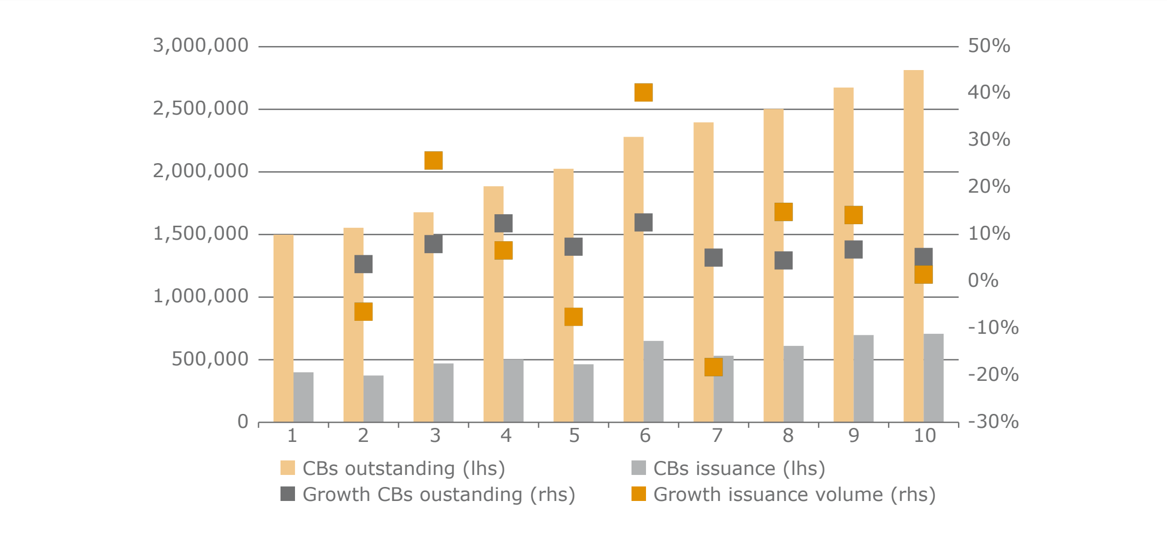
> FIGURE 1: DEVELOPMENT OF COLLATERAL FOR ECB, REPO AND COVERED BONDS, EUR BN



Source: ECB, ECBC, ICMA, LBBW Research

As we see it, a clear decision in favour of selected assets for the cover pool is an important factor for a stable cover pool trend. Covered bonds can be issued only if sufficient assets from a certain category are available. The definition of eligible assets has remained constant and is fixed by legislation, which at the same time limits covered bond volumes. If, for example, the volume of mortgage finance issued is low due to a recession, this also limits the issue volume of corresponding covered bonds. The following chart also shows the stable trend of covered bond volumes; during the period of observation the number of issuers has increased from 140 to 306. Given the market entry of many new issuers in a large number of countries over the past ten years, we are likely to see a certain amount of stabilization as far as the volume trend is concerned.

> Figure 2: Development of covered bonds



Source: ECBC, LBBW Research

By contrast, in the course of the financial crisis a gradual widening of potential collateral classes for deposit with the central banks occurred, as a result of which the potential refinancing volume for the banks increased. In 2013 marketable collateral amounting to EUR 14.2trn was classified as eligible, up from EUR 8.2trn in 2005. When depositing this collateral for refinancing via the ECB, asset encumbrance can thus be increased substantially, at least for certain periods of time.

COVERED BONDS AS A CAUSE OF ASSET ENCUMBRANCE

Nevertheless, covered bonds have found themselves time and again in the crossfire of the asset encumbrance debate. In our view, this is mainly because it is already possible to measure actual asset encumbrance fairly accurately by looking at the cover pool assets. Regular reporting, using in the form of cover pool evaluations, provide the capital market with information on the volume of assets separated for the outstanding securities and, accordingly, on the level of tied-up assets. However, the publicity requirements with regard to the frequency and level of detail provided (to assess the quality of the assets) vary across jurisdictions; this makes comparisons on an international, and in some cases even national, basis substantially more difficult. The ECBC has made the most successful attempt Europe-wide to facilitate the comparison of reporting within a country and at international level. By designing national templates, standard reporting forms are made available for a large number of jurisdictions. However, this initiative is a voluntary one.

We do, however, perceive a lack of transparency when it comes to retained covered bonds as their volume is usually not published. They are retained by the issuer and used for repo transactions with central banks, for example. During the financial crisis it was the periphery states, in particular, that had recourse to this type of covered bond, but their volume has declined substantially of late. Retained covered bonds tie up assets only, and only, if they are actually deposited with the central bank as collateral.

Not least the disclosure duties enshrined in law and the ECBC Covered Bond Label initiative have served to ensure that every market participant is able to establish the volume of individual issuers' asset encumbrance very easily. The EBA's two initiatives on the reporting and publication of asset encumbrance are expected to shift the focus gradually toward all potential "risks" for the tie-up of assets. However, the disclosure of asset encumbrance is of particular importance for investors. The EBA's guidelines provide for an overview of the tied-up assets, the collateral received and the various causes of asset tie-up in an annual publication as part of the annual financial statements. This will be supplemented by a qualitative assessment of the importance of asset encumbrance for the bank in question. Every bank will, however, be given up to six months following the publication of its annual report to comply with the disclosure duty. Given the potential momentum of this key figure, the proposal of an annual and possibly delayed publication does not seem very investor-friendly to us. Contrary to the proposition to report emergency liquidity assistance (ELA) provided by the national central banks as unencumbered, the EBA's guidelines considers this as factually misleading and decided to include all central bank operations including ELA in the disclosures, which we think is rational particularly during phases of crisis.

Back to covered bonds. In order to prevent covered bonds tying up too many assets at an early stage some countries already have in place mechanisms, even going so far as to impose stringent covered bond limits. In some jurisdictions the legislator already provides for a cap on covered bond volumes; the table below provides a summary overview:

> Figure 3: Limits for covered bonds in different countries

Country	Limitation of covered bond issuance
Australia	Value of cover pool must not exceed 8% of total assets
Austria	None
Belgium	Value of cover pool must not exceed 8% of total assets
Canada	Outstanding covered bonds must not exceed 8% of total assets
Denmark	None
Finland	None
France	None
Germany	None
Greece	20% of assets (unclear whether cover pool or covered bonds)
Italy	"No limitations for banks with: Tier 1 capital ratio >= 7% & total capital ratio >= 11% up to 60% of total eligible assets can be used as cover assets for banks with: Tier 1 capital ratio >= 6.5% & total capital ratio >= 10% up to 25% of total eligible assets can be used as cover assets for banks with: Tier 1 capital ratio > 6% & total capital ratio > 9% "
Ireland	None
Luxembourg	None
Netherlands	Case-by-case limit determined by the Dutch Central Bank (DNB)
New Zealand	Value of cover pool must not exceed 10% of total assets
Norway	None
Portugal	None

Country	Limitation of covered bond issuance
Spain	None
Sweden	None
Switzerland	None
UK	Case-by-case limit determined by the FSA

Source: national law, LBBW Research

In general, a distinction can be made here between two approaches. In the first approach, the outstanding covered bond volume is looked at in relation to total assets. As we see it, this approach prevents a separation of assets only to some extent as there are no restrictions on voluntary surplus cover. The second, more usual, approach provides for an upper limit on the ratio of cover pool to total assets, which results in an upper limit of tied-up assets. In tandem with this, the issue volume of covered bonds is also limited as often statutory minimum surplus cover or surplus cover requirements stipulated by the rating agencies need to be ensured.

CONTINGENT ASSET ENCUMBRANCE

It is not sufficient, however, to measure asset encumbrance at a certain point in time. Both the assets and liabilities sides of a bank's balance sheet are subject to continual change. The focus, however, is on market price changes on the assets side. Additional funding obligations arise if tied-up collateral is no longer sufficient since it became necessary to adjust the value of the assets. This situation may arise in the case of covered bonds and in other collateralized financing. The topic is discussed below under "Contingent asset encumbrance".

In the case of covered bonds, when falling market prices of assets are taken into account the minimum surplus cover might be undershot. This may affect programs whose cover assets are subject to an index valuation or to market risk. Thus price fluctuations can lead to a reduction in the cover pool volume. If the statutory or promised surplus cover can no longer be ensured, this results in additional funding obligations which lead to further contingent asset encumbrance.

However, changed risk assessments with regard to the default risk of the issuer in question may also lead to additional momentum. As we see it, for example, it is conceivable that a deterioration in the issuer rating leads to an increase in the surplus cover requirement in order to stabilize the covered bond rating. The same event might also lead to increased requirements regarding the collateral volume to be deposited by a counterparty in the repo business. In both these cases, asset encumbrance increases further while liabilities remain unchanged. Whereas the statutory minimum surplus cover constitutes a relatively stable and easy-to-calculate dimension for investors, we think that changes in voluntary surplus cover and haircuts are more difficult to gauge.

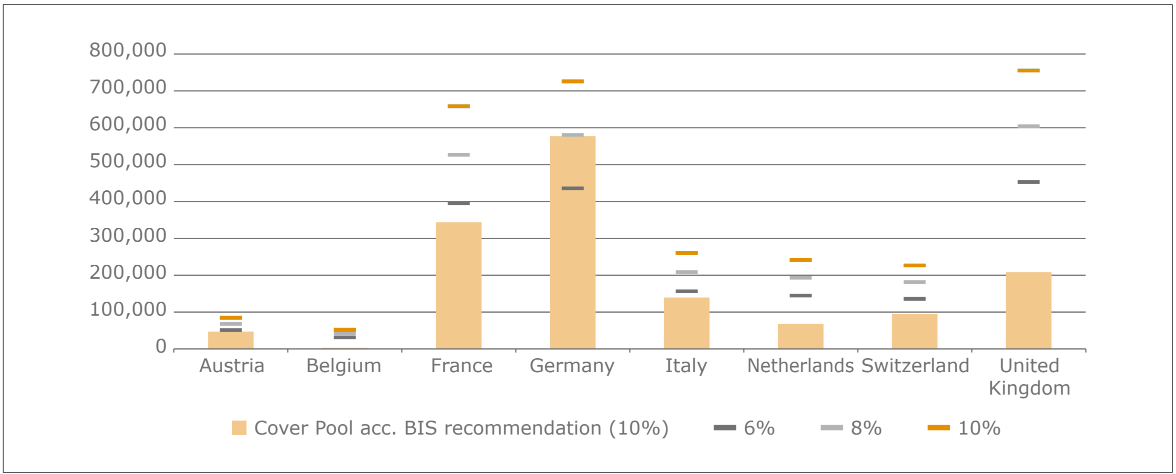
SCENARIO CALCULATION

Below we have simulated specific asset encumbrance limits for covered bonds for individual banking systems in Europe and contrasted them with the cover pools of these countries. To this end, we have used the data provided by the central banks in question, the ECB and the ECBC for 2012. The aggregate total assets of a jurisdiction were selected as representative of the markets in question. The starting point was the assumption that limiting the cover pool in relation to a bank's total assets is a more effective limit than putting the issue volume in relation to it. Since some countries have already adopted statutory asset encumbrance limits, it seems appropriate to be guided by these limits. In practice, the 8% limit (cover pool/total assets) is the most frequently used although we are not aware of a clear explanation as to why exactly this figure is used. We have calculated the scenario with asset encumbrance limits of 6%, 8% and 10% in order to demonstrate their effect on a banking system.

The minimum cover pool of a country's banking system is derived from the outstanding cover bond volume and includes a general, nominal minimum surplus cover of 10%. We have here followed the "Supervisory framework for measuring and controlling large exposures" published by the BIS in April 2014, which provides for the preferential treatment of covered bonds if they are UCITS-compliant and the surplus cover totals at least 10%. This means that for the first time in an international approach a specific surplus cover ratio is demanded.

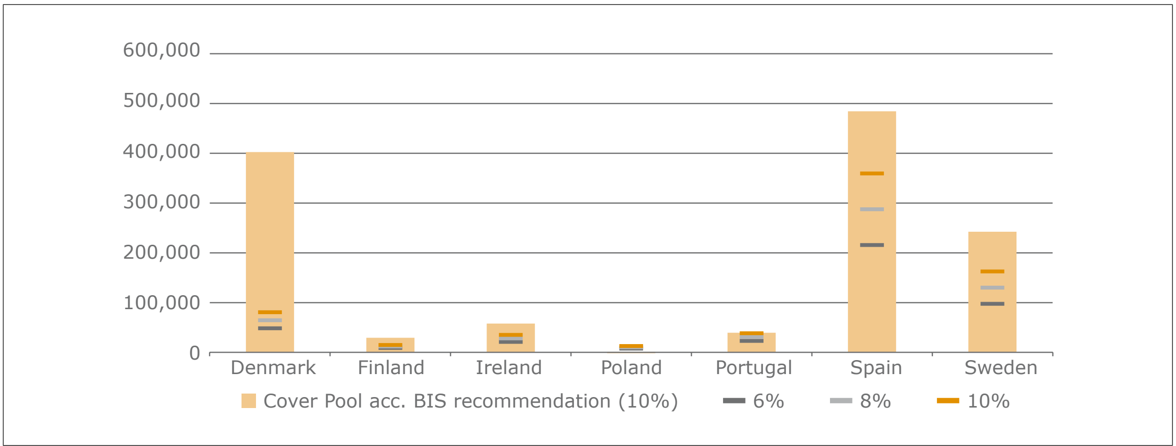
The result of our calculation is multi-layered. While some countries are quite far removed from these notional asset encumbrance limits, other jurisdictions would be affected significantly by such fixed limits. The following two charts show the individual banking systems with the three assumed asset encumbrance limits (grey, green and blue bars). If these limits already fall within the cover pool volume (light blue), the banks in these countries would have to either reduce their covered bond volumes or increase their total assets as a restrictive reference for the maximum cover pool volume. As we see it, the reduction in covered bond volumes in future in turn raises the question who or what would be available as a refinancing substitute in the countries affected. By contrast, an expansion of total assets does not appear very realistic to us given the contraction in total assets currently in evidence.

> Figure 4: Scenario calculation for core European banking systems (BIS proposal), in EUR m



Source: ECB, ECBC, *SNB, LBBW Research

> Figure 5: Scenario calculation for Nordic and peripheral countries (BIS proposal), in EUR m

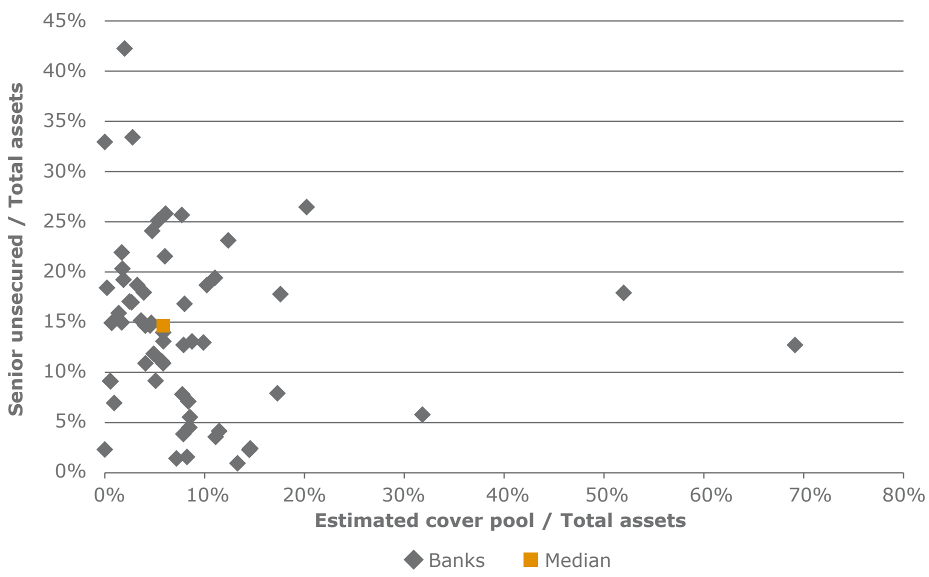


Source: ECB, ECBC, LBBW Research

The picture also shows, however, that a decisive factor here is the importance of covered bonds for the refinancing of mortgages or public-sector finance of an economy. National differences have developed over time and in some cases are fairly pronounced. Treating all jurisdictions the same with regard to possible covered bond limits does not really serve any purpose, we think, on the basis of these differences in market practice alone.

Moreover, we think it is important to point out here that this scenario calculation is an average one. Consequently, it does not take into account differences in business models. This, however, is a decisive factor for a bank's asset encumbrance due to covered bonds. In Europe, in particular, there are many different business approaches in the banking landscape, each of which entails a different refinancing policy. This, we think, needs to be taken into account when raising the question of tied-up assets and how they should be regulated. We set out below a group of 59 banks with their individual asset encumbrance due to covered bonds in relation to the percentage of senior unsecured in total assets. These banks are selected financial institutions from the largest banking markets which will be subject to ECB supervision in future, adjusted for banks that do not issue covered bonds.

> FIGURE 6: ASSET ENCUMBRANCE DUE TO COVERED BONDS COMPARED TO SENIOR UNSECURED FINANCING



Source: ECB, national central banks, companies, SNL, LBBW Research

A stringent limit on covered bonds is not sufficient, we think, to banish the risk of structural subordination for senior unsecured. Rather, all potential asset tie-ups must be included in the calculation. The following example illustrates this point:

Bank A: A mortgage bank that has high level of tied-up assets due to its core business activities and their refinancing via covered bonds. At the same time, this bank is not very active as far as ECB funding, repo and derivatives business is concerned and requires virtually no tied-up assets in this respect.

Bank B: A bank that is very active in the derivatives business and the interbank repo market. Moreover, it participates regularly in ECB funding. Most of its collateral is maintained for this purpose. Refinancing via covered bonds accounts for only a very small portion of tied-up assets.

If a stringent asset encumbrance limit were introduced, the regulatory stimuli this would provide to Bank A would be of a completely different nature than those provided to Bank B. Bank A would probably have to reduce its covered bond volume and turn to alternative refinancing options. The likelihood of this increasing the Bank's funding costs is very high. As we see it this would, in turn, have a direct impact on the bank's mortgage lending and ultimately on the country's mortgage market. Bank B would experience the biggest restrictions in its repo and derivatives businesses and might have to limit its ECB funding. The consequences of this are even more difficult to estimate, we think, but they might also have a direct market influence. Think, for example, of the possible limitation of ECB funding by exceeding asset encumbrance levels, on the one hand, and the financing of the real economy by the banks with the help of open market operations, on the other. As we see it, this makes it very clear that a discussion of asset encumbrance needs to take into account the different business models. Moreover, the potential regulation of asset encumbrance must not result in target conflicts that harm the real economy.

QUALITY OF ASSETS IS DECISIVE

The introduction of asset encumbrance was originally designed to protect unsecured creditors in the event of insolvency. However, ultimately the following question needs to be answered: What exactly is available to the unsecured creditor? The often-proposed approach to set the assets that are not tied up against the non-collateralized portion of the liability therefore makes a lot of sense, as we see it. After all, in the event of resolution sufficient assets should ideally be available to satisfy the unsecured creditors. A decisive restriction here is the introduction of the new resolution rules by the European Banking Union, which provide for the bail-in of senior unsecured on principle, if necessary. In the wake of this a minimum of eligible liabilities is required in order to be able to perform a bail-in. Ahead of a bail-in, however, the valuation of assets and liabilities is the decisive step which ultimately determines the ratio of assets not tied up to non-collateralized liabilities. Here, an initial balance may develop at the expense of the uncollateralized creditors due to the lack of asset value and quality. The BRRD's call for a fair, cautious and realistic valuation by an independent person is thus moving into the foreground as the value of the assets becomes the decisive factor. This applies to the unsecured and the secured creditors alike.

The collateral demands made by the ECB and the counterparties in the repo and derivatives business, in particular, usually stipulate that the assets need to be marketable and that they meet high credit quality standards, which among other things are often tied to specific minimum ratings from the rating agencies. Moreover, the following rule generally applies: the higher the asset quality, the lower the haircut applied on deposit. In our opinion, this automatically means that - if possible - high quality assets are used as deposit. In the case of covered bonds the assets have to meet fixed minimum conditions set out in law, with the external rating playing either a very minor role or no role at all. Of far greater importance is the restriction to certain forms of funding, which according to Article 129 CRR are limited to mortgage, public-sector and ship finance and provide for an LTV limit. In our view, there is a risk of the unencumbered assets available to senior unsecured creditors being on average of inferior quality, which stems in particular from the collateral demands of the ECB and the counterparties in the repo and derivatives business.

SUMMARY

The target is to make the tied-up assets of the individual banks fully transparent, which is the next step. Without wanting to pre-empt the outcome, we think it is safe to assume that highly individual and bank-specific structures will emerge. The results are likely to be evaluated by investors on the capital market, and they will ultimately among a large number of other factors be reflected in the funding costs of the issuer in question, we think. This would, above all, serve to make transparency a crucial factor in the valuation of asset encumbrance. Regulatory and standardized intervention would not serve its purpose here, as we see it. The complexity of asset encumbrance with its various causes and effects requires that every bank is looked individually. A regulatory one-fits-all approach if implemented would harbour the risk of undesired steering impetuses being triggered, which might harm the financial system. By making all tied-up assets transparent, the investment decision is ultimately left to the capital provider, taking into account his or her risk preferences.

1.5 BRRD – IMPLICATIONS ON BANK BALANCE SHEETS AND FUNDING

By Alexandra Schadow, LBBW and Maureen Schuller, ING Bank

BANK RECOVERY AND RESOLUTION DIRECTIVE (BRRD) ADOPTED

On 15 April 2014 the BRRD was adopted by the European Parliament. The EU member states use this Directive as a procedure for the restructuring and resolution of banks and investment firms. The regulations will now have to be implemented into national law by the end of 2014. The BRRD is embedded in the complete set of rules of the European banking union, which also consists of the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM), whereas the latter two will only be binding for the member states of the EUR currency union.

FUNDAMENTAL PROCEDURE OF THE BRRD

The BRRD pursues one goal in particular. The acting authorities will be given a reliable instrument in order to guarantee financial market stability. In doing so, a standardized procedure was agreed upon that gradually progresses from prevention to early intervention and resolution. The foundation for this, which is intended to avoid an "emergency" via prevention, is the Capital Requirements Directive IV and the Capital Requirements Regulation (CRD IV/CRR package), which stipulates the supervisory terms. The BRRD also requires banks to come up with recovery and resolution plans both on an individual basis and on a group level in order to show the degree of complexity of transnational institutions. While the recovery plan is drawn up by the respective bank, the resolution plan from the responsible supervisory authority is based on this.

In the event of violations of the supervisory regulations or even just a threat of this happening, extensive measures can be undertaken in the scope of an early intervention by the regulatory authorities. These include, among others, a change in strategy or letting members of the management go. This phase also attempts to guarantee that all regulatory requirements are complied with from the beginning through suitable restructuring measures. However, if these attempts are unsuccessful and the institution's situation deteriorates appreciably, it could become questionable down the road whether the institution will fail or is likely to fail. If this is answered with "yes", the responsible resolution authorities must decide whether the bank will be liquidated or wound up. In principle, a dying bank should be subject to a normal insolvency process. However, this may be countered by a few weighted arguments. Particular attention should be paid here to avoiding significant negative effects on financial market stability, which in the case of major institutions with a strong international network in the financial sector may lead to contagion risks in our view - see Lehman. However, securing critical functions and the protection of public funds, deposits and other assets of customers are at the center of the BRRD's focus. The Directive mentions three requirements in particular, which must be met for resolution to take place:

(1) The institution is failing or is likely to fail;

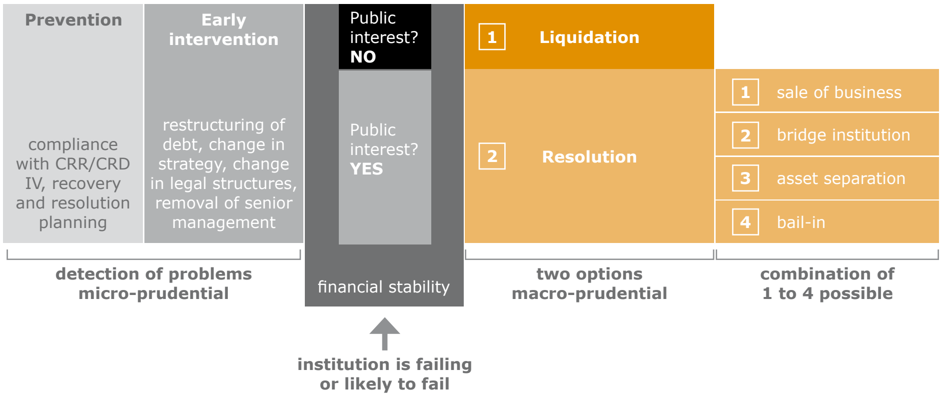
(2) There are no private sector measures that can prevent the institution from failing;

(3) The resolution measure is required in the public interest.

One crucial note, in our view, is that a going-concern principle still has to be assumed. This means that the measures taken will ultimately contribute to the part of a bank able to survive being rescued.

If the decision is in favor of a resolution, four possible instruments are available to the resolution bodies, which can be combined with one another. Although the instrument of a bail-in is most frequently discussed, we believe it is also worth briefly addressing the three other instruments, i.e. a sale of business, a bridge institution and asset separation. This is because covered bonds could also be affected by these measures.

> Figure 1: System of recovery and resolution of banks



Source: LBBW Research

Sale of business

The resolution authorities in principle can sell certain parts of an institution in the course of a resolution without the approval of the shareholders. However, the requirements for this tool stipulate that the responsible authorities must generate as high a sales price as possible. The buyer here is expressly not a possible bridge institution, but rather an external third party. The buyer must have the necessary approvals to be able to continue that part of the company acquired. This is very significant in the case of a separate sale of covered bond programmes, as special permits and licenses are necessary in the individual EU member states to operate the covered bond business. We (the authors) believe that, in the case of covered bond programmes, this rule largely serves to ensure that the strict supervisory and legal requirements of such programmes are also present in the case of a resolution process.

Bridge institution

This institution is founded specifically for the transfer of assets and liabilities from the bank to be wound up and is in public hands. The initial goal is to sell these to private investors. If this is not done within two years (with an option to extend), the bridge institution is wound up in the scope of an insolvency. It is also possible for covered bond programmes to be transferred to a bridge institution. In doing so, the bridge institution operates as a legal successor and may exercise all the rights and obligations that come with the assets and liabilities. We assume that a bridge institution in the ownership of a covered bond programme would initially remain fully functioning. We believe the question to what extent an insolvency procedure would be possible at all if the affected covered bond programme were to meet all legal requirements, must only be asked if a sale is not carried out in the intended period.

Asset separation

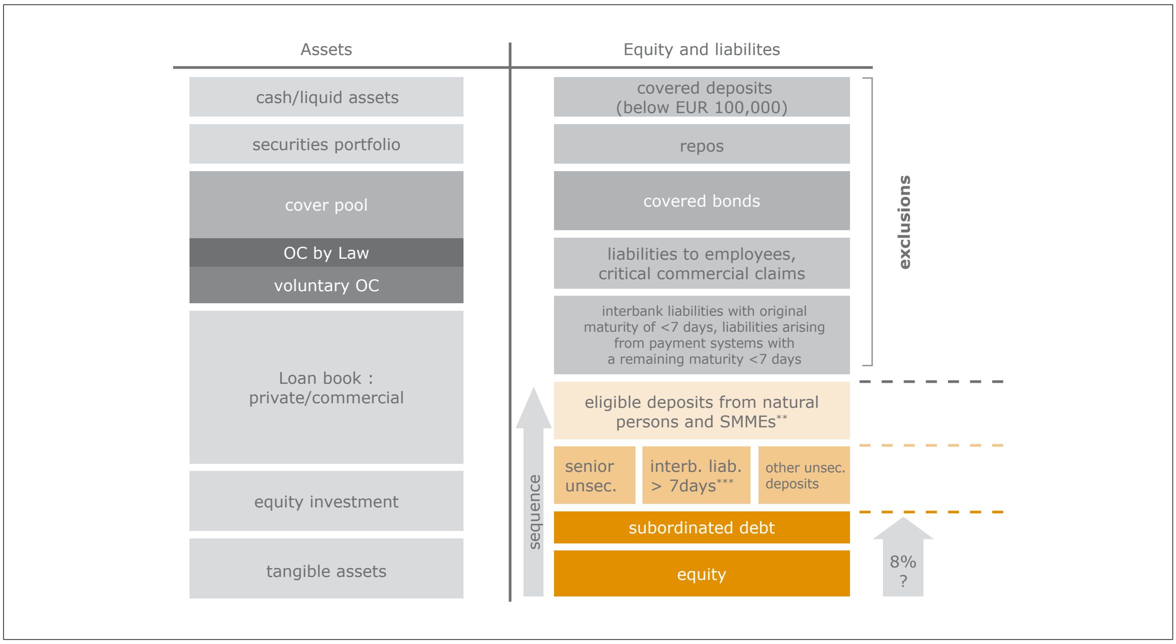
In order to spin off assets, a special purpose vehicle is founded specifically for this and is publicly owned. Contrary to the bridge institution, the goal of the special purpose vehicle is to maximize the value of the managed assets. The only assets that can be transferred to the special purpose vehicle are those whose liquidation threatens the financial market stability, which prevent the proper functioning of the institution to be wound up or which generate the highest possible liquidation proceeds. Because this pertains exclusively to the spin-off of assets, we do believe that covered bonds can only be partly affected by this measure. In case of separation of single assets out of a cover pool the remaining covered bond programme still has to fulfil the legal requirements, for example, enough overcollateralization. This could lead to specific actions like a transfer of assets or the buyback of covered bonds.

Bail-in

The bail-in instrument is intended to be used by the resolution authorities to carry out recapitalization. The goal here is either to restore a restructured institution to the point that it has sufficient capital to meet the regulatory requirements, or to equip the receivables and liabilities to be transferred with sufficient capital. The resolution authorities can achieve this by writing down or converting the eligible liabilities. The "no worse off" principle, which stipulates that no creditor may be put in a worse position than in the event of a regular insolvency, applies here.

However, two major parts of the process must be considered in the case of a bail-in. First, an exact sequence much be kept, which starts with the shareholders and includes the various asset classes back-to-back depending on their ranking. Second, there are liabilities that are explicitly exempt from a possible bail-in by the requirements of the BRRD. These also include the covered bonds that comply with Article 52(4) UCITS Directive 2009/65/EC. According to the Directive, a bail-in is possible for covered bonds only if the liabilities from the covered bonds exceed the corresponding collateral in the covered pool and the resolution authorities believe a bail-in is appropriate. This would mean underfunding. At this point, it should be noted that the covered bond legislation, albeit in a different national specification, always calls for sufficient cover. The issuer is required to rectify any emerging underfunding in a timely manner. However, we see certain risks that come with the implementation of the BRRD into national law with regard to this restriction and the concrete shape that the consequences of this may take.

> FIGURE 2: BAIL-IN INSTRUMENT IN PROCESS



* ESM aid for direct bank recapitalization:Conditions: CET1 must be replenished by the government to 4.5% (80% co-financed by ESM / (initially) 20% by government possible), later the contribution by the domestic government drops to 10% of the aid required. ESM volume limited to EUR 60bn (out of a total of EUR 500bn).

** SMME (Small, medium and micro enterprises); EIB (European Investment Bank). In accordance with EU recommendation 2003/361/EC, e.g. for companies with < 250 employees.

*** Not explicitly stated in the Ecofin draft, but is in our view a logical consequence of the protection of Interbank claims < 7 days.

Source: LBBW Research

As a rule, 8% of the total liabilities including the institution's own funds must initially be written down or converted in the order stipulated in the event of a bail-in. Only after that the BRRD offers some flexibility to exempt certain categories of eligible liabilities and make use of a resolution financing mechanism. This amount, in turn, is limited to 5% of the total liabilities including the own funds of the institution being wound up. In addition, if capital is still insufficient, the resolution authorities can take the additional step of bringing in funds from alternative sources, whereby all unsecured and non-preferential liabilities must have been fully subjected to a bail-in. Alternative sources of funding in our view may be both funds from the state and financing from the ESM. As was already mentioned, covered bonds are not directly affected by a bail-in. However, it can be assumed that the minimum requirement for own funds and eligible liabilities (MREL) demanded by the BRRD to be stipulated and complied with in the future has an influence on the covered bonds. The aim of this rule is to guarantee that an institution can be wound up at any time, so that the discussion of asset encumbrance (see Article on Asset Encumbrance in the ECBC Factbook) in turn finds its way in through the back door. However, there is one exception in the BRRD about mortgage credit institutions financed by covered bonds. If they are not allowed to receive deposits the resolution authority can exclude them from the MREL requirement. This, in turn, is only possible in case of a realizable winding-up according to a national insolvency procedure or other types of measures in accordance with the resolution tools in the BRRD and within the resolution objectives.

ASSESSMENT OF THE RATING AGENCIES

The rating agencies have already reacted to the rules of the BRRD. While Fitch and Moody's have adjusted their methodologies for covered bonds, S&P only announced a change after the official adoption of the BRRD. This change has yet to be made. We are therefore looking only at Fitch and Moody's.

Fitch

The covered bond rating remains tied to the credit risk of the issuer or reference issuer as reflected in the long-term issuer default rating (IDR). The IDR in turn is derived from the higher of the viability rating (VR) and support rating floor (SRF), whereby the VR assesses the stand-alone creditworthiness and the SRF evaluates the possible extraordinary support of institutional shareholders or the state. If the VR is the higher value, the issuer's IDR initially is not at risk as a consequence of the BRRD, meaning the basis for the covered bond rating would remain unchanged. However, if the issuer's rating is based on the SRF, sovereign support may weaken on the basis of the new rules, which would have a direct effect on the issuer rating and thus in turn on the basis for the covered bond rating. Fitch has indicated that SRFs could be revised downwards in late 2014 to 1H15. In assessing support, the propensity and ability of national and international authorities to grant support are factors considered by Fitch. In addition, Fitch has emphasized that the extent to which senior unsecured debt is in the "firing line" in the event of a bail-in may be very relevant. For example, sufficient tier-3 capital would have a positive effect on the default risk of the senior unsecured liabilities, from which the covered bonds would also benefit indirectly.

Taking this as a basis, Fitch has enhanced its covered bond methodology introducing the "IDR uplift". With regard to the potential IDR uplifts, the rating agency initially refers solely to those jurisdictions that explicitly rule out covered bonds in connection with a bail-in tool. Fitch links the IDR uplift to the results of an evaluation of the following three issues:

(1) Assessment of the possibility and motivation to use resolution methods other than liquidation;

(2) Assessment of the significance of covered bonds for a jurisdiction's respective financial market;

(3) Share of senior unsecured bonds within a bank's debt capital structure that are available for a potential bail-in.

An important point for the rating agency is the amount of the buffer of "bail-in-able" senior unsecured bonds besides equity and subordinated capital. The larger this buffer is, the more likely crises can be cushioned by a bail-in. Fitch makes this uplift factor dependent on the total volume of senior unsecured debt and specifies a 5% minimum ratio of senior unsecured to total assets (adjusted for insurance transactions and derivatives). Depending on the rating category of the IDR, the satisfaction of these three criteria may give rise to an uplift by either two or three notches maximum. Fitch's rating methodology for covered bonds otherwise remains largely unchanged."

Moody's

The covered bond rating from Moody's is also based on the assessment for the issuer. The senior unsecured rating in turn is based on the evaluation of the stand-alone creditworthiness using the Bank Financial Strength Rating (BFSR) or the Baseline Credit Assessment (BCA) plus potential uplifts of several notches, depending on the probability of support on various levels, starting from the parent company and up to the state. The uplift for state support is not entirely removed as consequence of the BRRD. However, the uplift for potential support should turn out to be weaker in the future.

For covered bonds in the EU and Norway, the reference or starting point for the covered bond rating has been redefined. With the so-called covered bond anchor, Moody's incorporates the probability of a "CB anchor event". This event applies if the issuer or another member of the group terminates support for the covered bonds both financially and administratively. For all other jurisdictions, the senior unsecured rating continues to be used as a basis. In detail, the CB anchor is determined by the following four factors:

(1) The issuer's inherent financial strength;

(2) The support provided to the issuer by the parent or a group;

(3) State support for the issuer;

(4) Support based on the debt capital's capacity to absorb losses.

Depending on the amount of unsecured debt that is available, the senior unsecured rating or adjusted BCA is uplifted. The key point is the ratio of "bail-in-able" debt capital to total debt, which is broken down into the three categories of less than 5%, 5-10% and more than 10%. Regardless of this, uplifts result and income will ultimately be:

(1) The adjusted BCA plus an uplift of zero to two notches, or

(2) The senior unsecured rating plus an uplift of zero to one notch.

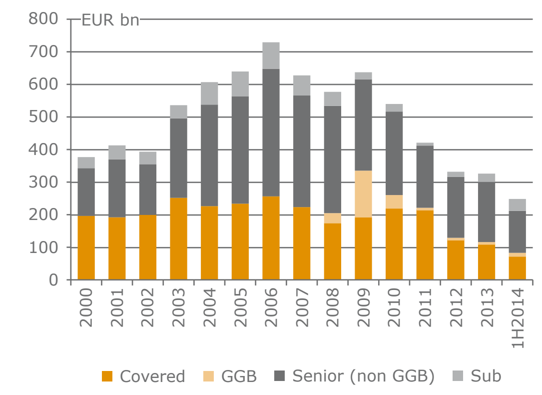
The processes stipulated in the BRRD in the event of a bank recovery or resolution offers incentives impacting the liabilities side of the balance sheet in particular. The focus here is on the rules for the bail-in. Although the BRRD has not yet been implemented into national law, the reorganization of bank balance sheets, especially on the liabilities side, is already in full swing. In the following section we examine the primary market consequences.

THE BRRD AND ITS IMPACT ON SUPPLY

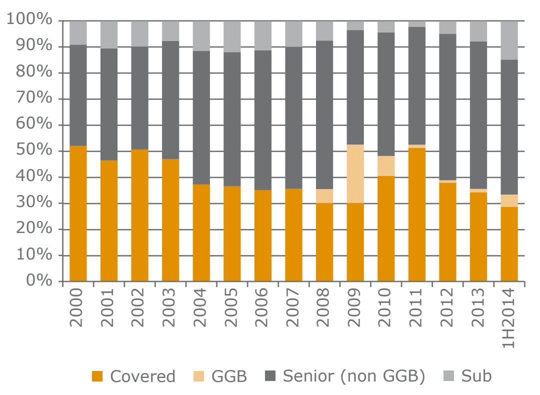
The intense scrutiny on the liability structures of bank balance sheets, induced by the BRRD, is without doubt impacting today's primary market dynamics. It is fair to say that in the past few years the ECB's Long Term Refinancing Operations (LTROs), as well as deleveraging and associated lower funding needs of banks, have been major contributors to the slowdown in issuance, including covered bonds. However, when analysing the current primary market conditions, the significance of the BRRD for bank funding decisions across the capital – liability spectrum should not be underestimated.

To firstly give some historical flavour to bank funding dynamics, Figure 3 plots the total EUR-denominated financials supply capturing the period from 2000 until the first half of this year (2014). After peaking over EUR 700 bn in 2006, financials issuance has more than halved since. With issuance in the area of EUR 330 bn in both 2012 and 2013, total EUR financials supply has troughed to the lowest levels since 2000. Covered bond issuance fell below the EUR 200 bn mark for the first time in 2008 and 2009 when government-guaranteed senior unsecured issuance partly replaced covered bonds as a more efficient choice of funding. However, in 2010 and 2011 primary activity in covered bonds recovered. EUR benchmark issuance even reached a peak of EUR 193 bn in 2011. But then, in 2012 and 2013, an even more pronounced decline in the absolute issuance levels in covered bonds took place. During this episode, the ECB's 3yr LTROs offered a cheaper refinancing alternative. In the past two years issuance has been in the range of EUR 110 bn to EUR 128 bn, while 1H 2014 EUR covered bond supply just tops EUR 70 bn. This suggests that the covered bond market is approaching something akin to drought conditions with the slowest issuance activity in fourteen years.

> Figure 3: Absolute EUR Financials issuance declines



> Figure 4: Share of covered bond issuance declines



Source: Dealogic, ING

Further insights into covered bond supply dynamics are provided by Figure 4, which gives an overview of the share of (non-retained) covered bond issuance within the aggregate EUR denominated financials issuance data. The chart shows that in the period 2000 to 2005, when the absolute levels of covered bond issuance did rise, covered bonds nevertheless declined in relative importance in the overall funding mix of banks. During peak supply year 2006 covered bonds only represented 35% of total EUR bank funding. Crisis years 2008 and 2009 remain the lightest years in terms of covered bond supply, not only in absolute terms but also as percentage of total funding. Only 30% of all EUR denominated funding was sourced via covered bonds as government-guaranteed senior replaced covered bonds as a pool of cheap funding.

Some straightforward and intuitive conclusions can be drawn from this narrative with respect to covered bond issuance:

1) The overall funding need of banks is a major driver for covered bond issuance.

2) Covered bonds offer a funding cost advantage over senior unsecured issuance, but only under more difficult senior unsecured market conditions covered bonds manage to increase their relative significance in the overall funding mix of banks.

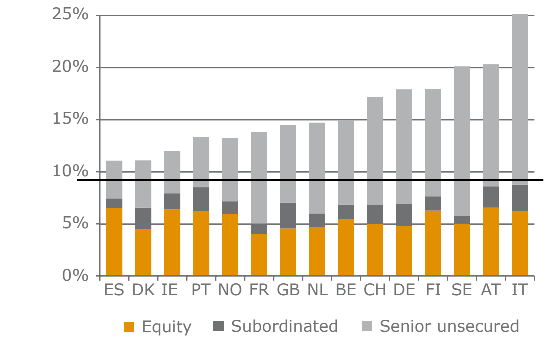
3) The past few years have taught us that distressed market circumstances tend to give rise to extraordinary, often last resort funding initiatives via government or central bank channels to meet refinancing needs of banks. Consequently, even during more distressed market circumstances covered bonds have occasionally experienced a more distinct fall in issuance versus other bank funding sources.

Although these findings still play out in today's supply dynamics, the focus by banks on the entire liability structure of the balance sheet has become an important add-on effect for bank funding decisions, as we will discuss in the next section.

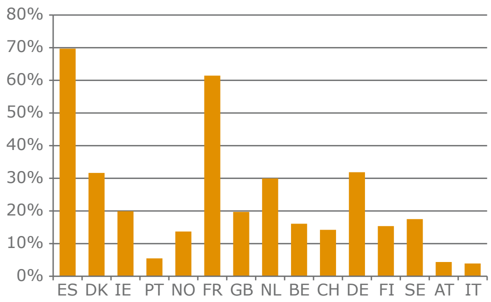
CAPITAL AND BAIL-IN BUFFER CONSIDERATIONS

Figure 5 plots the average equity, subordinated and senior unsecured buffers reported at the end of 2013 per jurisdiction for a sample of 75 European covered bond issuers. For the purposes of this graphic we have sourced SNL data[1], adjusting the reported senior debt issuance for the value of the covered bonds, securitization notes and government guaranteed bonds outstanding per issuer, as separately reported in their financial disclosures for 2013. For specialist bank entities the consolidated figures at the level of the parent entity are used. No further adjustments have been made, e.g. (interbank) liabilities with a maturity of less than seven days are not excluded. The buffers should also not be confused with the minimum requirement for own funds and eligible liabilities (MREL), which require eligible liabilities to have a remaining maturity of at least one year. The buffers, therefore, are approximate and calculated for the sake of illustration. They may indeed exaggerate the true buffer margin and also exceed the buffers as computed by Moody's and Fitch for the purpose of assigning their anchor point or IDR uplifts.

> FIGURE 5: AVERAGE COMPOSITION BAIL-IN BUFFERS PER JURISDICTION (YEAR END 2013)



> FIGURE 6: AVERAGE EXPECTED LOSS SENIOR UNSECURED BONDHOLDERS TO REACH 8% (YEAR END 2013)



Source: SNL, ING

That said, Figure 5 does give a relatively useful indication of the average buffers available for European banks per jurisdiction, and proves helpful, in our view, for the purpose of analysing the YTD supply trends in the financials space. For the majority of the constituents in the European banking sector, the equity and subordinated buffers (i.e. the buffer capital layer available to senior unsecured bondholders in case of a bail-in scenario) are still well below the generic 8% target, above which relief can be sought via resolution financing arrangements. In our view, this partly explains the increasing share of subordinated issuance in the bank funding mix at the expense of covered bonds. The clarity provided by the final CRD IV text last year (2013) on the qualifying characteristics of subordinated debt instrument for bank capital purposes also initiated fresh solvency capital issuance.

At the end of 2013 the equity and subordinated debt buffers were lowest for issuers from jurisdictions such as Sweden or France, arguing in favour of an increase of their equity or subordinated buffers, to secure a better safety net for senior unsecured bondholders against bail-in risks. For issuers from Spain, Ireland or Portugal, the equity and subordinated buffers are much closer to the 8% level. Banks from these countries are left with relatively small senior unsecured layers in the liability complex to absorb a potential bail-in event due to the senior unsecured debt that rolled off the curve in the past number of years without being refinanced or otherwise was replaced with mainly central bank funds. Senior unsecured layers are also low in Denmark. For these jurisdictions it is important to build up both senior debt and buffer capital layers. Raising the subordinated buffers towards

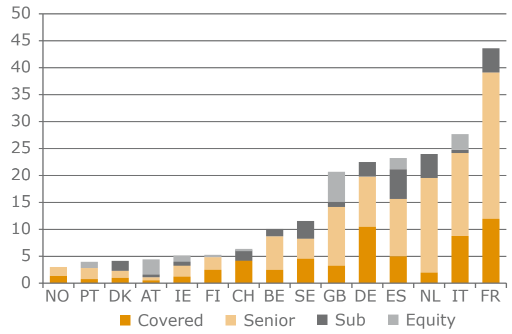
1 As per the Bank Peer Analytics tool of SNL Financial LC (www.snl.com).

8% will mitigate bail-in risks carried by senior unsecured debt holders. At the same time by increasing the senior unsecured debt layer, potential losses will be dispersed over a wider catchment of unsecured creditors. Consequently increasing the senior unsecured debt stock reduces the expected loss for existing senior unsecured debt holders in case part of the senior unsecured stock of debt is captured in a bail-in. Figure 6 plots the percentage of the senior unsecured layer that has to be written down to realise a minimum 8% bail-in proportion via eligible liabilities and senior unsecured debt. It shows that the average expected losses for senior unsecured bondholders to reach 8% are in particular high for Spanish and French issuers at 70% and 60%.

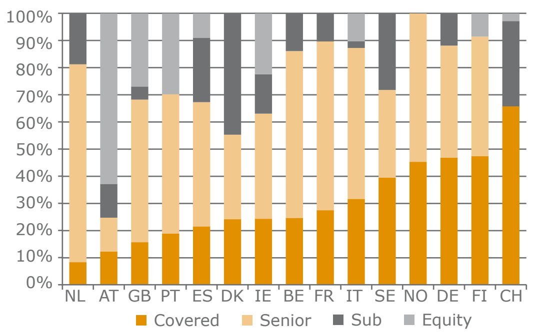
A DIVERSE YEAR-TO-DATE SUPPLY FOCUS

Figure 7 gives an overview of the total EUR funding levels of European banks per jurisdiction, including equity issuance. The figure confirms the dominance of the French banking sector in EUR primary, while at the same time the YTD covered bond supply also for this jurisdiction barely scrapes above the EUR 10 bn mark. France is among the majority of banking sectors where covered bonds have not even exceeded 30% of the funding attracted this year (Figure 8). We should caution that these supply data reflect the aggregate debt issuance of *all* banks in the selected jurisdictions and not merely the sampled banks set as per Figure 5.

> FIGURE 7: 1H14 EUR FINANCIALS ISSUANCE PER COUNTRY



> FIGURE 8: 1H14 EUR FUNDING COMPOSITION BY COUNTRY



Source: Dealogic, ING

When focusing on banking sectors with low equity and subordinated buffers, Figure 8 indicates that for Swedish issuers the balance between subordinated and senior unsecured supply has been approximately 50/50, confirming a strong focus on subordinated issuance. French issuers on the other hand mainly issued senior unsecured debt rather than subordinated debt. An explanation may be that French issuers have a relatively larger share of senior unsecured buffers with a maturity of less than 1yr, requiring a stronger focus on building senior buffers with a maturity of more than 1yr for MREL purposes than suggested by Figure 5. The expected loss statistics for senior unsecured bondholders in an 8% bail-in scenario as per Figure 6, furthermore show that French issuers would run a 60% expected loss in underwriting an 8% level of bailed in eligible debt. As discussed above, if subordinated bail-in buffers are not strengthened, expected losses for senior unsecured bondholders can alternatively be reduced by broadening the senior unsecured debt range.

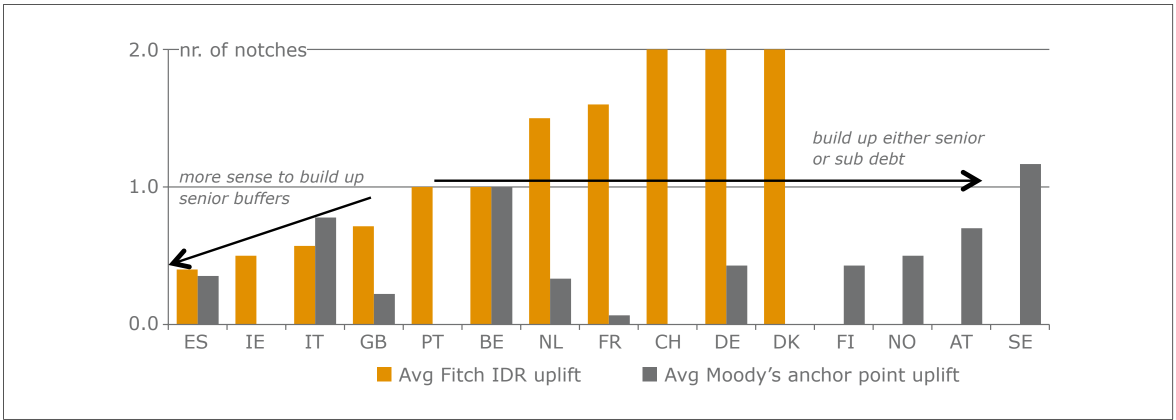
Figure 8 also confirms the relatively limited covered bond supply by Spanish issuers irrespective of the lower funding costs involved with this product. The Spanish banking sector has had a mixed focus on senior and subordinated issuance in combination with reparative equity issuance. Italian issuers on the other hand, have been in a better position to reap the funding cost advantages from covered bond issuance, considering their (on average) higher bail-in buffers. In Denmark, lower equity and subordinated in buffers have indeed resulted in a focus on subordinated issuance.

THE ROLE OF EVOLVING RATING AGENCY METHODOLOGIES

An important additional argument for favouring senior issuance over subordinated as an avenue for enhancing bail-in buffers are rating considerations. As discussed earlier in this article, at Moody's, senior and subordinated debt as a percentage of the adjusted liabilities has to be at least 5% for a one notch anchor point uplift versus the issuer's Baseline Credit Assessment (BCA) or Senior Unsecured Ratings (SUR), or at least 10% for a two notch uplift versus the issuer's BCA. At Fitch the senior debt (excl. debt held by retail investors) as percentage of total assets adjusted for insurance assets and derivatives has to be at least 5% for a potential IDR uplift. For those issuers with covered bond ratings at Fitch it makes sense to build up their senior buffers towards the required 5% minimum to be able to benefit from an (additional) notch in IDR uplift if they are not at this level yet or do not on other grounds benefit from a maximum IDR uplift. For issuers rated at Moody's but not at Fitch (such as the Austrian, Finnish and Swedish issuers), or that at this stage receive no bail-in recognition at Fitch (such as Norwegian issuers), the focus can be either on building up subordinated or senior unsecured buffers to qualify for an anchor point uplift.

In Figure 9 we plot the average BRRD rating uplift per jurisdiction for the covered bond programmes rated by Moody's and Fitch. The left arrow in the chart points out that from a covered bond rating perspective it makes particular sense for Spanish and Irish issuers to raise their senior buffers. The chart also underscores that for Swiss, German and Danish issuers, the average number of notches uplift they achieve is already two notches at Fitch. Hence for these issuers rating considerations are not necessarily a major driver for issuing senior unsecured debt. This potentially explains at least for Swiss and Danish issuers the stronger focus on subordinated issuance. In particular for the Swiss market this has coincided with an impressive share of covered bond supply, after a two year radio silence in EUR. In our view, it makes sense from a funding cost perspective for issuers to combine subordinated issuance with cheaper covered bond issuance. This holds in particular for issuers that are not restricted by asset encumbrance or collateral considerations.

> Figure 9: Average rating uplift per jurisdiction for BRRD purposes



Source: Moody's, Fitch, ING

CONCLUSION

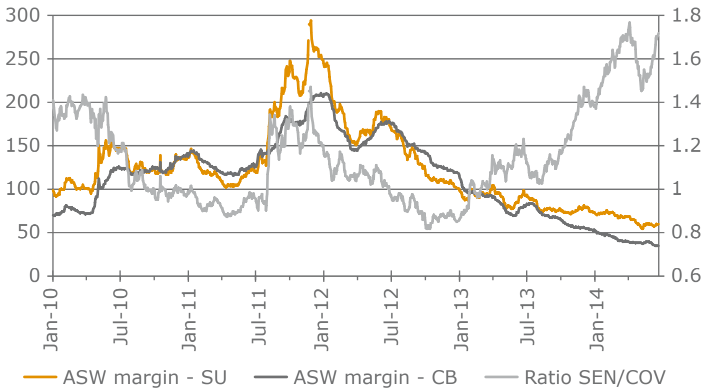
The explicit exemption of covered bonds from bail-in scope under the BRRD, as well as rating agency recognition of the going-concern bail-in advantages for covered bondholders underscore the safety of the covered bond product. Yet at the same time, the BRRD has prompted a refocus by banks on the complete liability structure in their balance sheets, and has arguably repressed primary activity in covered bonds. The deliberation of banks on building up equity and subordinated buffers is stronger than ever. In combination with the relatively favourable spread environment for senior unsecured issuance and generally limited bank lending growth, it is difficult to see how this supply trend will make a significant turn for the better this year, or indeed in 2015.

1.6 COVERED BONDS VS SENIOR UNSECURED RELATIVE VALUE: FROM RATINGS TO REGULATION

By Jean-David Cirotteau and Cristina Costa, Société Générale

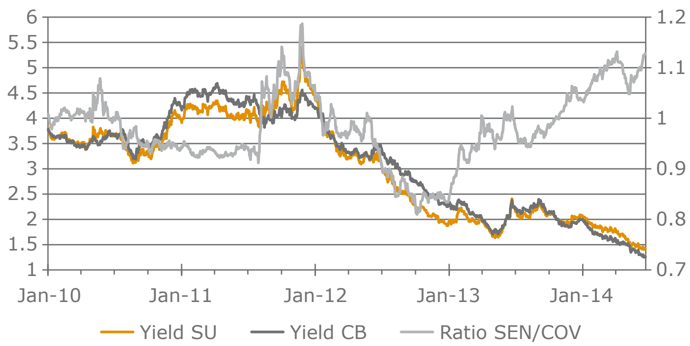
In this article, we look at the relative value (RV) of covered bond debt vs senior unsecured debt. We analyse the evolution of iBoxx indices (in particular the iBoxx EUR L4 Banks Senior and iBoxx EUR L2 Covered) through spread differentials and ratios. ASW spread and Yield ratios have been quite volatile in the last three months (April, May & June 2014) following a seven quarter period of covered bond outperformance. Several drivers can explain the rally starting with the affirmation of Spanish sovereign ratings at investment grade-level in October 2012. During this period the Bank Recovery and Resolution Directive (BRRD) was drafted and finalised on 12 June 2014. One of the key achievements was the exclusion of covered bonds from bail-in in case of issuer default. The ratio reached a high on 20 March 2014. After a significant correction, the ratios bounced back to their highs, corresponding to the expected positive evolution of the Liquidity Coverage Ratio (LCR) treatment including covered bond in level 1. This illustrates the strong impact of regulation as more harmonisation and disclosure lowers the credit risk in those products.

> FIGURE 1: IBOXX ASW MARGIN INDICES: CB INDEX BOUNCES BANK VS SU INDEX.



Source: SG Cross Asset Research/Rates

> FIGURE 2: IBOXX YIELD INDICES: CB INDEX BOUNCES BACK VS SU INDEX



Source: SG Cross Asset Research/Rates

We see two reasons why the covered bond levels outperformed senior unsecured bond levels since the end of May 2014. Firstly, after banks released their Q1 2014 results, the outlook was worse than expected, and this penalised senior unsecured debt. Secondly, the outcome of the discussions between the industry and the European Commission regarding the delegated act on the eligibility of assets for the LCR is expected to be positive for covered bonds, with some CB potentially becoming eligible for Level 1.

The positive news for covered bonds is very much priced in at current levels. We would expect some kind of correction at this point, although on a smaller scale than the previous april correction. The market should remain very supportive of covered bonds. We expect the indices to trade within a narrow range with ratios remaining within 1.6-1.9 in ASW margin terms (Figure 1), and 1.1-1.2 in yield terms.

PROS & CONS FOR USING INDICES INSTEAD OF SINGLE NAME SECURITIES

However, using indices may lead to other problems as evidenced in the IBoxx figures below, for which we identify two critical periods in the 4.5 years history: Q1 2011-Q3 2011 and Q3 2012-Q4 2012. During these two periods, the CB index curve traded above the senior index, which is not logical from a pure credit point of view. What happened then?

We looked at the sovereign rating changes for various peripheral countries during these periods which involved essentially downgrades and led domestic banks to be downgraded. The downgrades were much more significant regarding senior unsecured debt (SU) bonds, which resulted in a large reduction in the number of and even the disappearance of these peripheral bonds from the indices. This is one reason why the SU index trades above the CB index, particularly in 2011.

> Figure 3: Rating changes to HY grades (2011-2012)

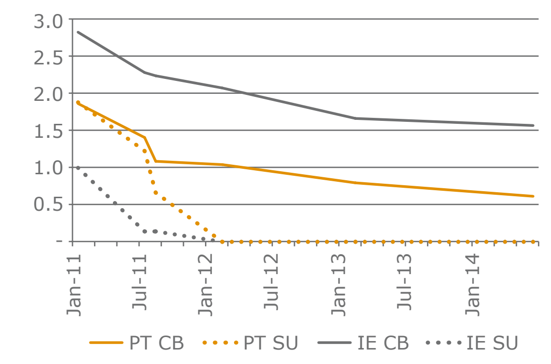
Country	Issuer name	Moody's	S&P	Fitch
PORTUGAL	Santander Totta	HY Mar-12	HY Feb-12	
	BESPL	HY Jul-11	HY Dec-11	WD Jan-11
	CXGD		HY Dec-11	HY Nov-11
ITALY	MPS	HY Oct-12		
	BANCO POPOLARE	HY Jun-12		
	BPIIM	HY May-13	HY Aug-12	HY Nov-13
SPAIN	SABADELL		HY Apr-12	HY Jul-12
	BCO Popular		HY Oct-12	
	Bankia			HY May-12
IRELAND	BKIR	HY Feb-11	HY Feb-11	
	AIB		HY Feb-11	

Source: SG Cross Asset Research/Rates

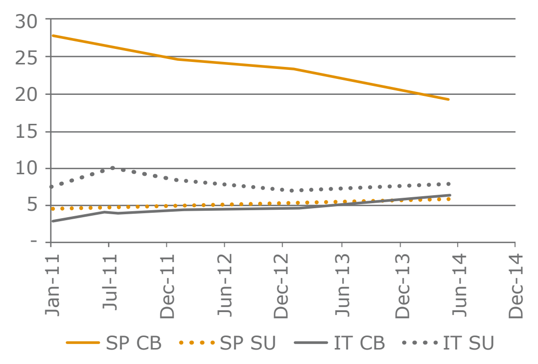
In February 2011, Ireland and Portugal were downgraded to high yield (HY). As a result, national banks were also downgraded to HY, which resulted in their exclusion from the Senior iBoxx index. Figure 4 below shows the drop in their weightings in the Senior index. In December 2011, no senior bonds from these jurisdictions were part of the index. However, in terms of the CB index, a number of covered bonds retained their investment-grade (IG) status and remained in the index. This is still the case for the June 2014 index.

From January to December 2011, the change in the composition of the index due to ratings downgrades resulted in movement of some 40 bps, all else being equal. By excluding Irish and Portuguese senior bonds, we calculated that the "improvement" in the Senior index was 27 bps, all else being equal (weightings fell from 1% and 2%, respectively, to 0%). Senior spreads were 15% and 12%, respectively, vs the average index yield of 4%. Over the same period, the widening of Irish and Portuguese covered bonds (200 bps and 350 bps respectively) resulted in a 10 bps deterioration in the CB index, taking into account the average weightings. This is an example of the strong influence of ratings, particularly when crossing the border between IG and HY.

> FIGURE 4: CHANGES TO WEIGHTINGS FOR IRELAND AND PORTUGAL



> FIGURE 5: CHANGES TO WEIGHTINGS FOR SPAIN AND ITALY



Source: SG Cross Asset Research/Rates, Markit

When applying the same reasoning to Italian and Spanish banks during the second time period, the exclusion of SU bonds from the Senior index after bonds became non-IG had no significant effect. Figure 6 below shows the changes in the composition of the index for Italian and Spanish SU issuers.

> FIGURE 6: ITALIAN & SPANISH ISSUERS EXCLUDED FROM SU INDEX BETWEEN FEBRUARY 2012 AND FEBRUARY 2013

Issuers	Feb-12	Feb-13
Banca Carige SpA	x	–
Banca delle Marche SpA	x	–
Banca Monte dei Paschi di Siena SpA	x	–
Banca Popolare di Vicenza	x	–
Veneto Banca SCPA	x	–
Bancaja	x	–
BPE Financiaciones SA	x	–
Caja de Ahorros y Pensiones de Barcelona (la Caixa)	x	–

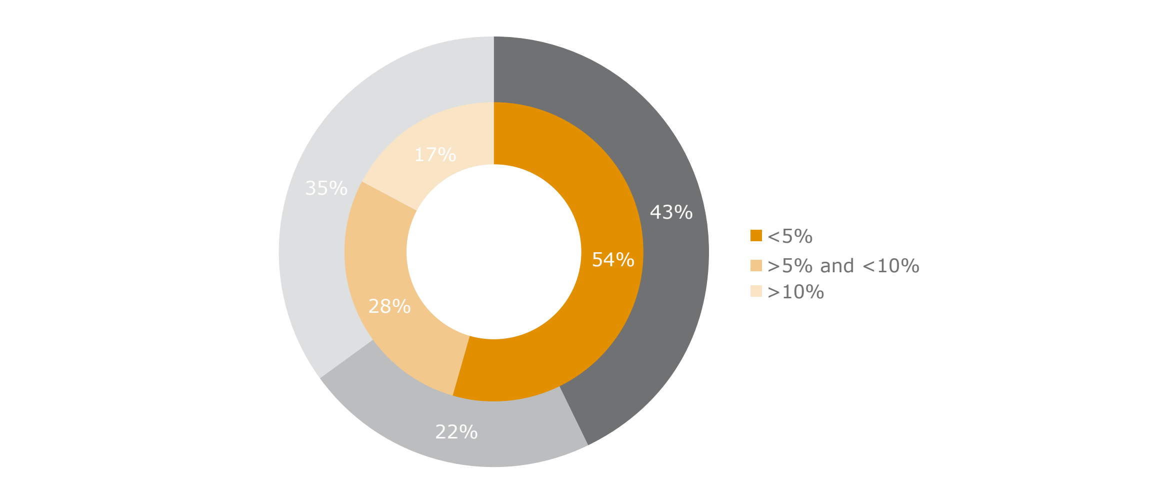
Source: SG Cross Asset Research/Rates

The change in index weighting is much smaller for these two countries. However, the effect on spreads from rating changes to sovereigns and banks was very significant as Spain accounted for roughly 24% of the covered bond index in particular.

IMPACT OF THE BAIL-IN EXCLUSION

Banks keep adjusting their balance sheets, especially on the debt side. In particular, the trend in senior unsecured debt (SU) as a percentage of total debt is one factor affecting the RV of SU, especially vs covered bond spreads. Figure 7 below shows a large sample of European banks with balance sheets of more than €50bn split into three categories according to their ratio of bail-inable debt (senior unsecured debt, subordinated debt and junior debt) to total assets. This is compiled from Bloomberg data. The three categories are as follow: ratio is below 5%, ratio is between 5% and 10% and ratio is above 10%. This is based on Moody's categories, which uses these buckets to apply uplifts to the anchor point when rating an issuer's covered bonds. The percentages are presented in number of banks and size of banks.

> Figure 7: Bail-inable debt ratio: by total assets in orange, by number in grey

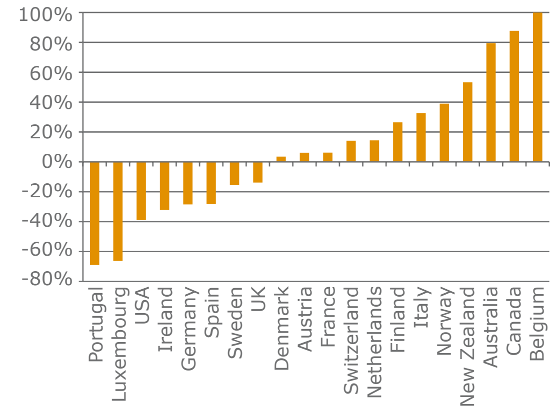


Source: SG Cross Asset Research/Rates

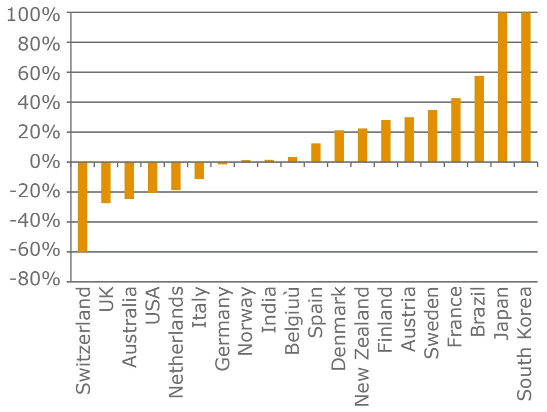
In our view, the situation is more stable now. Both Italy and Spain have been upgraded recently, and although the ratings of certain banks have not yet fully recovered to IG levels, the outlook is at least stable if not positive. We do not expect any big surprises from the upcoming asset quality review (AQR).

Another element contributing to stabilisation is the growing importance of "new" jurisdictions in the indices. Improvement will result from the regional diversification of the components, which should lower the correlation of the index to the peripheral countries in particular, as well as to the eurozone as a whole. The correlation should remain dominant however.

> Figure 8: CB index weighting: % change since February 2012 by country



> Figure 9: Senior index weighting: % change since February 2012 by country



Source: SG Cross Asset Research/Rates

> FIGURE 10: CHANGE OF WEIGHTING BY JURISDICTION WITHIN IBOXX INDICES: BANKS – CB / SENIOR DEBT (SU)

	Trend	Jun-14	Feb-13	Feb-12	Aug-11	Jul-11	Jan-11
AUSTRALIA CB	▲	1.95	1.04	0.40			
AUSTRALIA SU	▼	3.58	3.97	4.47	5.20	5.28	5.86
AUSTRIA CB	▲	1.88	1.84	1.77	0.90	0.89	0.86
AUSTRIA SU	▲	1.33	1.64	0.93	0.91	0.90	0.79
BELGIUM CB	▲	1.02	0.28				
BELGIUM SU	=	0.49	0.48	0.47	0.46	0.45	0.51
BRAZIL CB	_						
BRAZIL SU	▲	0.45	0.20	0.19	0.19	0.19	
CANADA CB	▲	1.31	0.16	0.16	0.55	0.55	0.61
CANADA SU	▼		0.56	0.72	1.15	1.13	1.44
CYPRUS CB	_						
CYPRUS SU	_				0.12	0.12	0.13
DENMARK CB	=	1.04	0.88	1.00	1.03	1.03	1.00
DENMARK SU	▲	1.02	1.33	0.81	0.77	0.75	0.79
FINLAND CB	▲	2.91	2.70	2.14	1.37	1.24	0.83
FINLAND SU	▲	1.02	0.92	0.73	0.70	0.69	0.62
FRANCE CB	▲	27.40	26.40	25.70	26.07	25.24	23.84
FRANCE SU	▲▲	19.30	14.77	11.05	10.33	10.14	9.42
GERMANY CB	▼	11.09	12.08	14.26	15.83	15.99	18.30
GERMANY SU	▼	3.80	4.46	3.85	4.92	4.72	5.11
GREECE CB	_						0.15
GREECE SU	=						
INDIA CB	_						
INDIA SU	=	0.19	0.19	0.19	0.19	0.19	0.20
IRELAND CB	▼	1.57	1.66	2.07	2.24	2.28	2.82
IRELAND SU	_				0.14	0.14	0.99
ITALY CB	▲	6.40	4.73	4.31	4.00	4.12	2.96
ITALY SU	=	7.64	6.97	8.52	9.74	9.83	7.52
JAPAN CB	_						
JAPAN SU	▲	0.32					
Luxembourg CB	=	0.13	0.12	0.22	0.12	0.12	0.14
Luxembourg SU	_						
NL ANTILLES CB	_						
NL ANTILLES SU	_			0.12	0.14	0.14	0.14
NL CB	▲	5.24	5.04	4.48	4.43	4.37	4.02
NL SU	=	15.09	17.16	17.93	15.87	15.55	15.04
NEW ZEALAND CB	▲	0.62	0.53	0.29	0.24	0.24	0.13
NEW ZEALAND SU	▲	0.52	0.42	0.40	0.38	0.37	0.42
NORWAY CB	▲	4.30	3.61	2.62	1.94	2.12	1.74
NORWAY SU	▲	2.22	2.19	2.19	2.08	2.04	1.74

	Trend	Jun-14	Feb-13	Feb-12	Aug-11	Jul-11	Jan-11
PORTUGAL CB	▼	0.61	0.79	1.04	1.08	1.40	1.86
PORTUGAL SU	_				0.66	1.22	1.87
SOUTH KOREA CB	_						
SOUTH KOREA SU	▲	0.13					
SPAIN CB	▼▼	19.29	23.29	24.73	26.20	26.45	27.70
SPAIN SU	▲	5.72	5.36	5.01	4.60	4.58	4.40
SWEDEN CB	=	3.11	3.45	3.59	3.66	3.64	2.89
SWEDEN SU	▲	8.28	7.76	5.39	5.09	5.01	4.99
SWITZERLAND CB	▲	1.57	1.39	1.35	0.99	0.98	0.94
SWITZERLAND SU	▼	3.77	4.54	6.03	6.17	6.61	7.81
UK CB	=	8.05	9.25	9.16	8.61	8.61	8.12
UK SU	=	9.83	11.88	12.54	11.59	11.39	10.88
USA CB	▼	0.52	0.74	0.72	0.75	0.74	1.10
USA SU	▼	15.31	15.21	18.46	18.60	18.57	19.33

Source: SG Cross Asset Research/Rates, Markit

1.7. LONG-TERM FINANCING OF THE REAL ECONOMY

By Matthias Melms, NORD/LB

In March the European Commission published the communication entitled "Commission roadmap to meet the long-term financing needs of the European economy", aimed at stimulating ways of unlocking long-term financing in order to support Europe's return to sustainable economic growth. Since the economic and financial crisis has impaired the ability of the banking sector to channel funds to long-term investments in particular, new ways must be found to provide capital for long-term lending. This is even more important since, in the United States for example, only one third of funding for the real economy comes from banks, while the proportion is about two-thirds in Europe. Due to the fact that the banking industry underwent a deleveraging of assets in the wake of the financial and economic crisis, it is now essential to ensure financing of the real economy, especially for long-term investments.

What exactly is long-term financing? The Organisation for Economic Co-operation and Development (OECD) defines certain key characteristics:

> It finances productive activities which support growth by reducing costs, diversifying means of production and creating jobs in a smart, sustainable and inclusive way;

> It is patient, in that investors take into account the long-term performance and risks of their investments, rather than short-term price fluctuations. This long-term perspective acts in a counter-cyclical manner and promotes financial stability;

> It is engaged, in that investors take longer-term aspects such as environmental, social and governance issues into account in their investment strategies.

In its report, the Commission also calls for better use of public funds. In this respect, export credit agencies in particular play an important role. It should be noted that guarantees issued by export credit agencies can also be used as collateral in cover pools. When Spain introduced Cédulas Internacionalización, it created its own type of covered bond to make export loans eligible for refinancing by means of covered bonds. In France and Germany, on the other hand, and in the United Kingdom, refinancing within the framework of Obligations Foncières and Pfandbriefe (public-sector) has already been possible for some time now. Covered bonds play an important role in financing the public sector. According to ECBC data, the volume of public-sector covered bonds amounted to EUR 428bn in 2013. Public-sector covered bonds are used for refinancing loans to the public sector in a total of eleven European countries.

In the context of developing European capital markets, the Commission not only analyses the use of equities, corporate bonds and securitised products, but also the use of covered bonds. The Commission recognizes that this instrument is a standard means which is collateralised through good quality assets. For investors, covered bonds offer a safe investment alternative compared to senior unsecured instruments. This alternative also has a higher liquidity. For issuers, they are a cost-effective source of funding, through which they can diversify their funding mix. The Commission also notes that, although there is a reference to covered bonds in various legal systems, there is no single harmonised legal framework. Even though not all countries have a covered bond law yet, a certain minimum standard in the market has become established through implementation of the Capital Requirements Regulation (CRR). The measures derived from this standard are to be examined in the context of Article 503 of the CRR by the end of 2014. This includes credit quality, eligible collateral and transparency. Another objective is to examine the extent to which it is possible to implement strengthening of supervision, enforceability of preferential rights and bankruptcy segregation aspects. Taking into account the results of the study, Commission services shall then conduct a study on the merits of introducing an EU framework for covered bonds.

IN WHICH AREAS ARE THERE ALREADY HARMONISING TENDENCIES?

While the Commission paper does suggest examining the option of establishing a common covered bond legislation, minimum standards have already become established within the EU in some areas, which market players use as a basis for their interactions. For example, Article 52(4) of the UCITS Directive 2009/65/EC (Undertakings for Collective Investments in Transferable Securities) primarily stipulates the requirements for regulated investment funds. The article defines requirements to be met by bonds, according to which investment funds may hold a higher proportion of these securities in the fund's assets if certain conditions are met:

> The issuer of the bond must be domiciled in the European Economic Area (EEA);

> Special supervision is applicable;

> The proceeds from the bond issue are invested in assets that adequately cover the liabilities arising from the bond during its term;

> The assets are used primarily to service bond creditors in the event of issuer default.

Especially within the scope of the recently introduced Capital Requirements Regulation (CRR), asset classes are now also defined that are approved as collateral for covered bonds in order to satisfy the requirements of the CRR. The relevant assets are defined in Article 129(1) CRR. In the area of mortgage collateral, these include residential property up to 80% of the value of the collateral; commercial property up to 60% of the value of the collateral, in exceptional cases up to 70%; guaranteed French real estate loans up to 80% of the value of the property and ship mortgage bonds up to 60% of the ship's value. The following are among the public-sector collateral items that qualify: claims against states, central banks of the European System of Central Banks, public bodies or regional or local authorities within the European Union as well as claims guaranteed by these bodies, claims against the central government of non-EU countries, central banks of non-EU countries, multilateral development banks and international organisations of credit quality step (CQS) 1 and if they satisfy certain criteria, claims against public bodies or the regional and local authorities of non-EU countries, or claims that are guaranteed by them. In addition, claims against institutions of credit quality step 1 qualify up to 15% of the nominal amount of the outstanding covered bonds and exposures to institutions from the EU with a maturity of up to 100 days if they meet credit quality step 2 as a minimum. According to the definition in Article 129(1)CRR, neither mortgage bonds on aircraft nor loans to small and medium-sized enterprises are currently subject to special privileges in relation to the risk weighting. Covered bonds that are backed by applicable collaterals are accordingly treated as senior unsecured bonds for the purposes of capital adequacy. However, this categorisation is expected to be reviewed by the end of 2014.

The CRR also requires a certain minimum level of transparency, which the issuer must guarantee in order to enjoy a privileged status in the legal framework. To this end, minimum standards are defined in Article 129(7) CRR, which the issuer must comply with. Accordingly, a covered bond is only privileged if the investor can prove that the following information is available:

> the value of the cover pool and outstanding covered bonds;

> the geographic distribution and type of cover assets and the loan amount, interest rate and currency risks;

> the maturity structure of the cover assets and covered bonds, and

> the percentage of loans overdue by more than ninety days. In addition, the issuer must provide this information at least every six months.

Article 129 (7) CRR thus establishes, for the first time, minimum requirements for the reporting obligations of issuers. Although it is not absolutely essential for issuers to comply with them, investors will, everything else being equal, prefer those covered bonds from issuers whose reporting complies with CRR requirements. The introduction of the Covered Bond Label (CBL) in 2013, however, was an initiative that was promoted by the covered bond market to improve transparency and provide easier access to information. The purpose of the initiative was to increase liquidity and prepare covered bond programmes for regulatory requirements. The Label is based on the Covered Bond Label Convention. This stipulates that the covered bond programmes shall be based on a legal framework and creditors must have claims against both the issuer and the cover pool. A supervisory authority must also review the programmes on a regular basis. In addition, the issuing bank must hold sufficient assets in the cover pool to cover the payment of creditor claims at any time, and it undertakes to provide investors with detailed information at regular intervals. This information can be accessed centrally on the online transparency platform (www.coveredbondlabel.com). The individual information is also based on the Covered Bond Label Convention and includes both general and specific data by programme type (mortgage, public- sector or ships). As at the end of July 2014, a total of 70 issuers from 13 countries made information available on this website, representing an outstanding volume equivalent to EUR 1.3 trillion.

USING LONG-TERM FUNDING TECHNIQUES FOR OTHER PRODUCTS

Innovation in covered bond markets by diversification - export financing

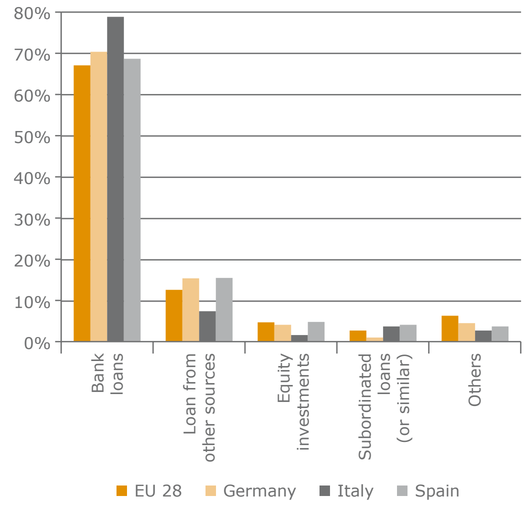
Exports play an important role in putting Europe back on a path of sustainable growth. In this respect, banks play an important part in providing finance along the entire value chain. In addition to providing a range of financing options during the entire production process, credit institutions also provide support in financing the settlement process. Export credit insurers and export credit agencies (ECA) such as CESCE (Spain), COFACE (France), Hermes (Germany), SACE (Italy), ECGD (UK) and JBIC / NEXI (Japan) are instrumental in mitigating the risks arising from export transactions. This type of financing can be used in a number of countries as collateral in cover pools which enables the participating banks to refinance their requirements using covered bonds. In Germany, for example, these claims are used as collateral for public-sector covered bonds (Pfandbriefe) under the Pfandbrief Act. In France, too, it is possible to use such claims as security for Obligations Foncières (OF). For example, some French banks have launched their own programmes to refinance receivables insured by export credit agencies via covered bonds. In Spain, it has also been possible to use export credit insurance as a funding instrument in the recently introduced Cédulas de Internacionalización since 2012. It has furthermore been possible to use export credits as cover assets, provided they have been backed by guarantees from public institutions or development banks. In the case of Cédulas Territoriales, these assets are not eligible as cover, unlike the German public-sector covered bonds (Pfandbriefe) and French Obligations Foncières. This is why a new type was created. In the case of CIs (Cédulas de Internacionalización), it is mainly loans backed by a guarantee from the Spanish credit insurance agency, CESCE, that are eligible as cover assets. Loans with guarantees from other export insurers may nevertheless also be used.

Innovation in covered bond markets by diversification - SME funding

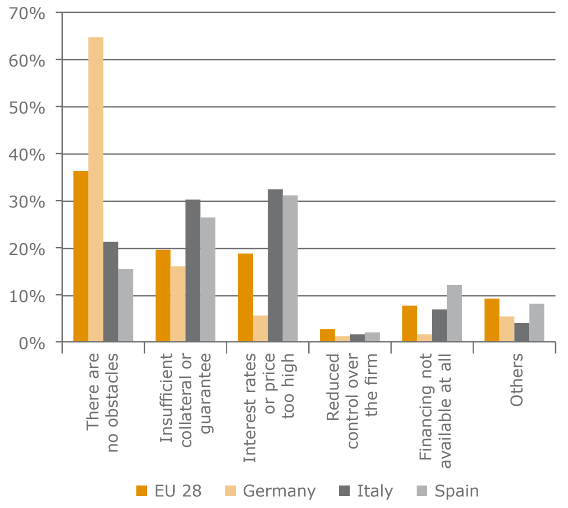
In the survey entitled "2013 SME's Access to Finance survey", the Commission and the European Central Bank looked at the financing situation of companies. 13,855 interviews were conducted and evaluated within EU 28 in Q3 2013. The majority (61.1%) of the companies surveyed had annual turnover of up to EUR 2 million. The survey results reveal clear differences between core countries of Europe and peripheral states. When asked the question, what is the biggest problem for companies currently, 20.0% of Italian and 23.4% of Spanish participants identified access to sources of funding as the biggest obstacle. The figure is therefore much higher than in Germany (8.2%) and is also above the EU average (15.4%). There are also significant differences in companies' assessment of the pressure when seeking sources of funding. On a scale of 1 (no pressure) to 10 (very high pressure), a large proportion of Italian (19.8%) and Spanish (19.6%) businessmen found themselves in the lowest category. In contrast, the majority (21.6%) of German companies did not feel any pressure at all.

The main source of funding, however, was the conventional bank loan, considerably in front of other instruments across the board. It was preferred by 67.2% of all companies as an EU average. In Germany, Italy and Spain, the figure was even a little higher, indicating the major dependence of small and medium-sized enterprises on bank lending and a healthy financial system.

> FIGURE 1: PREFERRED SOURCE OF FUNDING



> FIGURE 2: BIGGEST OBSTACLE TO REFINANCING



Source: EU Commission, ECB, NORD/LB Fixed Income Research

Nevertheless, refinancing via bank loans does not seem to be readily possible for many companies in the periphery. For example, interest costs and the other costs of bank financing have increased significantly. 61.1% of Italian and 67.1% of Spanish companies complained of a marked increase in interest rates in the six months prior to the survey date. However, the figure was only 34.0% as an EU average. In Germany, on the other hand, a majority (54.2%) saw no significant changes in interest costs or even registered a decrease (32.2%).

High interest rates were regarded as the biggest obstacle to refinancing by the majority of businessmen in Italy (32.5%) and Spain (31.2%), closely followed by lack of collateral (IT: 30.3%; ES: 26.5%). As many as 6.9% of Italian and 12.1% of Spanish SMEs found themselves cut off from all funding sources at the time of the survey. In Germany, 64.9% of companies surveyed saw no obstacles to their funding, substantially higher than the EU average of 36.4%.

The survey results make it clear that, in a number of countries throughout the EU, it is essential to improve SME's access to finance. Techniques which are also used for covered bonds can be used to facilitate banks in refinancing loans of this nature. Different approaches have been developed in various countries.

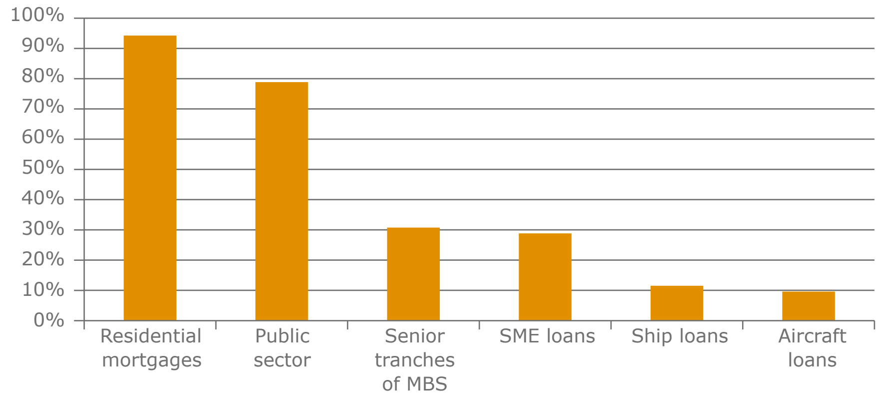
Long Term Financing of SME Transactions - The European Solutions

In Germany, Commerzbank has developed a programme for structured covered bonds, in which a pool of SME financing provides collateral for one bond. In this case, the SME covered bond is not the same as a mortgage bond (Pfandbrief). The transaction is based on a purely contractual arrangement and does not follow any specific legal framework. The assets are not covered by either the German Pfandbrief Act or the CRR. Likewise, they are not UCITS compliant. This means that, although they are permitted for repo transactions with the ECB, they are treated in a similar way to senior unsecured securities and cannot be used for compliance with liquidity coverage ratios. Structurally, too, they differ from mortgage bonds. Firstly, for example, the cover assets have a significant shorter residual term to maturity than the outstanding covered bonds. Secondly, the programme is converted into a pass-through structure in the event of default by the issuer. Similarities do exist, however, insofar as the bonds are issued by a bank and there is a claim against the issuer and the cover pool. The latter is dynamic, in contrast to ABS structures, and is maintained by the issuer. For example, non-performing loans are removed from the cover by Commerzbank. Similarly, there is a desire to increase the average residual maturity of the assets to about one year. In addition, Fitch for example notes that other properties such as the potential conversion into a pass-through structure, the integration of an SPV as guarantor as well as the purely contractual basis are not entirely new, but are already available in other covered bond jurisdictions.

HSH Nordbank went along another route in the refinancing of SME loans and used the PROMISE (Promotional SME Loan Securitisation) programme offered by the KfW. The KfW issues a guarantee for a specific SME portfolio of a bank through the programme, which was set up in the year 2000. Tranches are then formed according to risk classes and the safest tranche is hedged. The remaining tranches are transferred to an SPV, which passes on the risk to the capital market via credit-linked notes. Since the programme involves synthetic securitisations, the actual loans are not affected by the transfer, but only the risks. This is intended to reduce the risk incurred by the bank granting the credit, release capital and thus stimulate new lending to companies. HSH transaction PROMISE NEO 2012-1 was the first since the financial crisis. It also has the special feature that the risks were not transferred and passed to an SPV, but were bought back by HSH itself. By buying back the risks, they ultimately remain in the originator bank and there is no release of capital. However, the guarantee provided by the KfW has the effect that the SME loans can now be included in the cover pool for public-sector covered bonds (Pfandbriefe), since the Federal Republic of Germany (80%) and the German federal states (20%) stand behind the KfW.

In Spain, draft legislation was put forward which would allow structured covered bonds with conditional pass-through (CPT) structures to be issued. The issuer can select and delimit specific cover assets. Consequently, unlike the Cédulas, there is no entitlement to the institution's entire loan book. The delimitation is accomplished by transferring the assets to an SPV, which then guarantees the bonds issued by the institution. Since there will be no restrictions on the type of loan for the purposes of the transfer, lending to SMEs could also be used as collateral in this case. In Italy, too, a law was passed in February 2014, introducing a new class of secured claims (Obbligazioni Bancarie Collateralizzate; OBC) alongside the existing Obbligazioni Bancarie Garantite (OBGs). While traditional OBGs are mainly used for refinancing public-sector assets as well as residential and commercial mortgages, OBCs can be secured on the basis of the above-mentioned assets through SME claims and through corporate bonds, commercial paper, ship loans, leasing and factoring claims as well as ABS. This will also enable smaller institutions to issue OBCs. Euro Secured Notes Issuer (ESNI), a new issue unit established in France, issued its first bonds in April. Bonds totalling EUR 2.65bn were issued. They are backed by SME claims held by BNP Paribas, BPCE, Crédit Agricole, HSBC France and Société Générale. Generally, however, other banks are also free to use the vehicle. The ESNI is intended to offer the institutions a favourable refinancing option for SME loans. The Netherlands is also considering an amendment to the existing covered bond legislation. The draft law put forward this year provides for the option of using SME loans as collateral in the cover pool.

> Figure 3: Overview about investors intentions. (Which Collateral Types are You Willing to Invest In?)



Source: Fitch, NORD/LB Fixed Income Research

In the annual survey conducted by the rating agency Fitch among covered bond investors, indicated that investors were open for investment in non-traditional assets, aside from mortgages and public-sector debt: When asked "Which Collateral Types are You Willing to Invest In?", 29% of survey participants answered that they could imagine investing in SME loans. 12% of responses were for ships and 10% for aircraft loans. This indicates that some investors in traditional covered bonds are willing to invest in alternative assets that are designed along similar lines as traditional covered bonds. As a result there is a willingness to provide funding for granting loans of this type. However, the survey also showed that most respondents still prefer traditional assets as collateral for cover pools. For example, 94% of respondents stated that they invest in residential mortgages, while 79% indicated public-sector debt. A total of 53 investors who manage more than EUR 20bn in covered bonds took part in the survey, which was conducted in December 2013.

CONCLUSIONS

The innovation capacity of Europe's financial sector is illustrated through the example of creating solutions for export financing and SME funding. This capability has been instrumental in developing low-cost refinancing schemes for these types of credit. The solutions applied various techniques which were also used in covered bonds, without this necessarily involving covered bonds. This in turn enables banks, with the help of covered bonds and instruments that are based on covered bond techniques, to develop and offer affordable financing solutions for their customers. Borrowers also benefit from financing solutions that can be passed to them on favourable terms, due to advantageous refinancing conditions for covered bonds and related products. Thereby, covered bond techniques can be used to refinance SME or other non-traditional asset classes but there needs to be a clear distinction that these products are not covered bonds in a traditional way. Such differentiation is all the more important to secure the preferential regulatory treatment of traditional covered bonds and to enable investors to separate the different type of products.

As in the case of existing covered bond legislation, it is also apparent here that, over the medium and long term, a best practice approach leads to standards becoming established on the market that offer a high level of safety and transparency for investors. The task on the regulatory side should therefore be to define and introduce certain minimum standards. These would then provide scope for issuers to develop more wide-ranging solutions and innovations, to the benefit of investors and borrowers. This has already been achieved to some extent through the definition of minimum standards within the scope of the CRR. More extensive adaptations should build on this basis in order to attain advanced minimum standards that can provide the basis for further improvements.

1.8 PASS-THROUGH ONE YEAR DOWN THE ROAD

By Florian Hillenbrand and Franz Rudolf, UniCredit, and Frank Will, HSBC

One of the most interesting and widely-discussed developments in the covered bond market over the last couple of years has been the introduction of conditional pass-through covered bonds (CPTCB). Soft-bullet structures, with potential maturity extensions of one and up to three years, are nowadays commonly used by covered bond issuers across the globe and are also widely accepted by investors. CPTCB are another step into further amending the redemption profile in case of issuer insolvency. The Dutch bank NIBC was the first and, as of July 2014, the only issuer of CPTCBs. NIBC issued its inaugural CPTCB back in October 2013. The second deal followed about five months later in March 2014.

In the following, we describe the details of the programme, discuss the particularities of the various redemption formats and how they differ from each other and analyse the role of issuers, investors and rating agencies in order to individually assess the pros and cons for each market participant.

HOW DOES IT WORK?

The most fundamental idea of covered bonds is safeguarding a steady flow of payments to investors following an issuer event of default. Once the issuer ceases to exist, the cash-flow stemming from a separate portfolio of assets is used to cover all claims due to bondholders. The two most significant sources of risk threatening the ability to satisfy the claims are (i) credit default risk, which potentially leads to an over-indebted cover pool and (ii) market risk – first and foremost in the form of liquidity risk – which potentially leads to a sufficiently large cover pool, which, however, is no longer able to satisfy claims due to illiquidity.

In the past, the rating agencies and other market participants assumed that, following issuer default, the cover pool administrator could easily monetize the assets in the cover pool either by disposing parts of the cover assets or in an indirect way, i.e. by bundling them into an asset backed security (ABS) or – if applicable - by using the refinance register. Some covered bond structures may also be able to raise new debt either in a technically "unsecured" way or even in the form of covered bonds. In particular against the backdrop of uncertainty regarding the functionality and the efficiency of these tools, it is particularly important the cover pool administrator is equipped with many options so he is free to pick the most efficient one.

In cases involving hard bullet structures, issuers try to enhance the effectiveness of the tools by regularly calculating pre-maturity tests or by maintaining a certain amount of liquid assets in the cover pool – a costly exercise for issuers since liquid assets usually come with a negative carry. Soft-bullet structures that have a limited extension period (usually one year) aim to manage the liquidity challenge at the expense of investors. However, since the soft-bullet timeframe might still turn out to be insufficiently long, the idea of pass-through aims to completely eliminate any refinancing risk by eliminating pressure to sell assets at the expense of a maximum timeframe for the payment deferral.

In a nutshell, the three major redemption regimes for covered bonds work as described below:

> **Hard-bullet covered bonds:** payments have to be made when due according to the original schedule. Failure to pay on the Standard Maturity Date (SMD) triggers default of the covered bonds, and the covered bonds accelerate.

> **Soft-bullet covered bonds:** payments have to be made when due according to the original schedule. Failure to pay on the SMD triggers issuer default, but does not trigger covered bond default. The extension period grants more time (typically at least 12 months) to repay the covered bonds, setting a new Final Maturity Date (FMD). Failure to pay on the FMD triggers default and acceleration of the covered bond.

> **CPTCB:** payments have to be made when due according to the original schedule. Failure to pay by the SMD triggers issuer default but does not trigger default of that covered bond. The affected covered bond goes into pass-through mode. All other outstanding covered bonds are not affected and would only trigger the pass-through mode one after another if they are not redeemed on their respective SMDs.

In NIBC's CPTCB programme, following an issuer event of default, any repayments, including early repayments and excess spread, remain with the cover pool until a covered bond series reaches its SMD. Following an issuer default, a particular covered bond will only become pass-through once a covered bond reaches its SMD and the available cash is insufficient to fully redeem the bond. Other outstanding covered bonds will not turn into pass-through covered bonds as long as they are paid as scheduled. It goes without saying, that the switch to pass-through on the SMD does not prevent the cover pool administrator from trying to sell and sell assets in order to improve the liquidity of the cover pool and, in so doing, making the switch to pass-through less likely.

Following issuer default, the amortisation test has to be passed. If the test is failed, all covered bonds become pass-through. In this case, the covered bond company will be required to use all funds available to redeem all covered bonds on a pro rata basis, while interest continues to accrue on the unpaid part of the covered bonds.

An additional new feature in the CPTCB is the minimum overcollateralization (OC), which is needed to allow for the programme to switch to pass-through. Shortage of collateral, which could arise from paying administrative costs as well as covering potential credit losses, would otherwise instantly trigger a failure of the amortisation test and an acceleration of payments to bondholders. This is the reflection of the fact that cover pool credit risk is the only remaining source of loss in the cover pool asset-liability-management. In order to eliminate market risk completely, the legal final maturity is extended to beyond the maturity date of the longest asset in the pool. In the case of NIBC, this is 32 years after issuance for a maximum cover asset term-to-maturity of 30 years.

SALE OF SELECTED ASSETS

According to NIBC's provisions, following issuer default and switch to pass-through, a portfolio of cover assets is randomly selected, which the administrator is obliged to sell only if the proceeds are sufficient to redeem the series without a loss on the bonds and while respecting the minimum OC for the remaining outstanding bonds (SARA clause). In fact, the administrator is obliged to sell the respective amount of assets if a price that is 87% of the nominal is achievable, corresponding to the 15% mandatory overcollateralization requirement. If the portfolio is not sold, a new random selection of assets to be sold is made at the next calculation date at a semi-annual basis.

PASS-THROUGH VS. SOFT-BULLET

The decisive difference between soft-bullet redemption formats and (conditional) pass-through formats raises the question of the length of the deferral term. The longer the deferral period of the soft-bullet payment regime, the closer the two redemption formats become. The remaining differences are not essential and could be replicated in any case: the (implicit) SARA clause that NIBC posts is also frequently found in soft-bullet structures. Thus, during the deferral period, the scope of actions taken by each cover pool administrator is quite similar: both will not hold on to an unnecessary amount of liquidity but will instead use it to partially redeem the deferred principal amount. Furthermore, both will try and find opportunities to liquidate assets (in line with the SARA clause) in order to allow redemption to occur as quickly as possible.

However, the one-year deferral period of most soft-bullet covered bonds provides the cover pool administrator with a relatively limited timeframe in which the required amount of cover pool assets can be liquidated. In contrast, the opportunities in a (conditional) pass-through case are technically unlimited. Hence, market risk is mitigated with soft-bullets covered bonds and eliminated with CPTCBs.

As mentioned above, in July 2014, two five-year EUR 500mn CPTCBs were issued by NIBC. The inaugural deal was priced at ms+52bp in October 2013. In March 2014, NIBC priced its follow-up deal at ms+35bp. In terms of distribution, both deals looked similar: final order book for the inaugural was EUR 1.3bn, and for the follow-up it was EUR 1.5bn. One might derive from this an increase in investor appetite however at low significance. Regional allocation (37% vs. 34% Germany, 28% vs. 20% Nordics, 11% vs. 14% UK etc.) as well as allocation by investor type (47% vs. 50% Banks, 43% vs. 34% funds, 7% vs. 12% insurance companies) were almost identical in particular since the lines between funds and insurance companies are often blurred. The only aspects in which the deals differ was reoffer spread. However, the 17bp difference between the ms+52bp paid by the inaugural and the ms+35bp for the follow-up is allayed by the fact that, in the same period, 5Y NIBC senior CDS tightened from 298bp to 263bp and 5Y Dutch ING covered bonds tightened from ms+11bp to ms+7bp. In this context, the tighter primary market spreads are very much in line with the general tightening trend.

Issuers' perspective

Issuers currently find themselves in complex situations: At the peak of the sovereign debt crisis, quite a few issuers were seeking funding by retaining transactions which shoud have beenused to collateralize European Central Bank (ECB) open market operations. The ECB applies two different haircut schedules for covered bonds: one for those rated A- or higher and another less-favorable one for those rated in the BBB-range. Non-investment-grade covered bonds do not qualify. However, during the crisis, country ratings in the periphery dragged down the senior unsecured ratings of banks, which, in turn, resulted in lower covered bond ratings. In addition, quite a few assumptions of rating agencies, regarding the legal frameworks, market environment, refinancing cost, foreclosure periods of cover assets, etc., changed for the worse and, therefore, made it necessary for issuers to post ever-higher overcollateralization. Taking a look at the agencies' analyses of cover pool losses, it appears as if there was a unanimous view that the most significant source of losses was market-related rather than credit-related. Hence, eliminating market risk instantly reduces overcollateralization requirements by a significant share. This means that issuers are either able to issue more covered bonds against the same amount of collateral and/or are able to achieve higher ratings for their covered bonds with the same amount of overcollateralization - in any case, a massive increase of efficiency for the entire covered bond funding exercise.

Usually, one would expect an increase of (funding) efficiency to carry at a positive price. Since the investors accept a greater deal of uncertainty regarding the repayment date without claiming default, one might expect a slightly higher spread for the CPTCB compared to a bullet bond. With NIBC as the only CPTCB issuer so far, SNS – carrying similar senior unsecured ratings and issuing soft-bullet covered bonds – is a quite suitable comparison. With the CPTCBs NIBC 18 at ms+6bp and the NIBC 19 at around ms+8bp, the two bonds trade 3-4bp richer than what would be considered a fair SNS spread for the same duration. Hence, from the point of view of a mere funding spread, the efficiency gain not only comes for free, it even has a negative price tag. However, this is just the pure refinancing cost side. If the total administrative package taken into account, the conditional pass-through format generates less ALM necessities, lower need for derivative transactions and lower need for holding liquid assets, which usually generate negative carry. The only element that remains on the "cost side" for issuers is that opting for conditional pass-through format currently might not necessarily be interpreted as a sign of strength – in particular, since it is more tempting/efficient to opt for a pass-through format the lower the senior unsecured rating becomes.

Investors' perspective

Before going into the details of comparing various redemption formats, it is vital to depict the critical point in the life-cycle of a covered bond. Assuming they have the same issuer and identical collateral pools, the cash flows of a hard-bullet, soft-bullet and CPTCB are identical as long as the issuer does not default. In case of an issuer default, the cash flows of either redemption format are still identical if the available cash retained in the cover pool is sufficient. The only "interesting" case from an investor's point-of-view is in the case of (i) insufficient liquidity - because this when a bullet covered bond is prone to default - and a pass-through will start to defer payments or (ii) of insufficient collateral - because this is the case when all series of a covered bond programme, irrespective of the repayment regime, accelerate and become due.

The following considerations are based on the investment decision between a bullet covered bond and a CPTCB of the same issuer out of two different programmes but based on cover pools that have exactly the same risk characteristics.

Several investors seem to have problems with the very long final maturity date of CPTCBs which can substantially exceed the scheduled maturity. Therefore they prefer hard-bullets, which carry the obligation to be repaid on the SMD. However, while there are structural differences between the redemption regimes, arguably many of these differences blur quite a lot upon a closer look.

The total damage of any adverse event can be split into a probability of the occurrence of the adverse event and the impact it has once it occurs – the critical question an investor has to answer is whether the adverse event is a deferral of payments or the technical default of an investment. In a hard-bullet case, both events happen simultaneously, while, in a soft-bullet case, and even more so in the case of a CPTCB, the events drift apart.

First, we take a look at investors that consider the technical default of a claim more adverse than a payment deferral. In case of a default, the result in terms of cash-flows are quite likely to be similar for both cases bullet and conditional-pass-through. The result in a bullet case would, in quite likely, be a creditors' meeting to decide how to treat the leftovers: fire sale or natural amortization; result unknown ex ante. Thus is the case for a CPTCB; the roadmap is clearer in the CPTCB since there is an ex ante definition of what is about to be done. All bonds fall due and natural amortization of the collateral will be split pari passu unless a bondholders' meeting votes for something different. The difference comes in the form of the likelihood of the adverse "default" event. In both bullet and pass-through cases, a default could be triggered by asset-quality deterioration and, therefore, in both cases the issuer ex ante would have to post the same amount of overcollateralization for the same result of assessed credit risk. However, precautionary measures to address liquidity risk in the cover pool have to be performed by the issuer of bullet covered bonds only. Whether or not the liquidity buffer turns out to be sufficient can only be assessed ex post. In other words, any liquidity buffer is nothing but a suboptimal hedge for liquidity risk. By way of aligning the cash flows from the cover pool to the covered bond investors, CPTCB issuers perform the only existing perfect hedge against liquidity risk. Therefore, the likelihood of a default of the covered bond is lower for the CPTCB. Consequently, an investor that is sensitive to a default of a claim as opposed to being sensitive to payment disruption should rather be focused on CPTCB.

An investor that is rather sensitive to payment disruptions apparently has the opposite rationale. In case of the occurrence of the payment disruption, the impact is probably quite similar irrespective of the payment regime (see rationale above). It might be the case that the net present value of the recovery payment is higher in a bullet regime due to a self-selection of the investor base: Investors that fear a payment disruption might rather be inclined to vote for a shorter recovery period at the expense of a slightly lower nominal recovery rate. Investors that decided to invest in a CPTCB might be inclined to maximize nominal recovery at the expense of a longer recovery period. The true difference appears when considering the likelihood of the adverse event "payment disruption". Credit driven occurrence would be similar in both repayment regimes, whereas the likelihood of a liquidity-driven occurrence is much higher for the CPTCB due to the fact that liquidity-driven default-precaution is passed on to investors in the form of the negative event "payment deferral". In the bullet case, the liquidity-driven default-precaution comes in the form of additional overcollateralization requirements/ liquidity buffers. The liquidity buffers certainly are no perfect hedge against the occurrence of the adverse event "payment deferral" but are certainly better than taking no precautions.

However, given the important role covered bond ratings play nowadays within the regulation framework and in cooperation with central banks (e.g. spread-risk factors under Solvency II, CRR risk-weightings, liquid asset classification under LCR rules, ECB repo haircuts), risk aspects are not the only drivers of an investment decision. Rating-sensitive investors would benefit from the higher, and more stable rating of the CPTCB. However, empirical evidence does not indicate significantly tighter spreads of CPTCB compared to slightly lower-rated covered bonds. In our view, this partly reflects the current overall compressed spread environment as well as the fact that some investors cannot buy conditional pass-through transactions due to internal restrictions. As we mentioned above, the likelihood of a payment deferral might be larger than that of a bullet case. Therefore, the uncertainly regarding duration might increase without compensation in form of higher yield. The benefit comes in the form of the investment being more suitable for the regulatory challenges constraining investors in many respects.

One last aspect that differs slightly from the pure discussion of bullet vs. CPTCB has also become a matter in the mindset of investors. Quite a few ultra-long soft-bullet transactions (retained), but also the CPTCBs of NIBC, continue to pay a fixed coupon during the deferral period. Hence, while it might be a matter of taste whether individual investors prefer bullet vs. pass-through structures, quite a few object to the fact that they have to carry the interest-rate risk during the deferral period. From the point-of-view of issuers and rating agencies, passing on the interest rate change risk to investors is convenient. However, investors are left with the difficulty to hedge this type of risk.

Rating agencies' perspective

Rating agencies' methodologies have changed quite substantially in the past few years. Recalling Moody's plain and simple rating methodologies for covered bonds back in 2003/04, when covered bonds were all rated 2/3 notches (for mortgage and public covered bonds respectively) above the senior rating, which later was expanded to 4/5 without big analysis supporting it, life has become more complicated. However, analysis also more precise and detailed from an academic point of view. The step-by-step analysis of assessing issuer credit risk followed by the assessment of legal/regulatory/market related etc. aspects, and finalized by the assessment of the credit risk/liquidity risk etc. of the cover pool, was a milestone. Starting from the joint default basis, the degree of detail of rating agencies' analyses increased exponentially. The high end of complexity is probably to be found in the analysis of the cost of raising liquidity against a static cover pool in a post insolvency situation. This necessitates an assessment of potential funding sources, assumptions on amounts that need to be raised, valuation adjustments and, last but not least, assessment of the role and the abilities of the cover pool administrator running the matter after issuer insolvency. Against this backdrop, rating agencies have unsurprisingly welcomed the new development regarding CPTCBs. Default risk is reduced to credit-risk-driven events.

S&P explicitly stated that conditional pass-through structures can help reduce risks, thereby adding to the stability of its covered bond ratings. CPTCBs reduce, in particular, the asset-liability mismatch risk, which typically contributes more than two-thirds to S&P's over-collateralisation requirements. Fitch stated that its covered bond methodology, a covered bond programme with no asset-liability mismatch risk, can be rated on a de-linked basis from the issuer. This is because there should be no obligation to liquidate cover assets at any cost, thereby removing the majority of payment interruption risk for covered bonds after an issuer default and leading to a discontinuity risk profile that is more in line with amortising structured finance transactions.

The reason that Fitch has not entirely delinked the CPTCB rating from the issuer rating – in contrast to structured finance (SF) transactions – is because covered bonds allow for significantly more flexibility regarding cover pool composition and issuance capacity than typical SF transac-tions.

CONCLUSION

CPTCBs are an interesting addition to existing soft and hard-bullet structures. In most scenarios, the cash flows of the various redemption profiles would be similar, all else equal. In a worst-case scenario, after issuer default and in a situation where their cover pool is not sufficiently liquid, CPTCB promise a lower nominal loss at the expense of investors accepting a potentially much longer deferral period compared to those of hard-bullet and typical soft-bullet structures. Hence, investors have to make up their minds, which adverse event they are more inclined to accept: payment deferral or technical default. From a regulatory perspective, CPTCB offer higher ratings and higher rating stability. The fact that they could switch into pass-through mode and their very long theoretical final maturity dates represent a big hurdle for many investors.

1.9. FINANCING LOCAL PUBLIC SECTOR INVESTMENTS: THE IMPORTANCE OF COVERED BONDS

By Ralf Berninger, Caisse Française de Financement Local

LOCAL GOVERNMENT: RESPONSIBLE FOR OVER TWO THIRDS OF EUROPEAN PUBLIC SECTOR INVESTMENTS

Local and regional governments (LRGs) exercise a wide range of responsibilities across Europe. Important differences exist from one country to the other, however, the following areas are to a large extent under the responsibility of the local public sector in most of Europe:

> Local and regional infrastructure, including large parts of the local and regional rail and road network;

> Large parts of the primary and secondary education system;

> Basic services such as drinking water supply, sewerage, waste collection and treatment;

> Urban planning and development;

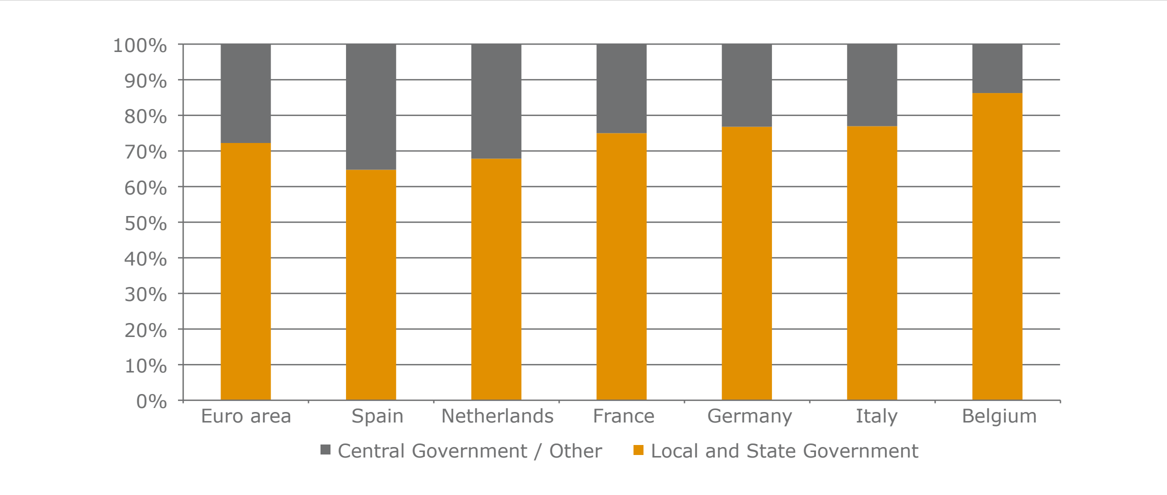
> Parts of the public health care system;

> Public order and safety, for example municipal police forces or fire-fighting services;

> Social housing in some European countries.

These responsibilities include key areas for public investments. As a consequence, local public sector investment expenditures exceed central government investments by a large margin. On average local and state government contribute more than two thirds of total public sector investments across Europe.

> Figure 1: Local and state government share of total public sector investments 2013



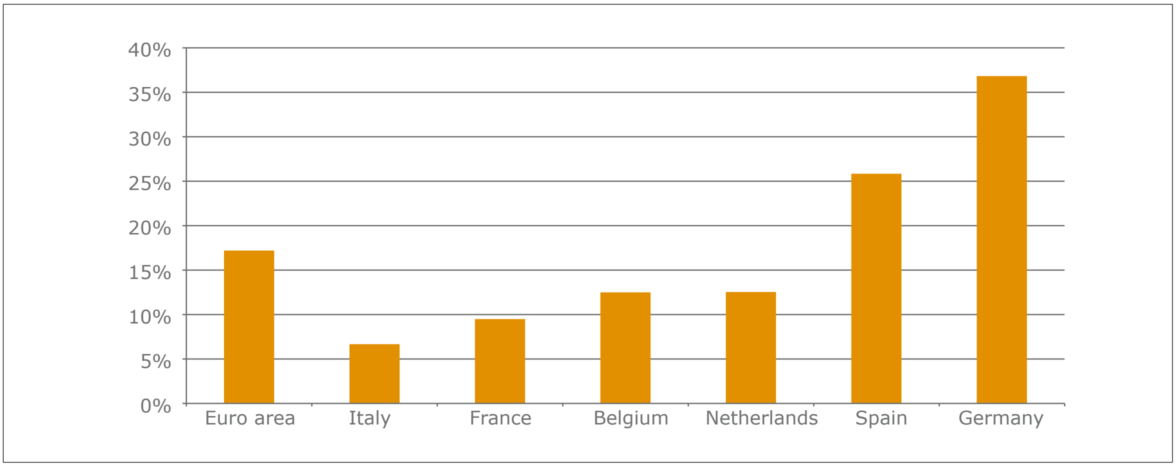
Source: Eurostat

Important differences exist with respect to budget rules for the local public sector from one country to the other. However, the principle of the golden fiscal rule applies in one form or the other across most of Europe. This rule implies that local authorities are prohibited from running deficits to finance operating expenses, new borrowing is only authorized to finance investments.

As a consequence of the strict budget rules, local and regional authorities only contribute a relatively small share to total public sector debt and deficits in Europe. The local public sector share of total government debt is just above 15% for the Euro area.

Here again, important differences exist from one country to the other. At one end of the spectrum, local and regional government (LRG) debt in countries like Germany and Spain with a high degree of decentralization also represents a relatively high share of total government debt. At the other end of the spectrum, local authority debt represents less than 10% of public sector debt in France and Italy.

> FIGURE 2: LOCAL PUBLIC SECTOR SHARE OF GENERAL GOVERNMENT DEBT 2013



Source: Eurostat

FUNDING SOURCES FOR LOCAL PUBLIC SECTOR INVESTMENTS

With much lower financing needs, local governments do not enjoy the same access to international capital markets as central governments do. Overall, local authorities have access to four main sources of funding to finance long-term investments, with a very different funding mix from one country to the other:

1. Direct Bond issuance;
2. Funding provided by specialized public banks or agencies;
3. Financing provided by covered bond issuers;
4. Funding provided by banks, often financed via deposits.

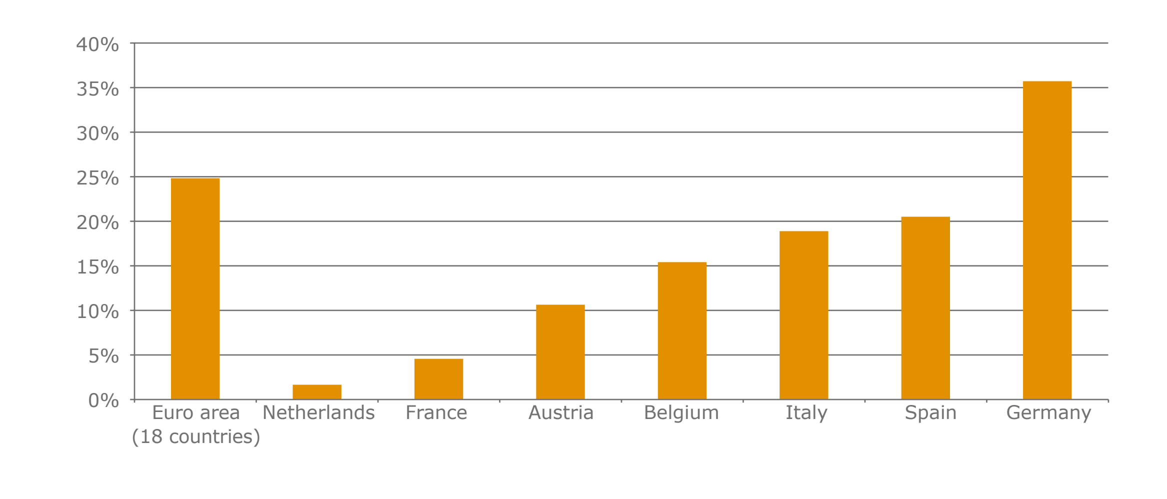
DIRECT BOND ISSUANCE AS SOURCE OF FUNDING FOR LOCAL AUTHORITIES – ONLY AN OPTION FOR LARGER LOCAL AUTHORITIES

Looking at the overall figures, direct bond issuance covers a large part of local authority funding needs. At the end of 2013, bonds issued directly by local authorities represented around 25% of outstanding local authority debt within the Eurozone.

However, the local authority bond market is to a large extent dominated by the German Länder who have the critical size for regular bond issuance. At the end of 2013, bonds issued by local and state government in the Euro Area stood at EUR 380 billion and German issuers represented 75 % of this market segment.

Elsewhere in Europe, bond financing plays a much lesser role as small funding needs by bond market standards and the need for amortizing structures prevent most local authorities from raising funds directly via the bond market. Whereas over a third of outstanding German sub-sovereign debt has been financed via bond issuance, this figure is below 5% for markets with smaller local authorities like France or the Netherlands.

> Figure 3: Outstanding bonds as percentage of total local and regional government debt 2013



Source: Eurostat, Bloomberg

FINANCING PROVIDED BY LOCAL GOVERNMENT FUNDING AGENCIES

Local government funding agencies provide an important source of funding for the public sector in a number of European countries. The structures put in place vary widely from one country to the other:

> Strong credit ratings may be achieved by mutual guarantee mechanism between local authorities or thanks to strong explicit or implicit government support;

> Funding to local government is in some cases provided by agencies dedicated only to local public sector financing or by state development banks with a wider range of activities;

> The legal form varies from one country to the other: some agencies are regulated financial institutions, other have been established under public law;

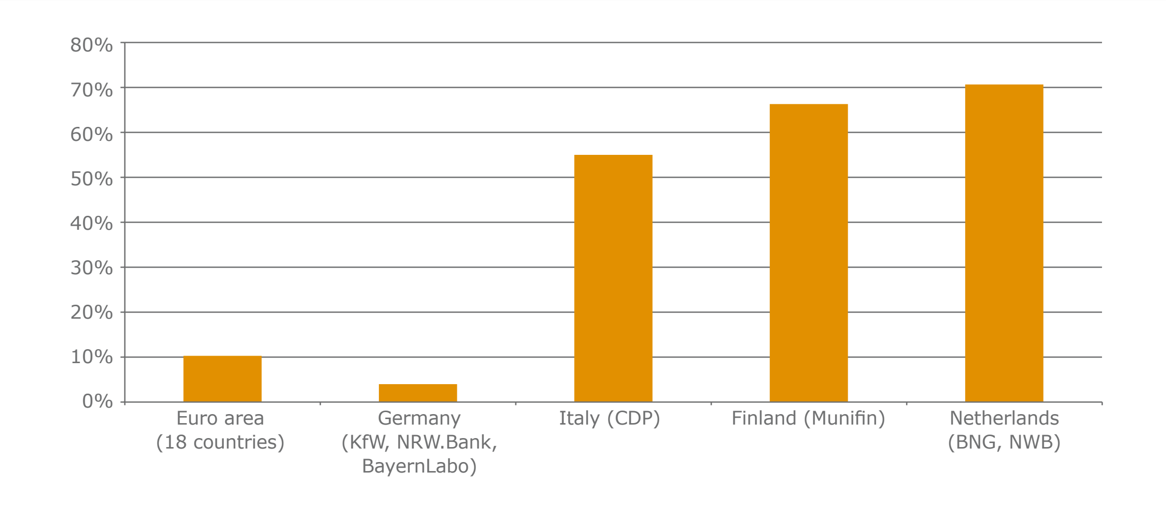
> Ownership may be with the central government or with local authorities;

> Funding may either be provided for general budget purposes or linked to specific infrastructure projects;

> Agencies are generally active on a national level, with the exception of Germany where the activities of lenders like NRW.Bank or BayernLabo are limited to their respective Federated State.

Market shares of public lenders are very much different from one country to the other. In the Netherlands, Bank Nederlandse Gemeenten (BNG) and Nederlandse Waterschapsbank (NWB) together hold around 70% of outstanding Dutch local government debt. Cassa Depositi e Prestiti (CDP) holds a dominant position in the financing of Italian local authorities with a market share close to 55% of outstanding Italian local government loans, not including local authority bonds and securitizations held by CDP. At the other end of the spectrum, specialized public lenders in Germany hold a much lower share of local authority debt. Local authorities in countries like Austria and Belgium finance themselves without access to any specialized public lender.

> FIGURE 4: LOCAL PUBLIC SECTOR LOANS REPORTED BY EURO AREA LOCAL GOVERNMENT FUNDING AGENCIES AS PERCENTAGE OF OUTSTANDING LOCAL AND REGIONAL GOVERNMENT DEBT 2013

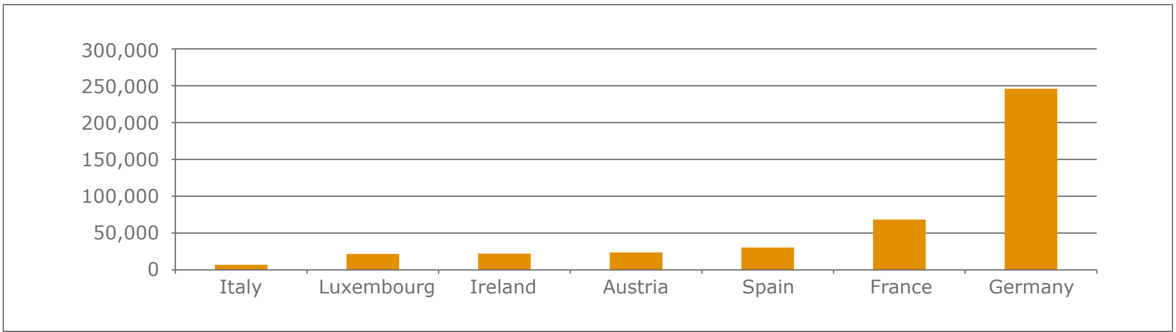


Source: Eurostat, Annual Reports by Munifin, BayernLabo, BNG, NWB, CDP, KfW, NRW.Bank for the Year 2013

FUNDING PROVIDED BY COVERED BOND ISSUERS

The use of covered bonds to refinance loans to the local public sector is well established in Germany, France, Austria, Spain and Italy. In addition, public sector covered bond markets exist in Ireland and Luxemburg although local public sector funding needs in these two countries are small. Hence, issuance programs have often been set up to refinance other assets than local authority loans. Also, the covered bond law in Belgium allows for public sector covered bonds but no issuance backed by public sector loans has taken place up to now.

> FIGURE 5: OUTSTANDING PUBLIC SECTOR COVERED BONDS IN EUR BILLION AS OF 31.12.2013



Source: ECBC Fact Book 2014

Over recent years, public sector covered bond issuance has gone back dramatically, down to EUR 36 billion in 2012, an 80% decline from levels in 2003. However, public sector covered bonds are used to finance different types of public sector assets and not exclusively loans to the local public sector. Special factors like the cost of German re-unification and the end of guarantees for the German Landesbank sector contributed to an initial steep increase and to the subsequent decline in public sector covered bond issuance volumes over the past two decades.

The traditional lending business to municipalities has been much more stable than the overall issuance volumes suggest. As an illustration, exposures by German Pfandbrief issuers to German municipalities stood at a total level of EUR 67 billion at the end of 2013, virtually unchanged from a level of EUR 69 billion in 2009[1].

For this reason, public sector covered bond issuance volumes alone do not capture the importance of covered bonds as funding source for the local public sector. A better way to measure the contribution of covered bonds is to compare the LRG exposures reported by covered bond issuers to total outstanding local public sector debt.

Overall, close to 20% of Euro area local and state government debt is currently refinanced by covered bond issuers. If we limit ourselves to the local government level, excluding for example the much larger German Länder and Spanish Autonomous Regions, this ratio increases above 30%. These figures only include reported exposures, either via the ECBC Label Templates, or via publications under national covered bond legislation. This does not include all public sector covered bond programs and actual total exposures will be higher.

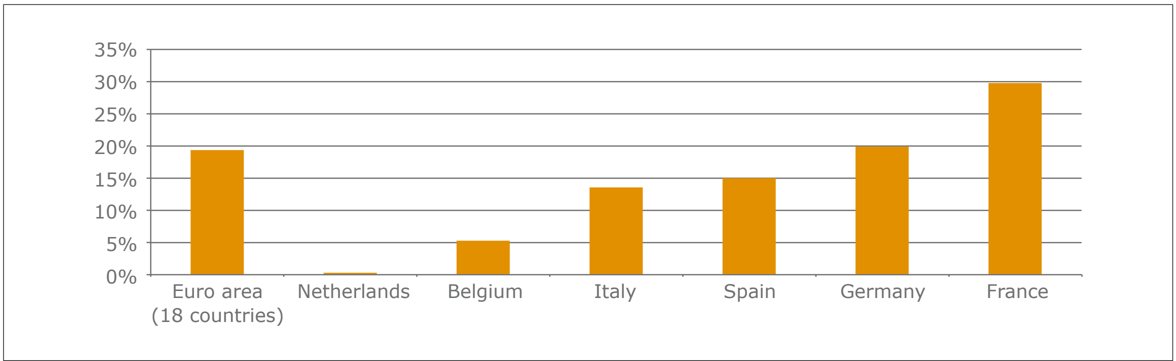
Again important national differences exist, with a strong reliance on covered bonds in France and Germany, with the exposures of covered bond issuers respectively close to 30% and 20% local and state government debt. At the other end of the spectrum, European covered bond issuers hold virtually no exposures to local government in the Netherlands with a dominant share of funding needs covered by the two Dutch public agencies.

>Figure 6: Reported covered bond issuer exposures in EUR billion (31.12.2013)

		Reported Covered Bond Issuer exposures in EUR billion (31.12.2013)			
		Germany	**Italy**	**Spain**	**France**
Local and state government exposures	Germany	156,603.4	0	0	854
	Belgium	2,166.7	0	0	389
	France	911.3	0	0	53,514.1
	Italy	3,201.1	8,012.96	0	7,506
	Netherlands	165.0	0	0	0
	Austria	2,958.1	0	0	601
	Spain	6,022.9	0	29,929.19	1,313
		173,022.1	8,013.0	29,929.2	64,269.1

Source: Cover Pool Data provided by issuer ECBC Covered Bond Label National Templates (BIIS, Caixabank, BBVA, CFF, Caffil, SG SCF, Arkéa SCF) and by VdP

> Figure 7: Reported exposures by covered bond issuers as percentage of local and state government debt (31.12.2013)



Source: Eurostat, VdP, ECBC Label data provided by BIIS, BBVA, Caixabank, SG SCF, CFF, Caffil, Arkéa SCF, estimates for Austria based on data provided on Pfandbriefforum.at as of 30.09.2013

1 Source : VdP statistical database.

Looking at these figures, countries with significant public sector funding needs rely:

> either on a public agency as is the case for the Netherlands, Italy or the Nordic countries,

> or on funding via covered bonds as is the case in France, Germany and Austria.

Italy is a special case as CDP has a dominant market share in public sector finance. However, significant exposures are also reported by covered bond issuers inside and outside Italy. Belgium is another exception as no dedicated public agency exists and a legal framework for public sector covered bonds has only recently been put in place.

Finally, in France, Societe de Financement Local has been set up as a public bank dedicated to the financing of the French local public sector. However, in contrast to agencies in other countries, local government loans are re-financed via covered bonds issued by Caisse Française de Financement Local, with new loans originated via the network of La Banque Postale.

OTHER SOURCES OF FUNDING – MAINLY AN OPTION FOR SMALLER LOCAL AUTHORITIES OR LINKED TO SPECIFIC PROJECTS

Across Europe, loans to smaller municipalities are often directly granted by local cooperative banks or savings banks. Aggregate figures are not available, but it is safe to assume that these loans cover a large part of the debt not financed by public agencies, direct bond issuance or covered bonds. However, financing long-dated public sector loans on the basis of deposits is not well adapted to cover significant funding needs. In addition, local authorities are dependant on a small number of local banks.

Other sources financing may sometimes provide interesting opportunities for local authorities, but are overall of lesser importance:

> Specific infrastructure projects may be eligible for financing via national governments or from institutions like EIB;

> Specific projects may be financed via Public Private Partnership, reducing the funding needs of LRGs;

> German insurance companies invest directly in Schuldschein transactions issued by local authorities, without many of the constraints and high legal costs associated with direct bond issuance;

> Securitization techniques have been used in order bundle local authority loans with small volumes for institutional investors.

CONCLUSION

Reported exposures of public sector covered bond issuers represent over 30% of the outstanding debt of municipalities in the Euro area. This makes covered bonds a key pillar for the financing of local public sector investments.

The increase and subsequent decrease in public sector covered bond issuance over recent years has been driven more by market specific factors and less by changes in the lending business to local authorities itself. Alternatives providing a better solution to the funding needs of local authorities are not available today:

> Direct bond issuance is only an alternative source of funding for sub sovereigns with important funding programs for regular issuance like German Länder or Spanish autonomous regions;

> Loans provided by local savings banks or cooperative banks are often financed directly via the deposit base and only provide a solution for local authorities with small funding needs;

> Specialized public institutions operate successfully in a number of countries, however, their activity is limited to the domestic market.

Looking ahead, the local public sector in Europe will continue to rely on long dated funding provided by covered bond issuers. Bundling large numbers of high quality loans via covered bond programs is well adapted to the needs of the local public sector one the one hand and of institutional investors on the other hand.

1.10 THE COVERED BOND MARKET FROM AN ASIAN PERSPECTIVE

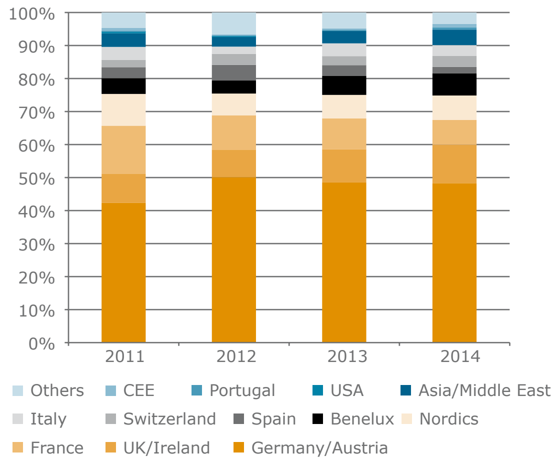
By Michael Schulz, NORD/LB

Although the cradle of the covered bond market is in Europe, the number of active countries with outstanding covered bonds has increased significantly in recent years and now spans almost the whole world. The covered bond market has found increasing support among issuers and investors in the past few centuries, starting from Central European countries such as Germany and Denmark. This is due primarily to the market's clean record from a historical viewpoint, without any payment impairment or default of bonds. Contributing factors include political support in times of crisis and legal requirements that are kept up-to-date to a very large extent. In this respect, however, attention must be drawn to the different framework conditions in each particular country, in most cases giving rise to individual characteristics in covered bond legislation. Despite this, the main anchor point in the financial crisis since the Lehman Brothers bankruptcy has not been so much the legislation that is applicable in each country. The principal factor in success is the broad and growing investor base which, at the height of the crisis, focused especially on domestic issuers. Detailed knowledge of the domestic banking market and the assumed intrinsic value of the assets used in the cover pools were decisive factors in the focus of investment on the domestic market. During this period, increasing numbers of global investors from beyond the European continent exited from the market, only returning gradually in the following years. The secret of success for a sustainable well-functioning covered bond market segment is consequently the presence of domestic investors, which is not the case in all countries. This also applies to Asian countries. Although few of these countries have a legal framework in place for covered bonds, they do have the investors, some of whom are highly active. In this article I, the author, will firstly examine the process through which the Asian covered bond market is passing as it emerges, in some instances in its initial stages. I will direct the attention at the investor and issuer side, and provide an overview of the legal frameworks that are currently in place. I will then assess the results of a survey of Asian investors conducted especially for this article. In addition to general questions about investment strategy in the bond segment, the survey also included issues specific to covered bonds.

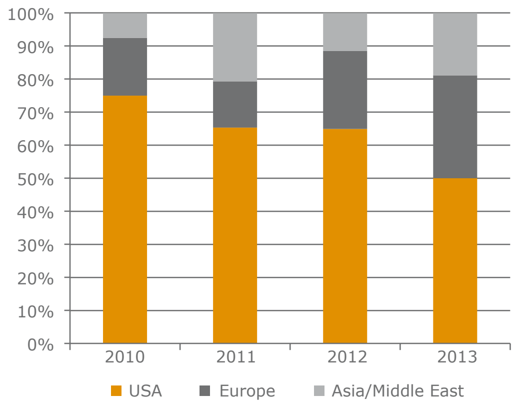
THE ASIAN COVERED BOND MARKET

Analysis of primary market allocations on the covered bond market in recent years indicates that the participation of Asian investors is at the consolidation stage. I, nevertheless, believe that the designation "Asia" in relation to the countries of participating investors is misleading. If we take a look at the definition chosen by the United Nations (UN), Asia includes the following regions: North Asia (including Russia), Central Asia (including Afghanistan and Kazakhstan), the Middle East or West Asia (including Saudi Arabia and Israel), South Asia (including India), East Asia (including China, Japan and South Korea) and South-East Asia (e.g. Malaysia and Indonesia), with a total population of more than 4.2 billion people. An analysis of primary market records shows that, with a few exceptions, Asian investors mainly comprise countries in the Association of South-East Asian Nations (ASEAN) and ASEAN Plus Three. The ASEAN has existed since August 1967 and was originally founded as an economic, cultural and political association of the countries Indonesia, Malaysia, Philippines, Singapore and Thailand. In subsequent years, Brunei, Vietnam, Myanmar, Laos and Cambodia also joined. The underlying objective is still to promote the economic strength and political stability of these countries. The ASEAN Plus Three additionally extends to the countries of China, Japan and South Korea, resulting in financial sector cooperation in the year 2000 through the Chiang Mai Initiative. For simplification reasons the term Asia is used in the following text, which generally includes the ASEAN Plus Three countries.

> FIGURE 1: ALLOCATION OF EUR COVERED BONDS



> FIGURE 2: ALLOCATION OF USD COVERED BONDS



Source: NORD/LB

Following a period at the height of the crisis when Asian investors' participation in the primary market declined sharply, a significant increase was recorded in the last four years. I have assessed the allocation of new issues in benchmark format (benchmark means EUR: >500m; USD: >1bn) both in EUR and in USD. Not surprisingly, there is a high proportion of German and Austrian investors. This group of investors recently accounted for an average of around 50% of the order volume for individual transactions. Another result is that, in the case of EUR-denominated covered bonds, investors from Asia or the Middle East accounted for a proportion of 3.0% to 4.7% in the period 2011 until now. The wide-ranging designations used for the investors nevertheless show that precise classification by country is difficult. Although it is not possible to establish a clear trend in this respect, the proportion was at the upper boundary of the specified range in 2014 (January to June). A look at the allocation of USD-denominated covered bonds reveals a somewhat different picture. In the years 2010-2013 this was sometimes significantly above that level. The year 2011 saw the highest point at 20.7%, although this is largely due to one issue from the Korea Housing Finance Corporation (KHFC) in July 2011. In this transaction, approximately 60% of the issue volume remained with Asian investors. After factoring this transaction out of the statistics, there is a clear upward trend in the direction of increased placements by Asian investors in USD-denominated covered bonds.

ASIAN ISSUERS AND THEIR LEGAL FRAMEWORK

South Korea is currently the only country in Asia with a covered bond legislation, which was used in the past for the issuance of covered bonds. Even though history shows that covered bonds do not necessarily have to be subject to statutory laws when they are issued in order to be regarded as high-quality assets on the market and by investors, countries in Asia are evidently interested in passing legislation as a first step. As early as 2011 a debate was started in India about introducing covered bond legislation with a view to strengthening the domestic real estate market. On the basis of an existing securitisation market, this was intended to be a step towards creating a broader funding base for Indian issuers. However, more far-reaching decisions have not been taken so far. China seems to be one of the countries that is far from considerations of this nature, while the Philippines is showing some interest in covered bond issues. Japan, however, decided only in the summer of 2013 against a legal underpinning of covered bonds. The Japanese FSA officially rejected the proposed legislative initiative, arguing that domestic issuers did not need legislation of this type. The examples of the UK, France, Australia, New Zealand and Canada, to name just a few countries, illustrate that a covered bond market can also be formed without passing covered bond legislation, or can be extended to include additional categories. What these countries have in common, however, is that the legislature followed a short time later with a legal framework. At this point I present a brief update of the latest statutory changes in Asian legal frameworks. For example, in December 2013 the South Korean National Assembly passed a covered bond law, which came into force on 15 April 2014. Fitch welcomed this in a statement of 22 December 2013 ("Korean Covered Bond Act a Boost to Wider APAC Market"), describing the move as positive for the covered bond market in the Asia-Pacific region. According to the agency, the legislation is similar to that of other jurisdictions. Cover pool assets that remain on the bank's balance sheet, for example, will be clearly defined in a cover register. Mortgage bonds, municipal bonds, ship and aircraft loans are permitted as cover assets, in addition to residential mortgages. The minimum requirement for the over-collateralisation is 5%, and up to 10% of replacement cover assets can be used. In order to limit the asset encumbrance, an issue limit of 8% of the issuer's total assets was also defined. The agency, nevertheless, believes that transactions through the Korea Housing Finance Corporation should be retained for diversification purposes. The Corporation pools the cover assets of different institutions and then issues covered bonds under a special law geared towards the institution. In Singapore the local financial regulator (Monetary Authority of Singapore; MAS) adopted guidelines for the issuance of covered bonds (MAS Notice 648) at the end of 2013, with immediate effect. According to these guidelines, issuers can choose to keep the assets on their own balance sheet or transfer them to an SPV, which can either act only as guarantor or itself act as issuer. Only residential mortgages are permitted as cover assets, in addition to substitute assets (max. 15%). According to MAS statements, the possibility of extending this to other asset classes will be examined at a later date. The over-collateralisation must be at least 3% and the maximum issue volume is limited to 4% of an institution's total assets. In the statement entitled "MAS Update Clarifies Singapore Covered Bond Rules" of 7 January 2014, Fitch welcomed this step, but at the same time voiced its criticism that some aspects still need to be clarified, such as separation of cover assets.

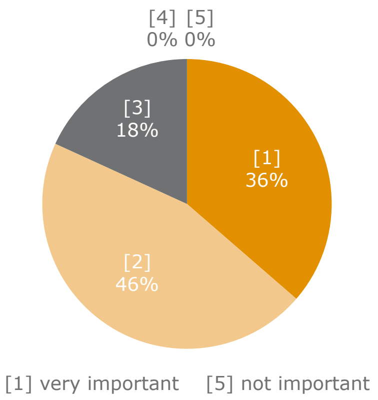
South Korea has been represented on the market through active covered bond issuers for several years. For example, Kookmin Bank issued its first covered bond in early 2009, which was subject to the basic principle of dual recourse. As collateral, the bank used a cover pool composition that was a novelty until then, consisting of Korean real estate financing and credit card receivables. The two small-volume USD-denominated tranches had maturities of three and five years. KHFC appeared on the market only a short time later, in mid-2010, also placing a USD-denominated covered bond. The institution brought out a single transaction in its debut on the market, deciding not to structure a programme. The second USD placement in benchmark format in the summer of 2011 was followed firstly by issues in domestic currency, before the third issue of a USD 500m bond appeared in July 2013. The buyers were located mainly in the region, while only a few European investors took up the bonds. The passing of the law in Singapore lays the cornerstone for the first issue under covered bond legislation. Although the current market situation does not make it necessary to establish a covered bond segment for banks from Singapore, according to some potential institutions, the signs are good. In this case, however, it could initially be one of the three major players, DBS, UOB or OCBC, that had played a major part in drafting the legislation.

HOW DO ASIAN INVESTORS TICK - A SURVEY

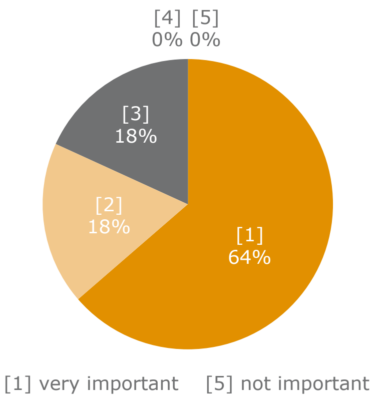
For the purposes of this article, a questionnaire was sent to institutional investors in the ASEAN Plus Three region, with a total of 14 major questions and sub-questions. The target was to enquire about the general investment behaviour of Asian investors in the bond segment, as well as their willingness to purchase covered bonds as investment instruments. Participating institutions included central banks and asset managers in addition to insurance companies. Due to the limited regional focus and the difficulties in delimiting by country as described above, the following analyses correspond to a section of Asian investors' interests. In addition, there is often a response spread motivated by strategic or business policy reasons with regard to the investor groups.

This may cause the aggregated results to produce a divergent overall picture. For this reason, investor-specific characteristics are sometimes emphasised separately. In addition to general questions concerning investment strategies in the bond segment, the survey also asked about experiences with covered bond investments. The first block included the question: "What are your rating requirements for bond investments in general?". The responses covered nearly all the available alternatives, with six rating groups ranging from very safe to high risky. The majority were in the investment grade range, spread largely across the segments AAA/Aaa and >AA-/Aa3 with 31% each. Only a small single-digit percentage responded that they had no credit rating requirements. This suggests that Asian investors generally have a need for investment safety that is similar to European investors. However, they have greater freedom to buy riskier assets as well, according to the survey. This is closely related to yield requirements, which are regarded as high by European standards and are in some cases at pre-crisis levels.

> Figure 3: How important is a high spread/yield for your bond investments in general?



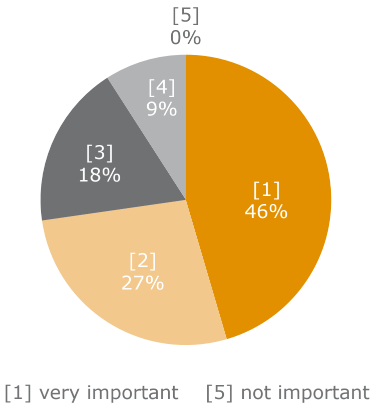
> Figure 4: How important is a high issuer rating for your bond investments in general?



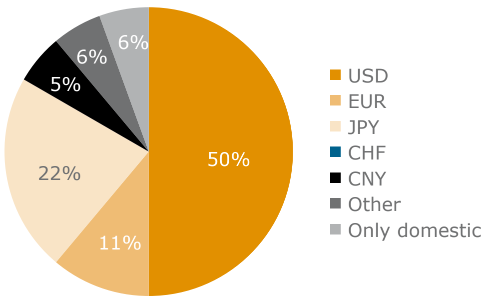
Source: NORD/LB

Analysis of the questions about the general yield requirements of Asian investors (see Figure 3) and the target rating for issuers (see Figure 4) contrasts more than partially with the general rating requirements of investors as described above. It can even be said that a conflict of objectives is apparent, due to demand for a good issuer rating at 64% and, on the other hand, the great (46%) or very great (36%) desire for a high return on investment. The situation described here is not uncommon, however, and occurs as a pipe-dream in the minds of many market participants. While European investors, often as a result of more stringent regulatory requirements, usually react conservatively and attach greater weight to a high rating, Asian investors mostly face fewer restrictions and can invest in riskier assets. Achieving a high target yield, not uncommonly above 4%, is thus possible despite the current low level of yields.

> FIGURE 5: HOW IMPORTANT IS MARKET LIQUIDITY FOR YOU?



> FIGURE 6: WHAT IS YOUR PREFERRED CURRENCY FOR BOND INVESTMENTS?



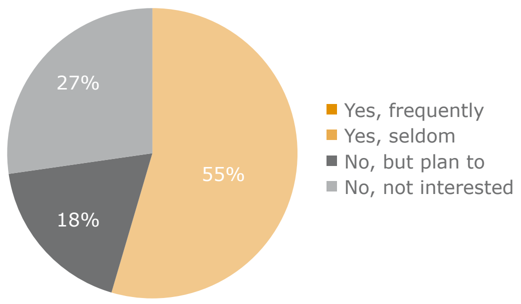
Source: NORD/LB

The fact that the Asian investors participating in the survey regard very high liquidity of their bond investments as a key attribute plays into the hands of covered bonds. Surveys conducted by the EBA provided proof of this. These placed government bonds and bonds that are subject to dual recourse on the same level of liquidity. 73% of respondents described the ability to sell their investments quickly as important or very important. The same applies to the preferred maturities for bond investments. At 94%, the bulk of maturities in demand is between one and ten years. The maturities bucket of 5-7 years accounted for most of this, while the shorter maturity bands of 1-3 years and 3-5 years received 31% and 19%, respectively. When asked about general currency preferences, 16% indicated the euro, while the more specific request in relation to bond investments delivered a score of only 11% in favour of the European common currency. As was to be expected, the greatest demand is clearly for USD assets. The main reason is that the lending business of Asian banks is handled mostly in local currency or in US Dollars. In relation to the responses of investors, the USD share is 50% in the case of bond investments, while restriction to the respective local currency is very low at 4%.

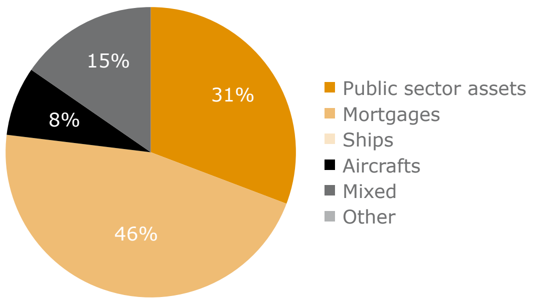
COVERED BONDS AS ASIAN ASSET CLASS

Even though this does not apply to all central banks in the Asian region, many central banks like to fall back on covered bonds for direct investments, even if they are EUR-denominated. Only a few of these players have never been in contact with the bonds known for decades in the core countries of Europe. Experience of covered bonds among Asian private banks, asset managers and insurance companies is very much lower. Within this group, too, there are investors who have long been engaged in brisk trade with covered bonds. However, they are in the minority. Yield targets significantly above those of safer investments and only low levels of contact with covered bonds in the past often keep institutions away from the market. This is shown, for example, by the question asked during the survey relating to experience of covered bonds ("Have you ever invested in covered bonds?"). Although 55% of investors responded that they have invested in covered bonds in the past, they generally do so very rarely. Once an investment decision has been taken in favour of covered bonds, mortgage covered bonds are the primary focus. In this case the interest level was 46%, while 31% prefer public sector and a small portion would also accept mixed pools and aircraft.

> Figure 7: Have you ever invested in covered bonds?



> Figure 8: If you have invested or plan to, which collateral type do you, or would you invest in?



Source: NORD/LB

While the Asian investors participating in the survey have formulated clear ideas regarding the permissible rating for their bond investments, the limits in relation to covered bonds seem to be somewhat more flexible ("Do you have special rating requirements for covered bonds?"). 60% of the institutions investing in covered bonds have no specific rating requirements for this asset class. If rating limits are, nonetheless, in place ("If yes, what are your rating requirements for covered bonds?"), they are in the rating classes AAA/Aaa and >AA-/Aa3. In relation to the existence of a specific legal framework for covered bonds, the majority of respondents regard the issuance of bonds without such a law being in place as a show-stopper. 20% of investors felt this to be important, while 50% even ranked it as very important ("How important is the issuance under an existing covered bond legislation for you?"). Based on the observable behaviour of established investors from the core countries of Europe, I nevertheless evaluate these responses as prevalent on the market. In many places, for example, great emphasis is placed on detailed legal frameworks that provide maximum protection against default of the investment instruments. The question of investment in pass-through structures has been met with some hesitation ("If you have invested or plan to, do you invest in pass-through structures?"). Only 25% of responses indicated that there is an increasing interest in this type of programme structure. This is largely due to the small number of bonds available on the market. It is also in the nature of things that the lower the level of experience with a product, the lower the willingness to make an investment.

ONE STEP AT A TIME

The financial market crisis has shown that the existence of a covered bond market that functions both from the investor viewpoint and on the issuer side is important in order for financial institutions to have access to liquidity at any time. In a stress scenario, investors focus mostly on familiar markets and tend to withdraw from other segments. Efforts to attract new issuers from Asia to the market are held back by the fact that the consequences of the financial crisis are continuing to preoccupy European banks in particular, while Asian financial institutions were able to look upon this from a safe distance. Although the first covered bond from Singapore could be launched within the next few months, the driving force behind it is probably not the direct need for diversified means of refinancing, but the commitment to the law that was recently passed. Asian central banks in particular have long been among the purchasers of covered bonds. For this reason they are likely to assist in pioneering an Asian covered bond market. Rising demand from Asia's own ranks is important because the potential issuers are expected to offer mainly USD transactions, which are in high demand especially among domestic institutional investors. This is evidenced by the bonds issued by the Korean KHFC that have been placed on the market in recent years. They have mainly used the USD as the currency of issue, in addition to the local currency. There are several factors that could throttle the speed at which a functioning market emerges:

> Asian banks often have high levels of deposits and are thus more independent of the capital markets;
> The low level of yields and the favourable conditions for obtaining fresh capital, even without a cover pool, are currently very good;
> Demand for covered bonds as a strategic asset class is several times higher among European investors. In these cases, mostly EUR-denominated bonds are in demand.
> The unfavourable risk/return ratio is likely to cause real-money investors from Asia to continue accessing other asset classes more and more.

There are also special cultural and religious aspects. In some countries, for example, investments in line with religious rules such as Sharia-compliant Sukuk bonds are the focus of investor interest. In this article it is not possible to examine conclusively the extent to which covered bonds meet these requirements. However, the bottom line is that the number of active Asian covered bond issuers is expected to increase slowly in the next few years. This also applies to the number of active investors. The reluctance to implement a legal framework for covered bonds in particular countries nevertheless demonstrates that, on the political front, there is no real urgency in some cases.

1.11 INVESTOR PERSPECTIVE

By Ralf Burmeister, Deutsche Asset & Wealth Management

One might say that since last year's edition of the ECBC Fact Book, it has been a relatively easy year for the investor side as spreads simply headed tighter and rating pressure on sovereigns and banks has eased on average. While we do acknowledge that the two factors mentioned above were amongst the major contributors to an overall positive performance of covered bonds, challenges in the market still persist.

At the time of writing, the finalization of the LCR (Liquidity Coverage Ratio) provision was still missing. While at least there was the indication to increase the proposed 40% threshold for covered bonds in the pool of liquid assets to be held by banks up to 70%, new regulatory topics have emerged. The different definitions of covered bonds by various regulatory initiatives as well as the Net Stable Funding Ratio (NSFR) are to be mentioned here. Given the current track record of the covered bond product in the regulatory space, we are not overly concerned but still prefer to know the rules of the game than just having good guesses about it. Besides, the low yield environment starts to take its toll in two aspects:

Firstly, the attractiveness of covered bonds as an investment has suffered due to absolute yield levels and tightened spreads which is a general topic in the fixed income market and not something being exclusively associated to covered bonds - remember all those buy recommendations in the last 12 months in various fixed income segments ending with a statement like e.g. "we acknowledge that overall pricing levels are tight but there is a lack of alternatives".

Despite the fact that the quality of covered bonds has been again demonstrated in the previous months in our view, the overall level of yields may drive at least some investors out of the market as they require certain minimum levels of return. There have been signs of increased acceptance lately amongst institutional investors that one cannot escape the relationship of risk and expected return so we witness as of today rather small adjustments between various fixed income asset classes here and not sudden shifts with corresponding market turmoil.

Secondly, the low yield environment heralds another tricky issue for the market – again a general fixed income topic and not necessarily a unique covered bond topic: low volatility. As especially for the majority of the first half year 2014 bond prices and spreads have been moving rather steadily in one direction, volatility reached new lows. This low volatility has undesirable consequences when it comes to trading: If there is an external shock to the market like e.g. we witnessed in May 2014, the bank's trading books being managed throughout the industry by a variety of value at risk models (VaR) tend to shrink in a situation where prices already started to fall, thereby contributing to a further drop in prices. Accordingly, in such an environment, screen prices will differ from realized trading prices, which in itself is potentially causing difficulties for investors when it comes to evaluating bond holdings. Furthermore, an increasingly bumpy trading pattern might in the future have again its implications when e.g. the LCR is revisited by banking regulators or when it comes to post trade transparency. To put it in other words, regulation has had its impact already on trading patterns and –volumes and the observed trading behavior itself might influence future regulatory treatment in the asset class of covered bonds – which shows the ever increasing complexity in the area of banking and capital market regulation these days.

But besides the above-mentioned topics of complexity within upcoming regulation as well as the general lack of alternatives in the fixed income space within a period of low absolute yields, we feel confident that covered bonds will continue to attract a very decent and stable investor base in the future. Obviously, the friendly rating trend which started in late 2013 (and did not exclusively concern covered bonds but also sovereigns, as well as banks) did help to support the sentiment for covered bonds. We would like to additionally mention four major trends which in our view will fuel the positive momentum:

> Covered bonds have a significant lower volatility on index level compared to the European government bond indices. This feature is of particular interest on the asset allocation level. Accordingly, for constructing an efficient portfolio in the context of the efficient frontier theory, the share of covered bonds in so called multi-asset mandates has increased over the last years. The fact that on average, the covered bonds are better rated than the corresponding sovereign also underpins the attractiveness. We do not expect this trend to reverse in the short run.

> The favorable supply and demand mechanics in our view will remain in place as the banking sector continues to deleverage. Looking at the relevant benchmark indices, covered bonds are still very much a European play with an outstanding benchmark volume of approx. 95% of total index volume. Using total banking assets of Eurozone banks as measured in the ECB statistics as a proxy, total banking assets have come down significantly from EUR 34.2 trn in mid-2012 to EUR 30.5 trn at the end of Q1 2014. Assuming a positive impact from upcoming banking regulation as stated above on the demand side of banks and looking at the first point mentioned, we expect to see continued demand for covered bonds besides the low yield environment.

> Capital ratios of banks are increasing quite significantly, as can be seen e.g. in the latest edition of the European Banking Authority (EBA) risk dashboard. Ongoing issuance of senior debt plus more subordinated debt by banks is effectively lowering the probability of default, making the sector and therefore the covered bond truly safer.

> Adjustments in rating agencies methodologies are under way, especially taking into account the exemption of covered bonds from bail-in measures as well as a decreased possibility of support for the banks from their state of domicile. To our understanding, so far the implications were positive on average as one would have rationally expected. Acknowledging the difficulty in making statements in terms of rating for the overall sector, the points mentioned above in terms of deleveraging plus better capital positions are per se rating positive. Although it does not necessarily lead to upgrades for banks on a senior unsecured level, the safety of the covered bond is undisputedly impacted in a positive way.

To sum up, the stage is set for another decent year until next year's edition of the ECBC Fact Book. We have outlined the potential obstacles which obviously do exist as history teaches that there is no such thing as a one way street in capital markets for a prolonged period of time. Besides regulatory issues and shrinking trading books, one may add two more topics which might turn into pitfalls for the market: the one thing is complacency and the other one are covered bonds in disguise. For the first topic, central bankers across the globe warned fixed income market participants in general already for quite some time that they should not neglect the fundamental risks notwithstanding the latest friendly price movements. For the covered bond market, it is fair to assume that new cash flow structures like e.g. pass-through mechanisms which are very much favored by rating agencies could accordingly lead to certain reluctance on the investor's side to analyze in depth the underlying risks of their bond holdings as they are awarded anyway with the highest possible ratings. This in turn leads to the later topic of covered bonds in disguise as there is currently a clear incentive to use the name "COVERED BOND" for any kind of new collateralized fixed income product due to its positive connotation, preferably also in combination with features that are very much favored by rating agencies. We are not arguing against innovation in the market as such but simply would like to point out to a common and preferably very strict understanding of what a covered bond should be and especially which covered bond should make it into the relevant indices. With the emergence of new asset classes serving as collateral for so-called covered bonds, we would like to opt for a narrow definition of a covered bond. Transparency in that regard is absolutely crucial and therefore, the use of a covered bond Label is also almost imperative for issuers in order to remain attractive to the traditional real money investors that are so relevant to the overall covered bond market.

1.12 INVESTOR PERSPECTIVE OF THE COVERED BOND INVESTOR COUNCIL (CBIC)

By Nathalie Aubry-Stacey, International Capital Market Association

The ICMA Covered Bond Investor Council ('CBIC') has, since its inception, focussed on strengthening the covered bond product, through better transparency. The CBIC mission statement makes a specific reference to its intention to promote '*the high quality, simplicity and transparency of the product*'. The CBIC represents long-standing investors who believe that only the most secure assets should be used in cover pools, and that covered bonds should remain a simple and strong product. With this in mind, enhancing transparency and facilitating better comparison between covered bond programs has been a natural priority work stream for the CBIC. The Council anticipates that increasing regulatory scrutiny will make it necessary for all covered bond issuers to prioritise the ongoing work of improving transparency to the highest possible standards.

The CBIC European Transparency Standards project is part of a process to achieve high transparency standards throughout Europe in the long run, but it is not intended to be an 'all or nothing' list in the short-term – or a loan-by-loan requirement. The template comprises the qualitative and quantitative information required to fulfil investors' transparency and information needs. This information has been agreed by investors independently from the data requested by rating agencies and used in their own analytical models.

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

The CBIC also expects that increased transparency will broaden the covered bond investor base. Increased transparency is a required to meet new investors' demands for information, notably those coming with a credit analytical tradition, but also provides smaller investors with better information that they may not be able to access otherwise. Indeed, covered bonds remain an important part of the financing of the mortgage and public sector in European markets and are an asset class with a significant public policy role. The covered bond market is also a significant source of bank financing beyond the current government guarantees and as such is part of any future solution for financial stability.

The CBIC noted that the Covered Bond Label Convention requires compliance with Article 129 of the Capital Requirements Regulation (CRR) and Article 52(4) of the UCITS Directive, a positive and credible step in the current regulatory context and discussions regarding liquidity ratios. However the current Label Convention requirements still do not provide extensive quality information about the labelled covered bonds to the investors, even though it ensures that the demarcation between covered bonds and ABS / ABS-like products, and covered bonds backed by other types of assets is clear. A label of 'quality' as understood by investors has to rest on the reporting of quality and comprehensive information, in a standardised manner.

The ICMA Covered Bond Investors Council has, unsurprisingly, been following closely progress with the Covered Bond Label, and has been particularly interested in developments in the last year (2014). The CBIC membership welcomes any market initiative, such as this one, which prevents any dilution of the quality of covered bonds.

Since the CBIC European Transparency Standards Template was first proposed, there have been significant developments in the field of data transparency. The most obvious of these has been the introduction of a new paragraph to the definition of covered bonds which qualify for a preferential risk treatment for investors. The new wording of Article 129 CRR puts the onus on investors to undertake due diligence on covered bond pools, in particular specifying some key data fields which must be reported on a timely basis.

Another relevant development is, as mentioned above, the introduction of the Covered Bond Label which specifies minimum pool disclosure standards on a country-by-country basis (i.e. the National Transparency Templates). Many covered bond investors, in particular those with experience of the securitisation market, have a growing appetite for data about cover pools. Whereas the needs of covered bond and securitisation investors differ significantly, it is clear that organisations such as the European Data Warehouse in the securitisation market have 'raised the bar' on pool transparency. If the covered bond market is to protect its excellent reputation, it is clear that we must continue to make progress towards higher standards of disclosure than the bare minimum.

At the last annual CBIC/Covered Bond Report conference held in May 2014, the CBIC Chairman, Andreas Denger, shared some disappointment on the progress that has been made regarding meeting investors' wishes in line with the CBIC European Transparency Standards Template. The Chairman also reflected on some of the issues linked to the CBIC European Transparency Standards Template, such as issuers possibly not perceiving its 'real tangible benefits' (e.g. preferential regulatory treatment). He also highlighted some potential risks in delaying the template's adoption, such as damaging the long-standing good reputation of covered bonds and being forced externally to improve transparency levels.

With this in mind, the CBIC is currently working to review the Template initiative to make it relevant to these changed circumstances and to build on the excellent work of the National Transparency Templates. Although this is a work in progress, it is safe to say that its objectives will include better cross border comparability of data, voluntary disclosure of relevant information over and above what is required by the National Transparency Templates and potentially the ability to perform simple portfolio analytics on cover pools.

The CBIC welcomes the infrastructure the Covered Bond Label has put in place for further strengthening of the European covered bond market, and notes the improvement in the minimum transparency requirement. It relies rightly on dedicated national covered bond legislation and on the supervision on both the issuing credit institutions and the cover pool. Against this background, the Covered Bond Label is an important, positive step. It has the merit of defining certain minimum requirements for covered bonds, if only at national level at this stage, which does not help the aim of making comparisons across European issuers. To achieve a high quality label and for investors to fully benefit from the Covered Bond Label, the CBIC believes an enhanced transparency regime, converging with the CBIC European Transparency Standards, following a coordinated and step-by-step approach, is key.

CHAPTER 2 - GENERIC SECTION

2.1 OVERVIEW OF COVERED BONDS

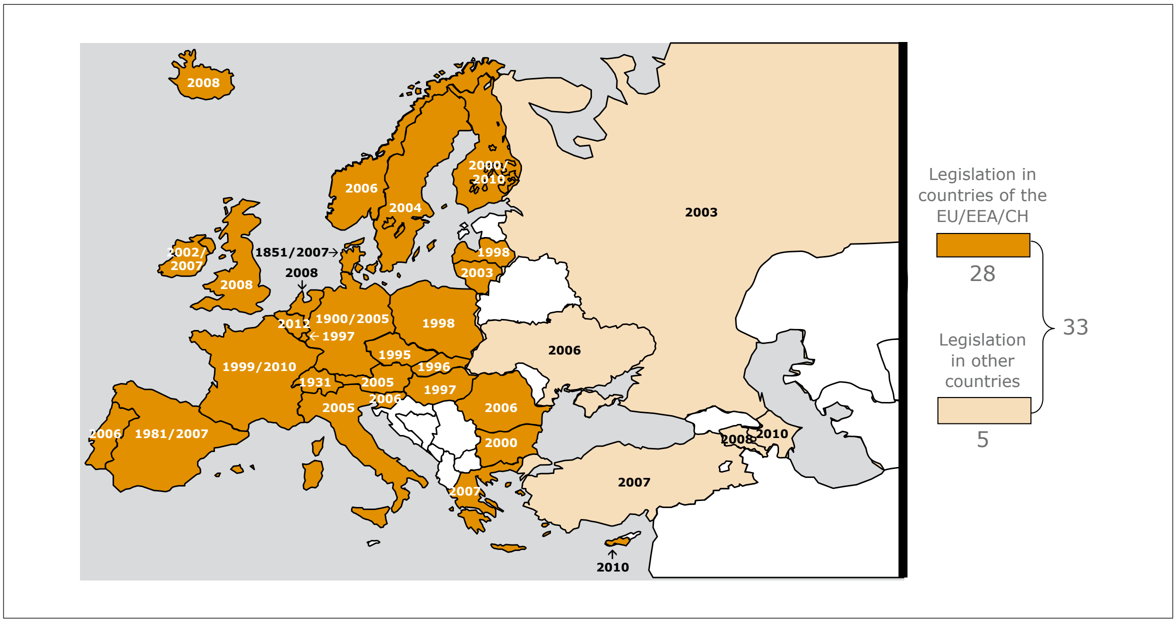
By Ralf Grossmann, Société Générale CIB & Chairman of the ECBC Technical Issues Working Group and
Otmar Stöcker, Association of German Pfandbrief Banks

2.1.1 INTRODUCTION

Over the past 20 years, 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 2013 amounting to EUR 2.6 trillion[1]. Today, there are active covered bond markets (i.e. with issuance activity on a regular basis) in 29 different European countries (for more information, please refer to the covered bond statistics section in chapter 5). In addition, there are several European countries which have enacted or are in the process of updating or adopting covered bond legislation and are expected to launch active covered bond markets soon.

Outside Europe, 4 countries (Australia, Canada, New Zealand, South Korea) have already noteworthy active covered bond markets and numerous countries have enacted or are working on covered bond legislation. Countries which have good prospects that their future covered bonds might attract international investors are probably OECD countries such as the US, Japan, Singapore, Mexico, Chile, large developing countries such as Brazil or India and countries with close ties to Europe such as Morocco or UAE, if they achieve high quality legislation for their covered bonds.

> Figure 1: Covered bond legislation in Europe (as of December 2013)



Source: vdp

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

Covered bonds have proved their resilience as funding instrument at various occasions during the financial and sovereign crisis. It is generally accepted that the covered bond market should play a pivotal role in bank wholesale funding as it provides lenders with a cost-efficient instrument of long-term funding for mortgage or public-sector loans and offers investors the best possible quality of 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. 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.

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 the creation of covered bonds in Europe in the course of 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 in the last decade of the 20th century with the fall of Communism, the German reunification and the introduction of the Euro. In 1995, the first German Pfandbrief in benchmark format (Jumbo) was issued. The format was created in order to meet liquidity needs of investors and to provide increased funding for public sector lending. In the late 90s, Central and Eastern European countries reintroduced real estate finance techniques. Covered bonds were an important element in the process to fund the growing number of mortgage loans to establish private housing markets.

The introduction of the Euro and the subsequent decrease of interest rates led to a lending boom in Europe. Banks needed to look for new funding sources via high credit-quality liquid bonds to attract international capital investors. At the same time, investors could no longer diversify regarding currencies, but intensified their search for liquid products. Therefore, banks in Western countries revitalised their covered bond systems to create a competitive capital market instrument. Since then, the Jumbo market has expanded strongly. The financial crisis further strengthened the importance of covered bonds as the most resilient wholesale term-funding instrument for credit institutions.

2.1.3 THE BENEFITS OF COVERED BONDS

Positive impact on credit supply conditions

Evidently, funding conditions of the banking sector are a key parameter for credit supply and, therefore, have important macro-economic repercussions. Conditions of mortgage credit supply impact the property market and, therefore, have important long-term effects on consumption and investment behaviour. In that context, covered bonds offer macro-economic benefits as an instrument generating reliable funding volumes at low credit spreads for borrowers in the mortgage market. Likewise, public sector covered bonds have undoubtedly reduced the funding costs of public sector borrowers. Moreover, homogenous funding instruments for banks lead to higher information efficiency increasing transparency as regards the pricing of loans (e.g. refer to the Danish mortgage bond system).

Prevention against moral hazard risk

Covered bonds also have an important role to play in the context of financial stability. In covered bonds, the issuer retains the credit risk of the underlying loans. This feature prevents the creation of those moral hazard problems which were one of the key factors of the 2008 subprime crisis in securitisation markets. Generally, the combination of credit risk retention by the issuer and strict cover asset eligibility incentivise the issuer to maintain a high discipline in lending standards and underwriting criteria.

However, as the crisis continued and covered bond issuance exceeded the issuance of senior unsecured bonds in the EUR market for the first time ever, asset encumbrance became a major topic in the financial stability debate. There are concerns that a high amount of bank assets, which are pledged to special creditors, and therefore would not be available in case of bank insolvency, would make banks more vulnerable in case of market turmoil and lead to further destabilisation of the system. Central bank and third party repo and credit support annexes of derivatives transactions are often more important and less transparent sources of asset encumbrance than covered bonds. Moreover, encumbrance induced by covered bonds is a long-term, non-volatile, good quality form of encumbrance justified by banks' business models and exhibit much slower, less volatile swings as a cover pool monitor needs to approve asset transfers.

Resilient bank funding instrument

Covered bonds are the most reliable funding source as they make banks less susceptible to adverse market conditions. They often offer issuers better wholesale capital market access, lower transaction execution risk and decrease the reliance on senior unsecured funding and interbank markets. During the European sovereign crisis, it occurred that under certain conditions, over an extended period of time covered bond issuers had cheaper access to wholesale funding markets than their respective distressed sovereigns.

As it is difficult to measure the creditworthiness of a bank, it is therefore 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. This is also mirrored in rating approaches where covered bond ratings generally benefit from a rating uplift of several notches over the unsecured rating of the issuing bank and certain decouplingin case of downgrades.

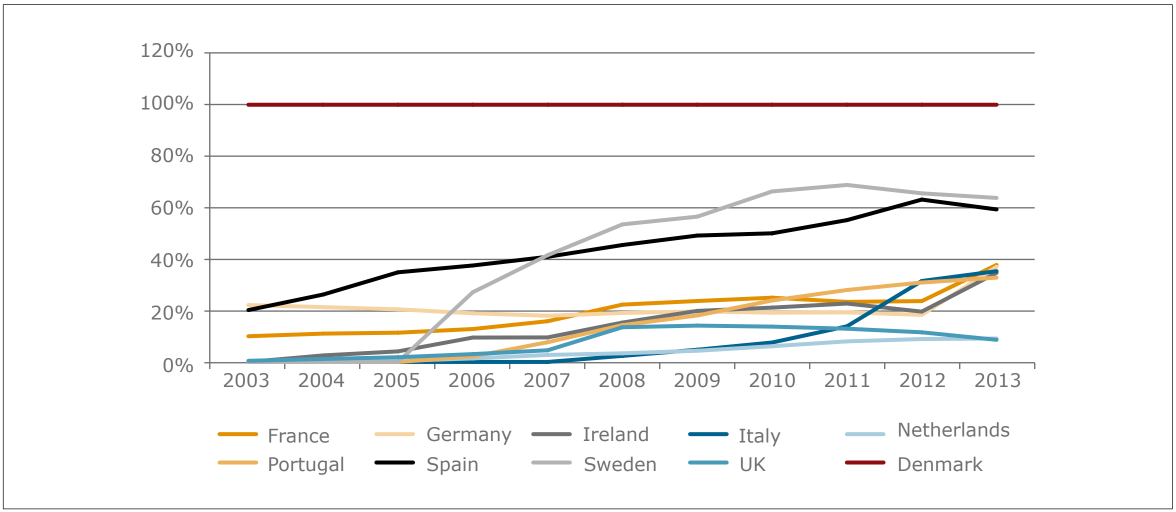
Moreover, the covered bond safety features (legal frameworks, high quality assets, public supervision, etc.) offering higher recoveries and more transparency than senior unsecured bank bonds and therefore resulting in a larger investor base and larger asset allocation quotas. The regulation around covered bonds (e.g. UCITS, CRD, Solvency II, lower ECB haircuts) reflects exactly those safety features and, in turn, allows more institutional investors to buy covered bonds and encourages them to engage themselves on a larger scale than in others products.

On the back of the severe market turmoil in 2008-2010, the ECB 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]

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.

The positive effects of covered bonds outlined in this section are clearly dependent on the extent of use of covered bonds within a particular country compared to the size of the domestic mortgage market and the alternative funding tools for banks (and their costs). The figure below confirms a comparatively high importance in most countries of the size of the covered bond market related to the volume of residential loans outstanding. Most of the countries have now reached stable relative size of the covered bond market after a phase of strong growth in 2007/2008 and more moderate growth subsequently.

> FIGURE 2: MORTGAGE BACKED COVERED BONDS AS % OF RESIDENTIAL MORTGAGE LOANS

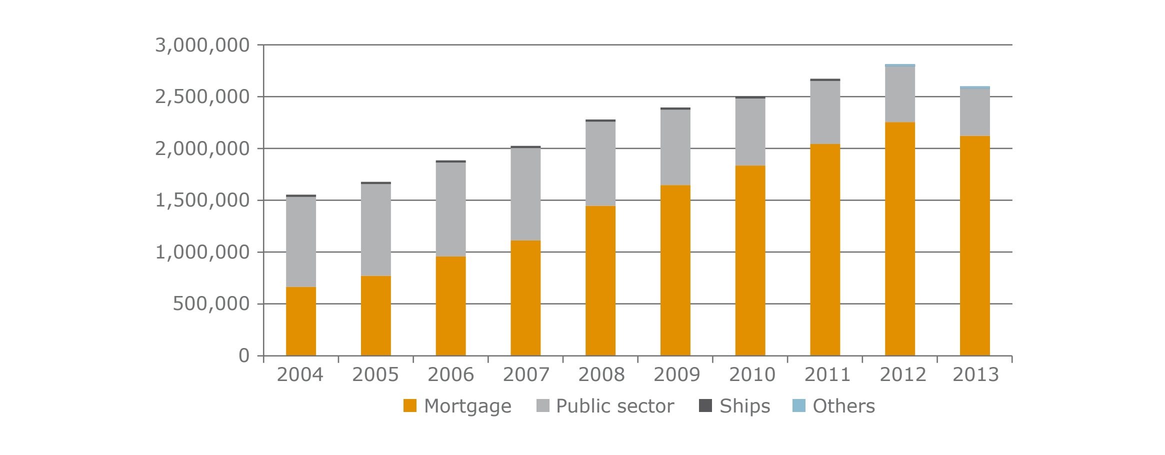


Source: EMF/ECBC

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 issued on a regular basis only in a limited number of European countries (Austria, France, Germany, Luxembourg, Norway, Spain and UK). Covered bonds backed by ship loans are rarer but can be found in Denmark and Germany. 2012 has seen first issuance of German Pfandbriefe backed by aircraft loans. In 2013, the first structured covered bond backed by SME loans was launched into the market by a German issuer. Italy and Spain have introduced special legislation permitting the issuance of covered bonds backed by other types of cover assets (SME, corporate bonds, receivables, etc.) but no issuance has occurred yet.

> FIGURE 3: TOTAL OUTSTANDING COVERED BONDS BY UNDERLYING ASSETS, 2004 TO 2013 IN EUR M



Source: EMF/ECBC - Covered bonds outstanding at the end of 2013.

2.1.5 ECBC COVERED BOND COMPARATIVE DATABASE

The ECBC website presents in an on-line database at www.ecbc.eu a comparative analysis, based on a questionnaire with the responses of 45 frameworks. The comparative overview is divided into 9 sections covering the essential features of the 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 complement existing general insolvency law protecting holders of secured debt. Frameworks 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 to ship and aircraft loans. Some covered bond systems distinguish between regular cover assets 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 or on a voluntary basis. In most covered bond countries, national data disclosure templates exist obliging the issuers (either by law or on a voluntary basis) to disclose standardised cover pool information.

Valuation of mortgage cover pool & LTV criteria

Most countries have legal provisions or at least generally accepted principles for property valuation. Those provisions are an essential element to guarantee a certain minimum credit quality of cover assets. In most cases, the property valuation is based on a mortgage lending or prudent market value. LTV limits for single assets are 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

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.

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 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.

Numerous covered bond systems have provisions that allow derivatives to become part of the cover pool with the purpose to hedge interest rate or currency mismatches. Derivative counterparties can rank *pari passu* or subordinated to covered bondholders. In covered bond systems, covered bondholders have recourse to the issuer's insolvency estate upon a covered bond 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 falls within the criteria of Art 129 of Regulation EU No 575/2013 (CRR). In some countries, the CRR 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.

2.1.6 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 2013 amounted to 2.6 trillion EUR (covered bonds covered by mortgage loans, public-sector loans and ship loans), which represents a decrease of 7.5% year on year. The five largest issuing countries in 2013 were Denmark, Sweden, Germany, Spain and Italy 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. The importance of covered bonds is also evidenced by the broad variety of different bond formats and currencies under which the product is issued and by the large investor base. Both subjects are addressed in the key themes section.

> Figure 4: Volume outstanding CB in Europe end of 2013 in EUR million

	Public Sector	Mortgage	Ships	Others	Mixed Assets	TOTAL
Australia	0	46,021	0	0	0	46,021
Austria	23,682	18,854	0	0	0	42,536
Belgium	0	8,188	0	0	0	8,188
Canada	0	50,459	0	0	0	50,459
Cyprus	0	1,000	0	0	0	1,000
Czech Republic	0	10,355	0	0	0	10,355
Denmark	0	359,646	5,514	0	0	365,160
Finland	0	29,783	0	0	0	29,783
France	68,349	202,822	0	0	73,015	344,185
Germany	245,961	199,900	5,792	506	0	452,159
Greece	0	16,546	0	0	0	16,546
Hungary	0	4,016	0	0	0	4,016
Iceland	0	803	0	0	0	803
Ireland	22,154	20,827	0	0	0	42,981
Italy	6,945	122,099	0	0	0	129,044
Latvia	0	0	0	0	0	0
Luxembourg	21,708	0	0	0	0	21,708
Netherlands	0	61,015	0	0	0	61,015
New Zealand	0	7,851	0	0	0	7,851
Norway	2,035	105,202	0	0	0	107,237
Panama	0	218	0	0	0	218
Poland	84	707	0	0	0	791
Portugal	1,200	34,199	0	0	0	35,399
Slovakia	0	4,015	0	0	0	4,015
South Korea	0	2,536	0	0	0	2,536
Spain	30,352	334,572	0	0	0	364,924
Sweden	0	217,854	0	0	0	217,854
Switzerland	0	89,064	0	0	0	89,064
United Kingdom	5,822	130,792	0	0	0	136,614
United States	0	6,000	0	0	0	6,000
EU-28	**426,256**	**1,785,042**	**11,306**	**506**	**73,015**	**2,296,125**
Total	**428,292**	**2,085,345**	**11,306**	**506**	**73,015**	**2,598,464**

Source: EMF/ECBC

Note: Please refer to section 5 for additional information on the ECBC statistics.

2.1.7 WHO BUYS COVERED BONDS

Anne Caris, Bank of America Merrill Lynch

Despite the reduced market volatility since 2013 and more risk-on investment strategies as a result, covered bonds have remained well bid overall. In the primary market, the bid-to-cover ratio has averaged 3.8x for peripheral covered bonds during the first half of 2014 (2.8x in 2013), compared with 2x for non-peripheral bonds (1.9x) and 1.1x for non-European ones. The rationale behind buying covered bonds has notably been:

> Regulation, especially in Europe, where covered bonds benefit from favourable treatment in relation to banks' liquidity and capital requirements based on their characteristics and historical performance. A key topic in recent months has been their inclusion in the Liquidity Coverage Ratio in some regions, although terms differ globally. The overall exclusion from bail-in in the final European Directive is also positive for the product.

> Relative Value investment opportunities. Covered bonds tend to provide a spread pick-up vs. sovereign bonds except in European peripheral markets, where the strongest covered bond issuers have been trading inside. Following the significant market rally, some peripheral senior unsecured bonds have also traded close to covered bonds, resulting in attractive switch trades in favour of covered bonds.

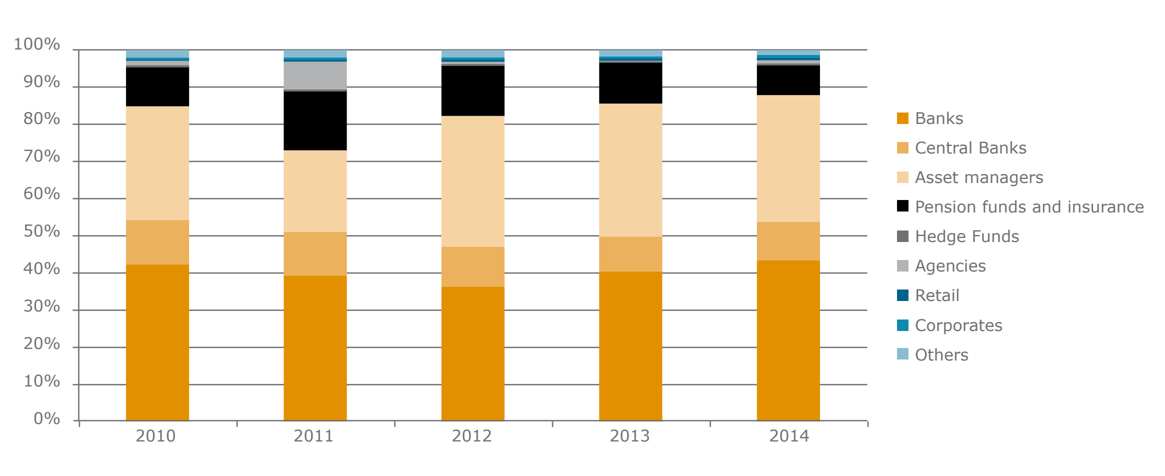
> The good entry point that the product offers, e.g. for investors wishing to invest again in European peripheral markets, given: 1/ its lower market volatility vs. sovereign or senior unsecured debt; 2/ its better rating stability and higher rating levels vs. other products – even more so under agencies' new methodologies; and 3/ the security provided by cover pools, which are increasingly domestic residential mortgages, although there are national differences.

Banks remain major investors in covered bonds; indeed participation is up in recent years (see Figure 1). Their investment strategy has been consistent – buying especially European non-peripheral and non-European paper notably due to regulatory criteria/requirements (see Figure 4). Central banks have also been key supporters of the market, with a similar geographical focus to that of the banks. Participation by asset managers has been more opportunistic, prioritising yield/performance, underpinning their increased and comparatively higher appetite for European peripheral covered bonds. Following the strong rally, hedge funds have more or less exited the covered bond market for now and moved down in banks' capital structure.

In terms of geography, while Germans/Austrians remain the dominant investors (see Figure 2), it is worth noting the lesser home bias visible in the primary market since 2013 (see Figure 3). New issue allocation in the primary market is now more diversified, including for European peripheral markets, notably thanks to reduced macro risks. The presence of Asian investors has also expanded further in total and across names, although investment strategies still focus on the strongest covered bond issuers whether peripheral or not. Buyers from Eastern Europe are also visible in 2014 but on core names only and in small amounts. US investors have mainly been hedge funds and have exited the market, as previously mentioned.

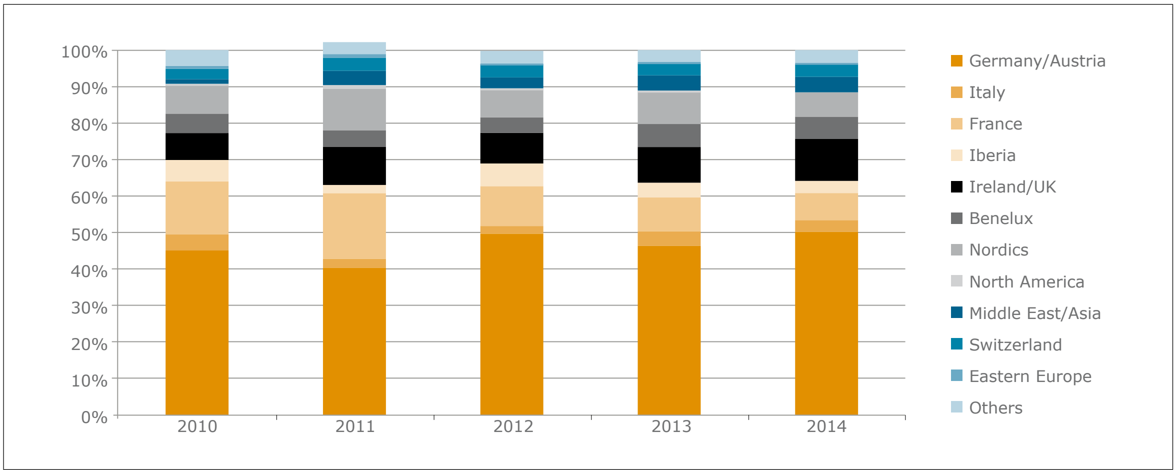
Sustained high demand for covered bonds and limited supply continue to support strong market technicals overall and tend to result in limited sell-off vs. other products even in times of renewed volatility.

> Figure 1: Allocation of EUR-denominated benchmark issuance by investor type



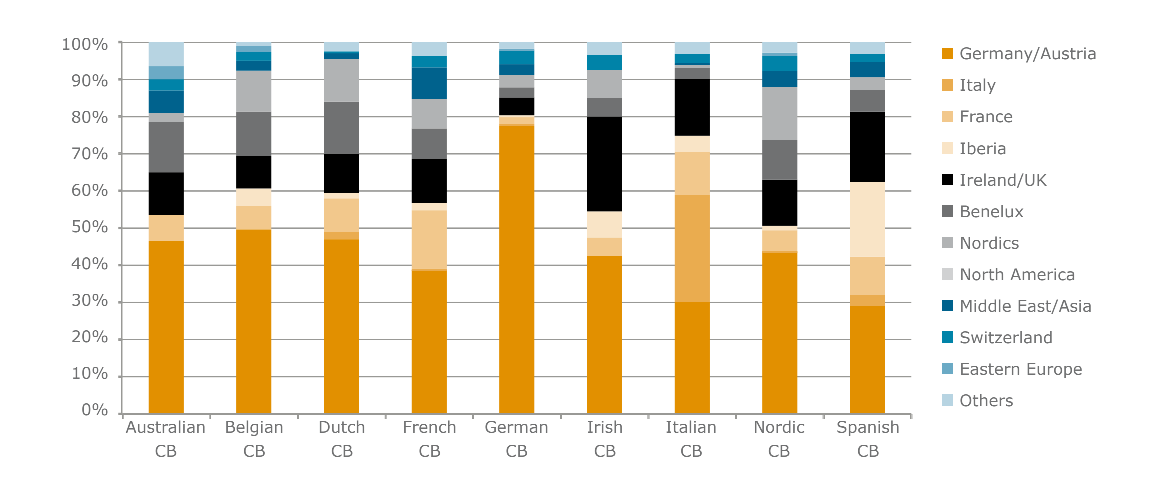
Source: BofA Merrill Lynch Global Research, Bond Radar LTD; 2014 is at end-June

> Figure 2: Allocation of EUR-denominated benchmark issuance by country



Source: BofA Merrill Lynch Global Research, Bond Radar LTD; 2014 is at end-June

> FIGURE 3: BREAKDOWN OF INVESTORS BY COUNTRY FOR EACH CB MARKET (NEW EUR-BENCHMARK ISSUES AT END-JUNE 2014)



Source: BofA Merrill Lynch Global Research, Bond Radar LTD

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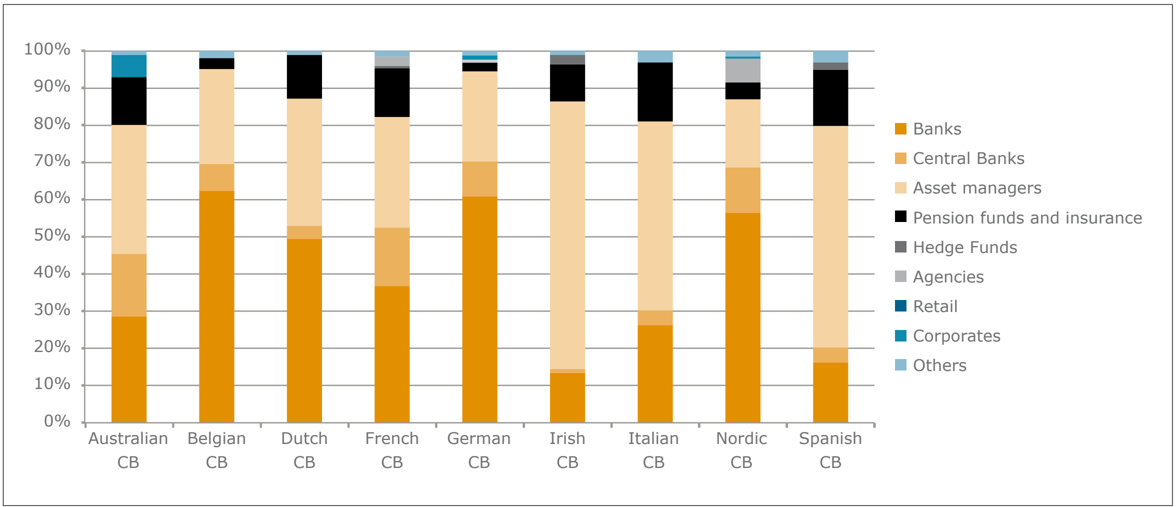


Source: Bloomberg

2.2 REGULATORY ISSUES

2.2.1 COVERED BONDS AND EU BANKING REGULATIONS

By Fritz Engelhard, Barclays

This chapter first provides an overview of recent regulatory developments, in particular relating to the qualification of covered bonds for liquidity buffer portfolios and the conditions under which covered bonds may benefit from a preferential capital treatment. In this context, it also gives some background on the discussion surrounding the harmonisation of covered bond frameworks. The chapter then describes how covered bonds are defined under EU regulations. It then provides an overview of the capital requirements for covered bonds under EU regulations for credit institutions. Lastly, it describes the treatment of covered bonds under liquidity risk management rules.

RECENT REGULATORY DEVELOPMENTS IN THE EU

Following the adoption of the new Directive[1] on access to the activity of credit institutions and the Capital Requirements Regulation (CRR)[2] by the European Parliament in April 2013, the respective rules became effective on 1 January 2014. For the introduction of minimum capital requirements and the Liquidity Coverage Ratio (LCR), the CRR applies a similar phase-in schedule as proposed under Basel III, but the main difference is that the minimum level of 100% LCR must be achieved one year earlier, on 1 January 2018. The submission date for a proposal of EU-wide Net Stable Funding Ratio (NSFR) rules is 31 December 2016.

When it comes to the detailed application of the respective rules on covered bonds, the CRR assigned specific tasks to the European Banking Authority (EBA) with regards to the qualification of covered bonds for liquidity buffer portfolios and the appropriateness of the capital requirements for covered bonds. In addition, in February 2013, the European Systemic Risk Board (ESRB) asked the EBA, together with national authorities, to identify best practices in covered bond legislations. According to Article 509(2)(c) CRR, until 31 December 2013, the EBA needed to propose a method for restricting the use of certain categories of liquid assets to cover liquidity requirements and test a minimum threshold of 60% for Level 1 assets "taking into account international regulatory developments". According to Article 503 CRR, the EBA needs to provide advice to the European Commission when it comes to answering the question whether the preferential capital requirements for covered bonds would be appropriate with a particular emphasis on product variations across Member States, the transparency of the covered bond market and the use of specific types of collateral (aircraft loans, guaranteed home loans or RMBS/CMBS notes).

In order to fulfil the requirement of Article 509(2)(c) CRR, on 23 October 2013, the EBA presented the results of its comprehensive empirical analysis on liquidity conditions in various market segments and on 20 December 2013, the EBA published two reports containing its recommendations on the treatment of covered bonds under CRR rules. While the empirical findings suggested that covered bonds scores are comparable to government bonds, in its final recommendation the EBA proposed to classify covered bonds as Level 2 assets and also confirmed that there should be a 40% cap on the use of Level 2 assets. The next stage for the EU liquidity regulation is for the European Commission to adopt it via a delegated act. Article 460(2) CRR stipulates a deadline of 30 June 2014, but for the time being (July 2014), the adoption is still pending. It is envisaged that the rules will come into force on 31 December 2014.

1 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:EN:PDF.
2 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0001:0337:EN:PDF.

Finally, on 1 July 2014, the EBA published its report on EU covered bonds and capital requirements. In its report, the EBA defined nine areas that are important for the robustness of a covered bond framework and indicated principles of best practice for each of them. These nine areas are as follows:

1. Dual recourse mechanism: covered bond investors should in any case be granted an unsecured claim on the covered bond issuer or sponsor bank's insolvency estate, including in cases where covered bonds are issued by non-deposit-taking specialized covered bond issuers.
2. Asset segregation and bankruptcy remoteness of covered bonds:
    a. With regards to asset segregation, the covered bond legal/regulatory framework should ensure that cover assets are either segregated through the establishment of a cover register and/or the transfer of cover assets to a special entity. There should be legally binding and enforceable arrangements in place, including in the event of default or resolution of the issuer. The segregation arrangement should include all primary cover pool assets, substitution assets and hedge contracts.
    b. With regards to bankruptcy remoteness, the respective framework should ensure:
        i. that payment obligations attached to the covered bond should not automatically accelerate upon issuer's default or resolution;
        ii. that the rights of covered bond holders and other parties whose claims ranks at least *pari-passu* with covered bond investors should be given priority in case of an issuer's insolvency; and
        iii. that the issuer has at all times a plan in place specifying the operational procedures aimed at ensuring an orderly functioning of the covered bond programme upon default or resolution.
3. Features of the cover pool:
    a. Cover pools comprising both residential and commercial mortgage loans should be structured and managed so as to ensure that the composition does not materially change throughout the life of the covered bond.
    b. Covered bond frameworks should provide that cover pools are generally limited to comprise of assets located in the European Economic Area (EEA), as this ensures that liquidation of collateral in the case of issuer default is legally enforceable. In case assets from non-EEA jurisdictions are used, legal enforceability of the respective claims should be ensured, similar underwriting standards should be applied as with EEA loans and the loans should have similar risk characteristics.
4. Valuation of cover assets and LTV limits and other requirements on mortgage cover assets:
    a. The covered bond framework should establish maximum LTV parameters to determine the percentage portion of the loan that contributes to the requirement of coverage of the liabilities of the covered bond programme.
    b. The covered bond framework should ensure that the valuation of properties is updated at least annually on the basis of transparent valuation rules and carried out by an agent who is independent from the loan origination process.
5. Assets and liability risk management - coverage principles and over-collateralisation: A legal /regulatory minimum over-collateralisation level should be stipulated.
6. Assets and liability risk management - stress testing, use of derivatives for hedging and liquidity risk mitigation:
    a. Early termination of hedge contracts upon issuer default should be excluded.

b. The cumulative net out-flows of the covered bond programme over a certain time frame should be covered by liquid assets. The rules should also take into account specific features of the covered bonds (i.e., hard bullet, maturity extension, conditional pass-through).

c. Mandatory stress tests should cover interest rate risk, FX risk, credit risk, prepayment risk, liquidation hair-cuts, set-off risk and commingling risk.

7. Covered bond monitoring: In cases where cover pool monitoring is not undertaken directly by supervisory authorities, but by a cover pool monitor, such monitors should not be the ordinary monitor of the issuer, he should fulfil minimum standards, his main duties and powers in particular with respect to coverage requirements, eligibility tests and the random auditing, should be described, and he should regularly report to supervisory authorities.

8. Role of the competent authority:

   a. The establishment of a covered bond programme and/or the right to start making use of covered bonds should be made subject to supervisory approval. Authorities should in particular focus on adequate operational policies, procedures and controls, specific restrictions applicable to the issuer and cover pool requirements. There should also be a clear and sufficiently detailed illustration of the duties and powers of the competent authority regarding ongoing supervision.

   b. There should also be a detailed description of the duties and powers of the supervisory authority on the covered bond programme, as well as its administration, in the event of an issuer default.

9. Disclosure to investors: Covered bonds issuers should be required to disclose, at least on a quarterly basis, aggregate data on the credit risk, market risk and liquidity risk characteristics of the cover assets and the covered bonds of a given programme as well as other relevant information, including information concerning the counterparties involved in the programme and the levels of contractual and voluntary over-collateralisation.

The EBA clearly states the expectation that any future change of national or EU-wide covered bonds legislation should give consideration to these elements and irrespective of the existing covered bond model should follow the recommended principles of best practice.

In order to comply with the EBA's guidance, lawmakers and banking supervisors in a number of jurisdictions will be required to refine their frameworks, in particular when it comes to monitoring and supervising covered bond issuance. This will not only further the level playing field but also make this part of the safety mechanism supporting covered bonds more transparent. Furthermore, the outcome of supervisory actions in case of stress scenarios should eventually become more predictable.

When it comes to the conditions under which covered bonds should benefit from a favourable regulatory treatment, the EBA suggests introducing the following additional qualifying conditions in Article 129 of the CRR:

1. A minimum regulatory over-collateralisation level.
2. Requirement to mitigate liquidity risk by means of liquid assets available at all times.
3. A more detailed role of the competent authority.
4. A more detailed specification of the disclosure requirements already included in Article 129(7). Regarding in particular the criteria in Article 129(7)(a) on disclosure to investor institutions, the EBA considers that these criteria leave excessive room for interpretation and should be further harmonised via regulatory technical standards to ensure a uniform application of disclosure to covered bond investors throughout the EU.

Regarding the use of specific types of collateral, based on its qualitative and quantitative analysis, the EBA came to the following conclusions:

1. Exclude loans secured by aircraft liens among the underlying asset classes eligible for the risk weight preferential treatment.
2. Keep residential loans secured by a guarantee in the scope of the preferential capital treatment under the following two conditions:
   a. The national legal/regulatory covered bond framework should not allow borrowers to place mortgage liens on the loans included in the cover pool.
   b. The national legal/regulatory covered bond framework should be such that no legal impediments exist for the administrator of the covered bond programme to place mortgage liens on the loans included in the cover pool, in a scenario where the covered bond issuer has entered default or resolution and where the guarantee, for any reasons, ceases to exist.
3. Remove the derogation to the 10% limit for the inclusion of senior RMBS and CMBS notes in covered bond asset pools after 31 December 2017. The EBA nonetheless recommends that the European Commission "should further consider whether a specific provision could be introduced in Article 129 CRR making it possible to allow specific intra-group transfers of CRR-compliant covered bonds as eligible collateral".

The European Commission shall by 31 December 2014 report to the European Parliament and the Council on the inclusion of aircraft loans and the use of residential loans secured by a guarantee. By 31 December 2016, the European Commission shall review the appropriateness of the derogation of the 10% limit for the inclusion of senior RMBS and CMBS notes in covered bond asset pools.

The debate on the regulatory treatment of covered bonds and the definition of best practices for covered bond frameworks is closely linked to the discussion surrounding the harmonisation of covered bond frameworks. This discussion has gained momentum with the publication of the EU's green paper on long-term financing of the European economy in March 2013, which was followed by an additional communication in March 2014. While in 2013, the EU just raised the question about the pros and cons of "a more harmonised framework for covered bonds", in 2014 it announced it was to launch a "study on the merits of introducing an EU framework for covered bonds". The emphasis on the benefits of a uniform covered bond framework clearly indicates that the EU does not see any material risk of such a development.

The main risk in the introduction of a uniform covered bond framework lies in the watering down of safety standards, which could result from compromising on a low common denominator when defining covered bonds. Furthermore, mortgage market standards and insolvency regimes still differ substantially across EU countries, which could make the adoption of a common regime not only very costly in individual countries, but it could also cause systemic disruptions. The debate about the adoption of the LCR in Denmark and the qualification of covered bonds in liquidity buffer portfolios is just one example for the potential repercussions from the introduction of a common standard. Finally, the history of covered bonds is full of examples where innovation has helped enhance the use of covered bond technology and/or make it more efficient while preserving, and in a number of cases also improving, the safety net for investors. The introduction of a common covered bond regime could eventually hamper innovation in this respect.

Clearly, the introduction of a single EU-wide covered bond framework would also have significant advantages. When based on best practices, it could help further strengthen the trust in the safety of the product, enhance the investor base and consequently lead to a deeper more liquid market. From a supervisory perspective, it would also facilitate the application of the Single Resolution Mechanism (SRM), as the application of standardized tools and procedures for banking resolution could then be applied to a single covered bond framework. The best practices as proposed by the EBA are an encouraging starting point, which could help ensure the EU is reaping the full benefits when heading towards a single EU covered bond regime. However, when it comes to the objective of mobilizing more long-term financing for the European economy at lower cost, other parameters, such as rules for solvency, liquidity and leverage, may have a much more dominant impact on the final result than the introduction of a single covered bond framework.

DEFINING COVERED BONDS

In the CRR, 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 129 CRR. It refers to the criteria of Article 52 (4) of the EU Directive 2009/65 (Directive on Undertakings of Collective Investment in Transferable Securities or UCITS) and additionally stipulates a series of eligibility criteria for cover assets. Article 52(4) UCITS gives a legal definition of a covered bond along the following lines:

> 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 a full or partial use of RMBS and CMBS notes only until 31 December 2017 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 the following:

a) Exposures to or guaranteed by central governments, EU central banks, public sector entities, regional governments or 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 credit 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 to 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 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) French home loans with an LTV of up to 80% and a maximum loan-to-income ratio of 33% at origination and fully guaranteed by a protection provider at least rated A-. There shall be no mortgage liens on the residential property when the loan is granted, and for the loans granted from 1 January 2014, the borrower shall be contractually committed not to grant such liens without the consent of the credit institution that granted the loan. The protection provider shall be a supervised financial institution subject to prudential requirements comparable to those applied to banks, a credit institution or an insurance company. The originating bank and the protection provider must both carry out a creditworthiness assessment of the borrower.

f) Loans secured by commercial immovable property 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.

g) 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 Article 208 and Article 229 of the CRR. 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.

In order to qualify for preferential treatment under capital requirement rules, according to Article 129(7) CRR, credit institutions investing in covered bonds are required to undertake due diligence on their respective products. The credit institutions need to demonstrate to the regulators that they receive portfolio information on: 1) the value of the cover pool and outstanding covered bonds; 2) the geographical distribution and type of cover assets, loan size, interest rate and currency risks; 3) the maturity structure of cover assets and covered bonds, and 4) the percentage of loans more than ninety days past due. Furthermore, according to Article 129(7)(b) CRR, covered bonds would qualify for beneficial treatment only when the issuer makes the above information available to the credit institution investing in covered bonds on a semi-annual basis.

ASSIGNMENT OF RISK WEIGHTINGS

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

Compared to the Capital Requirements Directive (CRD) III, the major change in the articles of the CRR 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 4 shows that a risk weighting of 10% will apply where the covered bonds are rated at least AA-/Aa3 and a risk weighting of 20% will apply where the covered bonds are rated between BBB-/Baa3 and A+/A1. This compares with risk weightings of 20% and 50%, respectively, for similarly rated senior bonds issued by banks.

Figure 1: Covered bond risk weightings under the standard approach (covered bond rating assigned)

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

Note: Mapping based on PRA rules

Source: European Commission, PRA, Barclays Research

In case no rating has been assigned to the respective covered bonds, the risk weighting is linked again to the risk weighting of senior unsecured exposures of the issuer according to the table below.

Figure 2: Covered bond risk weightings under the standard approach (covered bond rating not assigned)

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

Note: Mapping based on PRA rules

Source: European Commission, PRA, Barclays Research

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 of 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 CRR 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 160).

> 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 162).

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 2.5yr 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 (1981-2013)	Moody's (1983-2013)	Fitch (1990-2013)
AAA/Aaa	0.00	0.00	0.00
AA/Aa	0.02	0.03	0.03
A/A	0.07	0.07	0.08
BBB/Baa	0.21	0.19	0.19
BB/Ba	0.80	1.14	1.09

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 Research.

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

In the CRR, the regulations for the use of securities as liquidity buffer investments are stipulated in Part six (Liquidity) in Articles 415, 416, 417, 418 and in Part ten (Transitional provisions, reports and reviews) in Article 509. 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".

Article 416(2) CRR allows for the inclusion of covered bonds. Interestingly, those covered bonds that are only compliant with Article 52(4) UCITS, but not with the enhanced collateral criteria of Article 129 CRR, may also qualify for the liquidity buffer.

As explained above, in its report from 20 December 2013, the EBA recommended to treat covered bonds as Level 2 assets. According to the CRR, they would thus be subject to a 15% haircut and also to the general limit on Level 2 assets of 40% of the total liquidity buffer. This limit has been proposed through Article 509(2)(c) CRR and it has been confirmed by the EBA impact assessment on Article 509(1) CRR published on 20 December 2013. However, the EBA acknowledged that derogating from such a limit should be envisaged, in case "the supply of HQLA falls short of the justified demand".

The EBA recommendation from December 2013 not only contrasts with its own empirical findings, but also with recital (100) of the CRR. In this recital, lawmakers highlight that "when making a uniform definition of liquid assets at least government bonds, and covered bonds traded on transparent markets with an ongoing turnover would be expected to be considered assets of extremely high liquidity and credit quality."

Final decisions will be made only 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. In particular, it should also work on the "definition of circumstances of stress, including principles for the use of the stock of liquid assets and the necessary supervisory reactions under which institutions would be able to use their liquid assets to meet liquidity outflows and how to address non-compliance". By 31 December 2015 the EBA 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.

2.2.2 INSURANCE REGULATION – SOLVENCY II

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

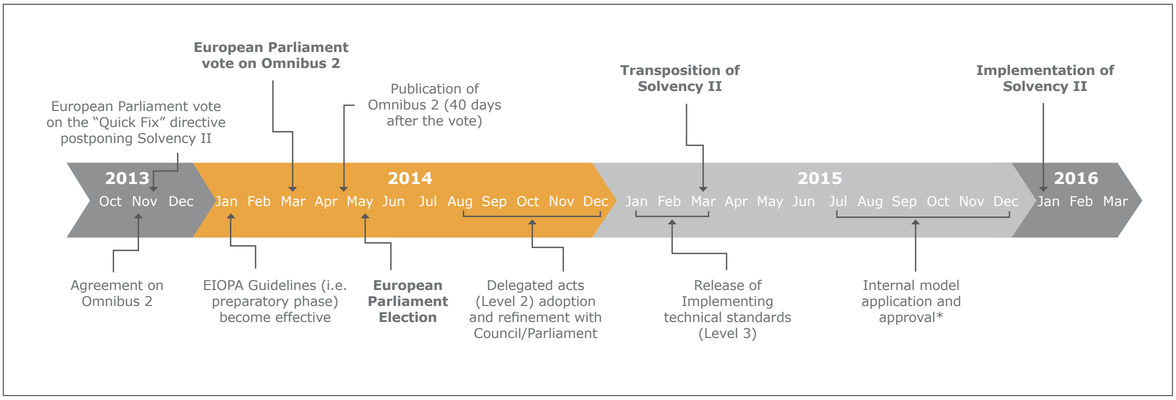
The Solvency II Directive (2009/138/EC) is what the Capital Requirements Directive (CRD) IV is for the banking world – a regulatory regime that introduces risk based capital charges. It is also an attempt to harmonise the EU insurance landscape.

While the Solvency II Directive was adopted by the European Parliament and the Council of the European Union in November 2009, the actual implementation, however, has by now been delayed quite a few times. In the past, the implementation date was a moving target that was regularly pushed down the road whenever the previous target became unrealistic.

In the meantime, amendments to the original Solvency II Directive had become necessary to be in line with EU's implementing measures according to the Lisbon Treaty of 2009 and EU's new supervisory structure by introducing the European Insurance and Occupational Pensions Authority (EIOPA). These amendments are implemented through the so-called Omnibus II Directive.

The agreement on Omnibus II was passed by the European Parliament on 11 March 2014 after a text had been agreed between the European Commission, Parliament and Council on 13 November 2013. Solvency II will now come into effect on 1 January 2016.

FIGURE 1: TIMELINE OF IMPLEMENTATION



* The most « advanced » companies could have their model approved well before 2015

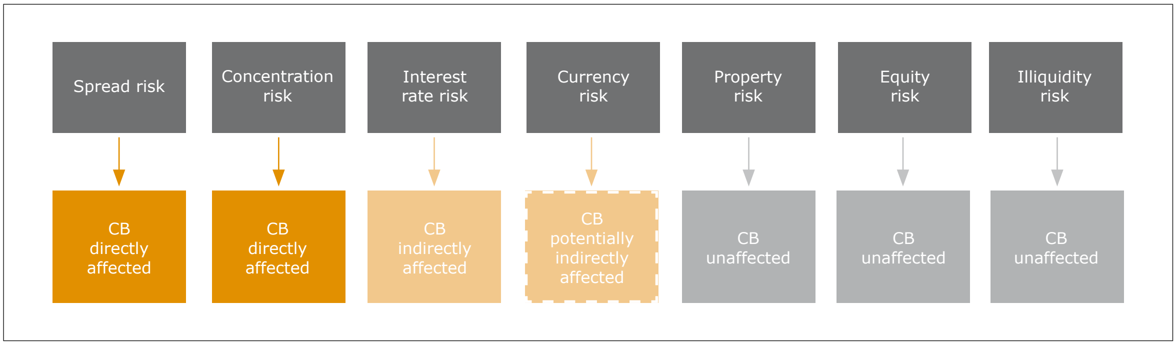
Source: European Commission, Crédit Agricole CIB

OVERVIEW OF SOLVENCY II – WHERE ARE COVERED BONDS IMPACTED?

Solvency II is a highly complex framework which addresses a vast number of different sources of risks that all interact with each other to come up with a final solvency capital requirement (SCR). Risks range from market risk to underwriting risk, longevity risk or default risk on loan exposures.

Covered bonds are mainly affected by the market risk section and specifically mentioned in the spread risk and concentration risk modules.

> Figure 2: Market risk modules in Solvency II and their relevance for covered bonds



Source: EIOPA, Crédit Agricole CIB

SPREAD RISK MODULE

The spread risk module is the biggest single investment specific driver of capital charges under Solvency II. Interest rate risk is an even bigger driver of capital charges overall but other than spread risk is driven by the overall asset and liability structure of an insurance company and not by the individual asset purchased.

EIOPA describes spread risks as the "results from the sensitivity of the value of assets, liabilities and financial instruments to changes in the level or in the volatility of credit spreads over the risk-free interest rate term structure." In other words, we are talking about the spread vulnerability in volatile scenarios. Spread risk applies to virtually all fixed income instruments apart from sovereign debt rated AA- and better.

Since insurance companies are longer term investors than banks, capital charges for investments are also significantly higher than they are for banks. In addition to this, they are not only driven by credit risk, as is the case for the standardised approach in banking regulation, but are also determined by a combination of rating and duration. The weaker the rating and the longer the investment, the higher the capital charge. The spread risk module capital charges are expressed as a charge per year of duration. Initially, Solvency II had planned for a strictly linear relationship between duration and capital. This, however, was changed with the increase per extra year of duration beyond 5Y having been reduced and a further flattening of the increase after 10Y. After all, the long end is exactly where insurance companies are active and regulators did not want to dis-incentivise them through onerous capital charges.

Covered bonds do receive preferential treatment under the spread risk module if they comply with the following criteria:

> They have a credit quality step 0 or 1 which means a minimum rating of AA-;

> They meet the requirements defined in Article 52(4) of the UCITS Directive 2009/65/EC,

For covered bonds that fulfil the UCITS Directive and are rated AAA, a spread risk factor of 0.7% applies per year of duration up to 5Y while AA- to AA+ rated ones have a factor of 0.9%. Covered bonds that do not meet these requirements are treated as senior unsecured exposure. Capital charges are 0.2% higher per duration year.

When looking at the numbers it is also important to mention that the percentages do not relate to 8% of the invested notional as is the case in the banking world but to the actual invested notional. A 10% risk-weight on covered bonds essentially means a 0.8% capital charge for a bank. Talking about 0.7% capital charge in Solvency II for an equally rated 1Y covered bond also means 0.7% capital relative to the invested notional. The longer the duration of the bond is, the higher the Solvency charge becomes in both absolute terms as well as relative to bank capital charges. While the AAA covered bond with a 1Y maturity is treated slightly better under Solvency II, (0.7% vs. 0.8%), the relationship reverses from year 2 onwards. For an AAA rated 10Y covered bond, insurance companies have to hold 6% of the invested notional in capital, which is 7.5 times as much as banks.

> FIGURE 3: FORMULAS FOR THE SOLVENCY II CAPITAL CHARGE CALCULATIONS FOR COVERED BONDS AND OTHER ASSET CLASSES

Credit quality	Up to 5 years	5 to 10 years	10 to 15 years	15 to 20 years	20 years +
AAA covered	0.7% * D	3.5% + 0.5% * (D -5)	6% + 0.5% * (D -10)	8.5% + 0.5% * (D -15)	11% + 0.5% * (D -20)
AA + to AA- covered	0.9% * D	4.5% + 0.5% * (D -5)	7% + 0.5% * (D -10)	9.5% + 0.5% * (D -15)	12% + 0.5% * (D -20)
A+ to A- covered	1.4% * D	7% + 0.7% * (D -5)	10.5% + 0.5% * (D -10)	13% + 0.5% * (D -15)	15.5% + 0.5% * (D -20)
BBB+ to BBB- covered	2.5% * D	12.5% + 1.5% * (D -5)	20% + 1% * (D -10)	25% + 1% * (D -15)	30% + 0.5% * (D -20)
BB+ to BB- covered	4.5% * D	22.5% + 2.5% * (D -5)	35% + 1.8% * (D -10)	44% + 0.5% * (D -15)	46.6% + 0.5% * (D -20)
AAA to AA- sovereign	0,0%	0,0%	0,0%	0,0%	0,0%
A+ to A- sovereign	1.1% * D	5.5% + 0.6% * (D -5)	8.4% + 0.5% * (D -10)	10.9% + 0.5% * (D -15)	13.4% + 0.5% * (D -20)
BBB+ to BBB- sovereign	1.4% * D	7% + 0.7% * (D -5)	10.5% + 0.5% * (D -10)	13% + 0.5% * (D -15)	15.5% + 0.5% * (D -20)
AAA corporate	0.9% * D	4.5% + 0.5% * (D -5)	7.2% + 0.5% * (D -10)	9.7% + 0.5% * (D -15)	12.2% + 0.5% * (D -20)
AA+ to AA- corporate	1.1% * D	5.5% + 0.6% * (D -5)	8.4% + 0.5% * (D -10)	10.9% + 0.5% * (D -15)	13.4% + 0.5% * (D -20)
A+ to A- corporate	1.4% * D	7% + 0.7% * (D -5)	10.5% + 0.5% * (D -10)	13% + 0.5% * (D -15)	15.5% + 0.5% * (D -20)
BBB+ to BBB- corporate	2.5% * D	12.5% + 1.5% * (D -5)	20% + 1% * (D -10)	25% + 1% * (D -15)	30% + 0.5% * (D -20)
BB+ to BB- corporate	4.5% * D	22.5% + 2.5% * (D -5)	35% + 1.8% * (D -10)	44% + 0.5% * (D -15)	46.6% + 0.5% * (D -20)
AAA ABS (type1)	2.1% * D				
AA + to AA- ABS (type1)	4.2% * D				
A+ to A- ABS (type1)	7.4% * D				
BBB+ to BBB- ABS (type1)	8.5% * D				

Source: EIOPA, Crédit Agricole CIB

> FIGURE 4: SOLVENCY II CAPITAL CHARGES FOR COVERED BONDS AND OTHER ASSET CLASSES

Credit quality step	1	3	5	7	10	15	20
AAA covered	0.7%	2.1%	3.5%	4.5%	6.0%	8.5%	11.0%
AA + to AA- covered	0.9%	2.7%	4.5%	5.5%	7.0%	9.5%	12.0%
A+ to A- covered	1.4%	4.2%	7.0%	8.4%	10.5%	13.0%	15.5%
BBB+ to BBB- covered	2.5%	7.5%	12.5%	15.5%	20.0%	25.0%	30.0%
BB+ to BB- covered	4.5%	13.5%	22.5%	27.5%	35.1%	44.0%	46.5%
AAA to AA- sovereign	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
A+ to A- sovereign	1.1%	3.3%	5.5%	6.7%	8.5%	10.9%	13.4%
BBB+ to BBB- sovereign	1.4%	4.2%	7.0%	8.4%	10.5%	13.0%	15.5%
BB+ to BB- sovereign	2.5%	5.0%	10.0%	15.5%	20.0%	25.0%	30.0%
AAA corporate	0.9%	2.7%	4.5%	5.5%	7.2%	9.7%	12.2%
AA+ to AA- corporate	1.1%	3.3%	5.5%	6.7%	8.5%	10.9%	13.4%
A+ to A- corporate	1.4%	4.2%	7.0%	8.4%	10.5%	13.0%	15.5%
BBB+ to BBB- corporate	2.5%	7.5%	12.5%	15.5%	20.0%	25.0%	30.0%
BB+ to BB- corporate	4.5%	13.5%	22.5%	27.5%	35.0%	44.0%	46.5%
AAA ABS (type1)	2.1%	6.3%	10.5%	14.7%	21.0%	31.5%	42.0%
AA + to AA- ABS (type1)	4.2%	12.6%	21.0%	29.4%	42.0%	63.0%	84.0%
A+ to A- ABS (type1)	7.4%	22.2%	37.0%	51.8%	74.0%	100%	100%
BBB+ to BBB- ABS (type1)	8.5%	25.5%	42.5%	59.5%	85.0%	100%	100%
AAA ABS (type2)	12.5%	37.5%	62.5%	87.5%	100%	100%	100%
AA + to AA- ABS (type2)	13.4%	40.2%	67.0%	93.8%	100%	100%	100%
A+ to A- ABS (type2)	16.6%	49.8%	83.0%	100%	100%	100%	100%
BBB+ to BBB- ABS (type2)	19.7%	59.1%	98.5%	100%	100%	100%	100%
BB+ to BB- ABS (type2)	82.0%	100%	100%	100%	100%	100%	100%

Source: EIOPA, Crédit Agricole CIB

The capital charge differences between AAA and AA rated covered bonds are noticeable but not huge (1% difference for 10Y). The moment covered bonds drop into single A space and thus lose their preferential treatment, differences start to become very pronounced though (4.5% difference for 10Y) and with BBB (14.0% difference for 10Y) and BB covered bonds (29.1% difference for 10Y) they become massive.

When looking across asset classes, it becomes apparent that Solvency II favours sovereign debt over corporate and covered bonds. Nonetheless, differences between corporates and equally rated covered bonds are not massive (1.2% difference for 10Y AAA).

Even though there have been improvements lately, securitisation deals are still at a massive disadvantage. Even the highest quality securitisation have around three times the capital requirement of AAA covered bonds in 5Y (10.5% vs. 3.5%) and three and a half times in 10Y (21% vs. 6%). For lower rated ABS, the differences to equally rated covered bonds grow disproportionately (for example in 5Y: 21% vs. 4.5%).

Trying to translate the different capital requirements into spread numbers that one product has to yield in excess of another is not a straightforward exercise. After all, spread risk is merely one factor and there are many others driving the final SCR. It also depends on the return on equity an insurance investor needs to generate. Nonetheless, we have tried to estimate the additional yield required to cover the extra capital from this risk module.

> We have calculated the average capital charge for a buy and hold investor over the whole life of the investment;

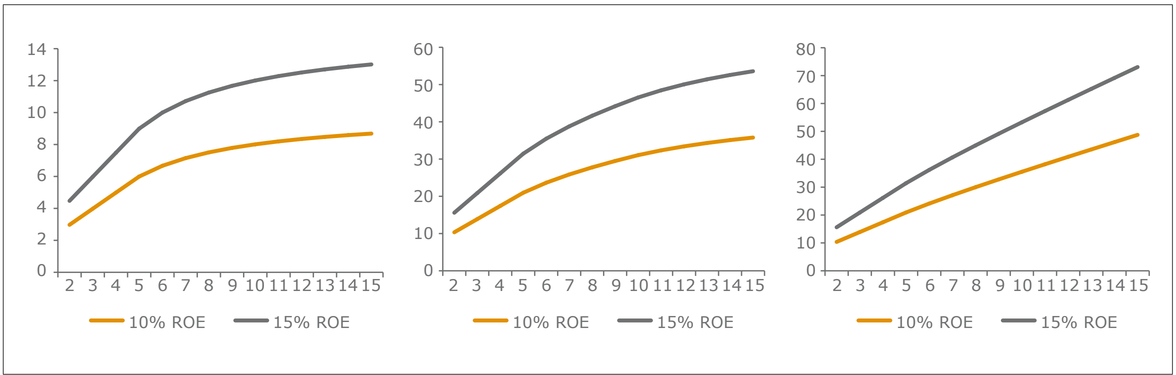
> We have then used two different ROEs, 10% and 15%, to calculate the extra return needed to fulfil this return requirement.

> FIGURES 5: SPREAD IN BP NEEDED TO COMPENSATE FOR ADDITIONAL CAPITAL BETWEEN...

...AA RATED COVERED AND AAA RATED COVERED BOND BY MATURITY

...A RATED COVERED / CORPORATE AND AAA RATED COVERED BOND BY MATURITY

...AAA RATED COVERED AND AAA RATED SOVEREIGN BOND BY MATURITY



Source: EIOPA, Crédit Agricole CIB

The charts above show the required spread pickup for a range of product pairs.

CONCENTRATION RISK MODULE

The concentration risk is defined by the EIOPA as "the risk regarding the accumulation of exposures with the same counterparty" which means that large exposures on a single issuer should be limited. Other concentration types dealing with geographical area, industry sector or the like are not considered though.

Similar to the spread risk module, covered bonds receive a preferential treatment here in the sense that the concentration threshold is much higher at 15% than it would be for equally rated corporate debt for which exposure to a single counterparty is limited to 3%.

While the 15% level should not be a major issue for most covered bond markets, it may become an issue for Danish issuers as this market is dominated by insurance companies and pension funds on the investor side and only a handful of issuers. The 15% limit might thus be a problem for some of the Danish investors and in turn, for the Danish issuers.

> Figure 6: Concentration risk thresholds by bond type and rating

Type of bond	Rating	Concentration threshold
Corporate bonds, sub + hybrid debt, ABS, CDO	AAA - AA	3,0%
	A	3,0%
	BBB	1,5%
	BB or lower	1,5%
Covered Bonds	AAA - AA	15,0%
Exposure to EEA state, multilateral development banks, international organisations, ECB		none

Source: EIOPA, Crédit Agricole CIB

BOTTOM LINE

Solvency II is still one of the most pro-sovereign debt regulatory regimes out there. It is also a regime that still focusses a lot on external ratings.

Highly rated covered bonds do fare relatively well though as they get preferential treatment in both the spread risk and concentration risk modules. Non-UCITS compliant covered bonds are treated as senior unsecured exposure but as long as they are highly rated, differences to UCITS compliant covered bonds are not major. Capital charges do jump up though the moment ratings drop to below AA- and become very onerous from BBB and below.

The asset class treated by far the harshest is still securitisations. Lower rated type 1 securitisations as well as all type 2 securitisations are virtually un-investable for anyone that has to look at capital as the required spread to cover capital cost is substantial.

2.2.3 MIFID

By Richard Kemmish, Consultant

When MEPs and Commissioners know that they face an election, they get very good at finishing major pieces of legislation. In April this year, agreement was finally reached on the Market Abuse Directive, the Banking Union, and the subject of this update – MiFID, all in the space of two days. Perhaps we should have elections more often?

The bad news, however, is that political agreement is far from the whole story and, for MiFID there now follows two years of hard work by the European Securities and Markets Authority (ESMA) to develop the all important technical standards ahead of the Directive's implementation into national law from mid-2016 and then its intended start date in 2017.

But what is MiFID and why is it so important for the covered bond market?

MIFID

The Markets in Financial Instruments Directive has been with us for 10 years already, it was initially published in 2004 and came into force in 2007. But when we talk about MiFID now we more accurately are referring to both MiFID II and the Markets in Financial Instruments Regulation (MiFIR). These vastly expand the scope of the initial Directive and, in the words of Commissioner Barnier, will "establish a safer, more transparent and responsible financial system and restore investor confidence in the wake of the financial crisis". So that is all good.

In more concrete terms, the intention of MiFID is to harmonise the rules that govern the behaviour of banks to protect investors and make sure that markets are transparent. There are plenty of aspects that need not concern us here, such as accountability and corporate governance but it is the proposals for greater market transparency and, to a lesser extent trading venues, that the covered bond community has mostly focused its concerns on.

The road to hell is paved with good intentions and with even the most well-meaning directive, we have to be very careful to avoid some potentially damaging unintended consequences.

POST-TRADE PRICE TRANSPARENCY

It has long been argued by covered bond traders that the disclosure of trading prices immediately after a trade is fine in highly liquid markets, such as equities, or for small, non-price moving tickets in our own market. But when a covered bond trader wants to take on a significant position in a bond on behalf of a customer, full post trade transparency is going to stop him from doing so. Quite simply if it is a market moving ticket, before the entire market is aware of it, the trader needs to be sure that he or she can work that ticket through the salesforce or at least find some way to hedge the position. If the trader does not have that confidence, they will be forced to quote a larger bid/ask spread to protect themselves to the detriment of clients.

Accepting, however, that some form of post-trade disclosure is inevitable, the most frequent request is for some sort of reporting delay for large tickets in small bonds, either a delay of the whole trade's reporting or at very least of its size. It has been pointed out by some covered bond traders that the US equivalent – the TRACE system – does allow indefinite omission of trade volumes in some circumstances.

Although the covered bond community has been one of the most concerned groups about this (thanks perhaps to our high expectations of liquidity born in the pre-crisis market making agreements), we certainly are not the only market to be affected.

The Commission has listened and there is now scope in the final directive for the competent authorities to exempt certain trades from disclosure or to allow a lower standard of disclosure. The devil, as ever, is in the detail. What is a significant market moving trade for one bond, is not necessarily market moving for another. Or for the same bond at different stages in its life. Or for all bonds at different periods of market stress. A fixed definition of an exempt trade might be sufficient in a normal market but inadequate in a stress scenario – further reducing the ability of a market maker to provide liquidity just when the investors need it most.

Assuming that it is the intention of ESMA to define exemption sized tickets on an ISIN by ISIN basis, what is the process for setting the thresholds? Or for amending them? How do I find out if a bond has a reporting exemption before I bid on it? An entire infrastructure has to be developed around these questions before the regime is implemented in 2017.

PRE-TRADE PRICE TRANSPARENCY

The Commission has argued that market makers, when showing a price to one customer should show it to all customers. And that any qualifying customer should be allowed to transact at that level. This raises many problems.

Firstly, there is the obvious practical detail. In order to be able to transact, all customers have to be aware of the price shown. Given the amount of trading conducted by phone, this is clearly impractical.

Also, practically whatever the disclosure method is, it will prevent flexibility. The initial quote shown to a client frequently has to be changed, either improved to win the trade or adjusted to reflect, for example a move in bund futures. Will market makers still be able to do this as efficiently, if the old price has just been shown to all customers?

More importantly, there are legitimate commercial reasons to show different prices to different market makers – to distinguish the real enquiry from the speculative, for example. The idea that all customers should be treated equally is totally appropriate in the retail market, less so in the wholesale.

Nevertheless, the restrictive proposals of the European Commission have been improved during the legislative procedure. The final text is more flexible and suitable for the practical requirements. The general obligation for investment firms to offer access to quotes which have been made available through their systems will be specified by Level II measures with the perspective to enforce the implementation of thresholds in favour of market makers.

TRADING LOCATION

MiFID also sets down rules about where covered bonds can be traded. In addition to the familiar venues: Regulated Markets (such as the Frankfurt Stock Exchange) and Multi-lateral Trade Facilities (for example, MTS) there are some less well-known categories defined in MiFID such as Systematic Internalisers (for example, Danske Bank), large market makers who match buyers and sellers in house subject to strict rules to ensure best execution and, the most recently introduced category - Organised Trading Facilities.

The covered bond market is more sanguine about this aspect of MiFID than they were a couple of years ago thanks to this new OTF definition. Previously, there was a concern that smaller market makers who did not qualify for SI status would be forced to use one of the other trading venues, which would not necessarily be in the best interests of competition between market makers.

Whereas the rules around OTFs are still uncharted territory, it is clear that they will address many of the concerns of, in particular, the smaller market makers.

LOOKING FORWARD

Now that there is political agreement on MiFID, it is up to ESMA to draft the technical standards that will make it workable. The ESMA published a Consultation Paper on MiFID II/MiFIR on 22 May 2014 which will be followed by a set of draft technical standards possibly as soon as late 2014. Two final sets of guidelines aimed at enhancing the protection of investors in the EU were also published on 6 July 2014. These guidelines relate to the provisions under MiFID relating to the suitability of investment advice and the compliance function. The Market Related Issues Working Group of the ECBC will be working with ESMA to ensure that the laudable objectives of the Directive do not have any unpleasant side effects.

2.3 THE REPO TREATMENT OF COVERED BONDS BY CENTRAL BANKS

By Jan King, RBS, and Frank Will, HSBC

I. CENTRAL BANK REPOS: THE SAFETY NET FOR THE BANKING SYSTEM

Since the onset of the financial markets crisis, central banks worldwide have stepped in, putting in place a number of measures to backstop the banking system. Wide-scale unsterilized asset purchases (Quantitative Easing, QE) have been extensively used by the Federal Reserve and the Bank of England. The European Central Bank (ECB) responded with its EUR 60 bn Covered Bond Purchase Programme (CBPP) initiated in mid-2009 and a second one with a total size of up to EUR 40 bn in late-2011. A crucial pillar of the responses of almost all central banks has been their monetary policy operations, either by increasing the number or nature of their short and long term repo operations such as the two 3-year Long-Term Refinancing Operations (LTROs) from the ECB in December 2011 and in February 2012, or by widening the pool of repo eligible collateral. The targeted LTROs announced by the ECB back in June 2014, however, aim at enhancing the functioning of the monetary policy transmission mechanism by supporting bank lending to the real economy rather than being a direct response to the financial market crisis.

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.

> Figure 1: 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 Covered bonds?
ECB	Repo Operations (Main and Long term refinancing operations)	Yes	Covered bonds compliant with UCITS Article 52(4) or similar safeguards	EUR, USD, GBP, JPY[1]	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
	Discount Window	Yes	US 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
	Level B Collateral (ILTR, DWF, CTRF and FLS)	Yes	UK, French, German & Spanish regulated covered bonds		Broadly equivalent to 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
	Level C Collateral (ILTR, DWF, CTRF and FLS)	Yes	UK, US & EEA (based on the location of the underlying assets)		Broadly equivalent to A-/A3		None	Yes

1 Foreign currency-denominated debt instruments constitute eligible collateral for Eurosystem credit operations from 9 November 2012 onwards, subject to the fulfillment of the relevant eligibility criteria. In addition to the haircuts applicable to similar EUR-denominated securities, a further mark-down will be applied (16% for USD and GBP, 26% for JPY).

Central Bank	Operation	Covered Bonds eligible?	Eligible Covered Bonds	Currency	Minimum Rating	Rating Treatment	Minimum Size	Own-name Covered bonds?
SNB	Repo operations, Standing Facilities	Yes From 2015 on, Covered Bonds must be eligible under the Swiss LCR framework	Any covered bond fulfill-ing the eligible security and rat-ing criteria, but not issued by a Swiss bank	CHF	Security: A/A2 with various excep-tions Issuer's country: A/A2 From 2015: AA-/Aa3	Best Rating	CHF 100 m equivalent (issuance amount)	No
			Any covered bond fulfill-ing the eligible security and rat-ing criteria, but not issued by a Swiss bank	EUR, USD, GBP, DKK, SEK, NOK	Security: AA-/Aa3 with various excep-tions Issuer's country: AA-/Aa3		CHF 1 bn equivalent (issuance amount)	
Norges Bank	Repo Operations	Yes	Any covered fulfilling the eligible security criteria	NOK, SEK, DKK, EUR, USD, GBP, JPY, AUD, NZD, CHF	Domestic currency: None but BBB- for favourable liquidity category (II not III) Foreign Bonds: A/A2	Best Rating	None	Yes
Reserve Bank of Australia (RBA)	Repo Operations	Yes	Any covered bond fulfilling the eligible security criteria	AUD	AAA or BBB+ for domestic covered bonds >1Y	Lowest Rating	None	No
Reserve Bank of New Zealand (RBNZ)	Repo and/or Swap of NZ Government Bonds	No	None	n/a	n/a	n/a	n/a	n/a
	Overnight Repo Operations, Bond Lending Facilities	Yes	Any covered bond fulfilling the eligible crite-ria on the cover pool composition	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
Bank of Canada	Standing Liquidity Facility	Yes	Canadian covered bonds	CAD	At least two ratings, second highest must be at least A (low) by DBRS, A3 by Moody's, or A- by S&P or Fitch.		n/a	No

Source: RBS, Central Banks.

II. 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 European debt crisis through its repo operations. Within the ECB's liquidity operations covered bonds play an increasingly important role. While during certain periods during the sovereign and banking crisis the benchmark covered bond market was shut for many issuers out of Europe's periphery the ECB continued to provide liquidity to those banks. Measures of this type include the two 3-year long-term refinancing operations the ECB conducted in December 2011 and in February 2012. Banks took more than EUR 1 trn in gross liquidity – backed by eligible collateral. Many covered bond programmes have been set up not just as an additional funding channel, but also in order to allow the banks to use the repo facilities at the ECB as means to access liquidity in a closed wholesale market.

After reviving the covered bond market back in 2009 with its EUR 60 bn purchase programme, the ECB has seen covered bonds being one of the fastest growing assets in terms of collateral posted, almost tripling amounts posted since 2007 (+132%, second in terms of growth only to other and non-marketable assets) and largely exceeding the overall increase in total collateral posted for repo operations (84%). See the section below for a more detailed discourse on covered bond usage in ECB operations and the ECB classification of a "covered bank bond".

ECB repo operations

Article 18.1 of the Statute of the European System of Central Banks and of the European Central Bank states that the ECB and the national central banks may conduct credit operations with credit institutions and other market participants, as long as lending is "based on adequate collateral"[2]. According to the ECB, adequacy means firstly, that collateral must protect against losses in credit operations, and secondly, that there must be sufficient collateral potentially available to ensure that the Eurosystem can carry out its tasks.

Consequently, underlying assets have to fulfil certain criteria in order to be eligible for Eurosystem monetary policy operations. The Eurosystem has developed a single framework for eligible assets common to all Eurosystem credit operations (the "single list"). There is no collateral differentiation between monetary policy instruments or intraday credit, and a single auction rate is applicable to different types of collateral in tender operations. The scope of eligible collateral is broad and includes secured assets like covered bonds and ABS, the latter of which can be backed by receivables such as residential and commercial loans (secured and unsecured), auto loans, lease receivables etc., provided they satisfy certain eligibility criteria (set out below), as well as unsecured claims against governments, credit institutions or corporates. In February 2012 the ECB approved, for seven national central banks (Ireland, Spain, Portugal, Italy, Cyprus, France and Austria) specific national eligibility criteria to accept additional performing credit claims as collateral.

The Eurosystem additionally applies risk control measures in the valuation of underlying assets. The value of the underlying asset is calculated as the market value of the asset less a certain percentage ("valuation haircut"). The haircut-adjusted market value of the underlying assets used in its liquidity-providing reverse transactions must be maintained over time. This implies that if the value, measured on a regular basis, of the underlying assets falls below a certain level, the national central bank will require the counterparty to supply additional assets or cash (i.e. it will make a margin call). Similarly, if the value of the underlying assets, following their revaluation, exceeds a certain level, the counterparty may retrieve the excess assets or cash. The current eligibility of assets in the ECB framework and recent changes to this are set out below:

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

> Figure 2: Eligibility of assets in the ECB framework

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, multi-step coupon or floating-rate coupon linked to an interest rate reference or yield of one euro area government bond with a maturity of one year or less or inflation-indexed > Debt instruments, including covered bonds, but not including ABS, must have a fixed, unconditional principal amount
Definition of Covered Bonds	> The ECB does not provide an official definition of what they classify as covered bonds in the context of eligible collateral > In general, 'Covered Bank Bonds' for ECB collateral purposes means bonds issued in accordance with Article 52 (4) of the UCITS Directive, (i.e. subject to covered bond specific legislation) or similar safeguards > Covered bonds with external, non-intra group MBS as well as both internal and external public sector ABS in the cover pool are no longer eligible as collateral for repo transactions since March 2013. However, the ECB granted a grandfathering period of two years until 28 November 2014 for already issued covered bonds
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 minimum ratings for ABS are A- (S&P) / A3 (Moody's) / A- (Fitch) / AL (DBRS) on a second-best basis. Certain ABS fulfilling additional requirements could qualify if they have at least two triple-B ratings. In September 2012 the ECB suspended the minimum credit rating threshold in the case of instruments issued or guaranteed by the central government of countries that are eligible for OMT or are under an EU-IMF programme and comply with the attached conditionality
Place of Issue	> European Economic Area (EEA)
Settlement Procedures	> Transferable in book-entry form > Held and settled in the euro area
Acceptable Market	> Debt instrument must be admitted to trading on a regulated market or a non-regulated market as specified by the ECB
Type of Issuer/ Guarantor	> Central banks, public sector or private sector entities or international institutions
Place of Establishment of the Issuer/ Guarantor	> Issuer must be established in the EEA or in non-EEA G10 countries and guarantors must be established in the EEA
Currency of Denomination	> EUR, USD, GBP, JPY[3]

Source: HSBC, ECB

In January 2011, the ECB implemented its current haircut scheme, graduating haircuts according to differences in maturities, liquidity categories and the credit quality of the assets concerned (see Figure 3 & 4). 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.

3 Foreign currency-denominated debt instruments constitute eligible collateral for Eurosystem credit operations since 9 November 2012. This measure reintroduces a similar decision applicable between October 2008 and December 2010. In addition to the haircuts applicable to similar EUR-denominated securities, a further mark-down will be applied (16% for USD and GBP, 26% for JPY).

In June 2012, the ECB further increased the collateral availability of ABS, when it lowered the minimum rating threshold to "BBB-" (second-best) from "A-". Based on the amended haircut schedule, ABS with ratings below "A-" fulfilling additional requirements will be subject to higher haircuts of 22%.

In September 2012, the ECB decided that marketable debt instruments denominated in currencies other than EUR, namely USD, GBP and JPY, and issued and held in the euro area, are eligible as collateral until further notice. This measure reintroduces a similar decision applicable between October 2008 and December 2010, with appropriate valuation markdowns. Covered bonds with external, non-intra group MBS as well as both internal and external public sector ABS in the cover pool are no longer eligible as collateral for repo transactions (since 31 March 2013). However, the ECB granted a grandfathering period of two years until 28 November 2014 for already issued covered bonds. This means that new issues with external RMBS or other ABS in the cover pool will no longer be repo eligible as of the end of March 2013 although tap issues of grandfathered covered bonds will remain eligible during the 2-year period, as long as no additional external RMBS or ABS are added to the cover pool. Covered bonds with external RMBS in their pool would still be repo-eligible but not be treated as 'covered bank bonds' and thus would face higher repo haircuts. As of 1 March 2015, own-name covered bonds where the asset pool contains own-name uncovered government-guaranteed bank bonds will no longer be accepted by the Eurosystem.

In September 2013, the ECB amended again its haircut schedules. One of the biggest changes was the reduction of the haircut for ABS from 16% to 10%. Several haircuts for other assets classes were also lowered, though by significant smaller margins. In case of triple-B rated assets, the haircuts for assets in liquidity category I and II were increased whilst the haircuts of liquidity category III and IV were slightly reduced.

> FIGURE 3: ECB HAIRCUTS BY LIQUIDITY CATEGORY AND RESIDUAL MATURITY[4]

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*, Corporate Bonds*		**Liquidity Category IV** Unsecured Bank Bonds*		**Liquidity Category V** ABS*
Residual maturity (years)	**Fixed coupon**	**Zero coupon**	**Fixed coupon**	**Zero coupon**	**Fixed coupon**	**Zero coupon**	**Fixed coupon**	**Zero coupon**	**Fixed or zero coupon**
0-1	0.5	0.5	1.0	1.0	1.0	1.0	6.5	6.5	10.0
1-3	1.0	2.0	1.5	2.5	2.0	3.0	8.5	9.0	
3-5	1.5	2.5	2.5	3.5	3.0	4.5	11.0	11.5	
5-7	2.0	3.0	3.5	4.5	4.5	6.0	12.5	13.5	
7-10	3.0	4.0	4.5	6.5	6.0	8.0	14.0	15.5	
>10	5.0	7.0	8.0	10.5	9.0	13.0	17.0	22.5	

Source: ECB (*Assets that are given a theoretical value will be subject to an additional 5% haircut; additional valuation markdowns for own-use covered bonds (8 % for CQS1&2 and 12 % for CQS3)

4 Haircuts of variable rate debt instruments included in liquidity categories I to IV, excluding "inverse floaters", will be those applicable to the 0-1 year maturity bucket of fixed coupon instruments in the corresponding liquidity and credit category.

> Figure 4: 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*, Corporate 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	6.0	6.0	7.0	7.0	8.0	8.0	13.0	13.0	Not eligible[5]
1-3	7.0	8.0	10.0	14.5	15.0	16.5	24.5	26.5	
3-5	9.0	10.0	15.5	20.5	22.5	25.0	32.5	36.5	
5-7	10.0	11.5	16.0	22.0	26.0	30.0	36.0	40.0	
7-10	11.5	13.0	18.5	27.5	27.0	32.5	37.0	42.5	
>10	13.0	16.0	22.5	33.0	27.5	35.0	37.5	44.0	

Source: ECB (*Assets that are given a theoretical value will be subject to an additional 5% haircut; additional valuation markdowns for own-use covered bonds (8 % for CQS1&2 and 12 % for CQS3))

Classification of covered bonds within the Eurosystem operations

The ECB considers covered bonds to be a relatively liquid asset class. Hence, covered bonds benefit from preferential liquidity class classification and favourable haircut valuations for repo transactions with the ECB when compared with, for example, ABS. Moreover, unlike senior bank debt (and government-guaranteed senior bank debt from 2015), the ECB will accept self-issued "covered bank bonds" as collateral (see below for more information 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. Over the last few years the market has moved away from the "Jumbo" definition and we would not be surprised if the ECB were to also update its internal criteria at one stage.

"Structured" covered bonds are issued under a general legal framework, rather than being subject to "special public supervision", they do not fall within the UCITS definition and as such have not been recognised as covered bank debt by the ECB from a liquidity haircut perspective and in the past were assigned to category IV similar to senior unsecured bank debt. However since 1 January 2011 all non-Jumbo covered bonds, including "structured covered bonds" and multi-issuer covered bonds, together with traditional (UCITS-compliant) covered bonds, have been classified in liquidity category III. As of July 2014, also all Spanish covered bonds – including single name bonds – are classified as Category III securities. Interestingly, the ECB has classified Commerzbank's inaugural EUR 500 m SME covered bond issued in February 2012 as "structured covered bond" and has put it into Liquidity Category III next to other non-Jumbo covered bond.

5 https://www.ecb.europa.eu/ecb/legal/pdf/l_30120131112en00060012.pdf

For "structured covered bank bonds" there are additional requirements, including the following: (1) substitution asset limit of 10%, which can be exceeded at the discretion of the National Central Bank, (2) maximum LTV limit of 80% for residential and 60% for commercial mortgages, (3) minimum mandatory OC of 8% for residential and 10% for commercial mortgages, (4) maximum loan amount for residential real estate loans of EUR 1mln, (5) covered bond must have a long-term minimum rating of A-/A3. Covered bonds with external, non-intra group MBS as well as both internal and external public sector ABS in the cover pool are no longer eligible as collateral for repo transactions (since 31 March 2013). As of 1 March 2015, own-name covered bonds where the asset pool contains own-name uncovered government-guaranteed bank bonds will be no longer accepted by the Eurosystem.

Covered bonds and "close link" exemption

"Covered bank bonds" also benefit from certain preferential treatments compared with other bank debt when it comes to self-issued bonds. The ECB states that "irrespective of the fact that a marketable or non-marketable asset fulfils all eligibility criteria, a counterparty may not submit as collateral any asset issued or guaranteed by itself or by any other entity with which it has close links"[6]. 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 securitise 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', to also extend to situations where a counterparty submits an asset-backed security as collateral when it (or any third party that has close links to it) provides support to that asset-backed security by entering into a currency hedge with the issuer or guarantor of the asset-backed security or by providing liquidity support of more than 20% of the nominal value of the asset-backed security.

The main exemptions from the "close links" rule remain "covered bank bonds". Self-issued UCITS compliant covered bonds (as well as structured covered bank bonds, subject to strict additional criteria, as outlined above) can be used by counterparties as collateral, i.e. an issuer can use its own covered bonds and there are no close link prohibitions. This has been one of the drivers of the strong increase in new covered bond programmes since 2008.

In November 2012 the ECB amended the close-link provisions regarding own-use of covered bonds as collateral. As of now only CRD compliant covered bonds and UCITS compliant covered bonds that offer comparable protection are eligible. Our understanding is that some of the structured CB programmes that have been used for ECB funding but are not UCITS compliant may cease to be eligible if retained and submitted (close-links).

Use of Covered Bonds as Collateral in Eurosystem Operations

The overall volume of marketable assets which had become eligible for repo operations had increased over 80% from EUR 7.6 trn in 2004 to EUR 13.7 trn at year-end 2010. In 2011 the eligible collateral volume decreased for the first time – by circa EUR 1 trn. Since then, the volume has remained more or less stable at around EUR 14 trn. At the end of Q1 2014 central government debt accounted for the largest share (46%) followed by uncovered bank bonds (16%), covered bank bonds (11%), corporate bonds (10%), ABS (5%) and other bonds, which include regional government securities (12%).[7]

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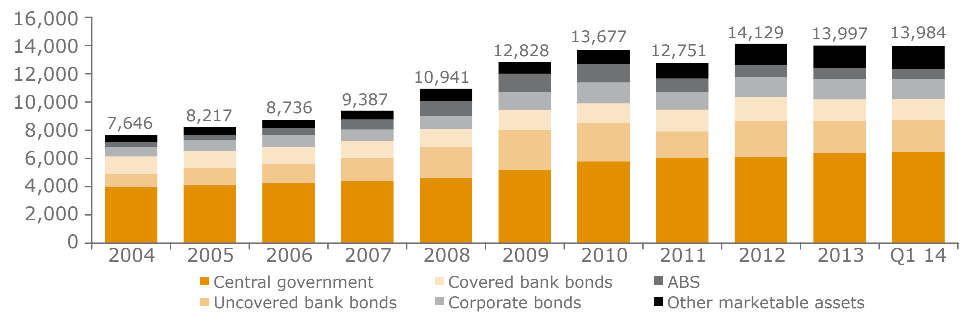
6 "Close links" means the counterparty is linked to an issuer/debtor/guarantor of eligible assets by one of the following forms: (i) the counterparty owns directly, or indirectly, through one or more other undertakings, 20 % or more of the capital of the issuer/debtor/guarantor; or (ii) the issuer/debtor/guarantor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

7 Although included within the list of eligible collateral, the volume of potentially eligible non-marketable assets is difficult to estimate since the eligibility of credit claims (the largest share of non-marketable assets) are not assessed until they are registered with the Eurosystem.

> Figure 5: Eligible collateral by asset type, EUR bn



Source: ECB, HSBC

The actual breakdown by type of 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 10% in 2008; though this has slightly risen again over the last few years to 15% as of Q1 2014.

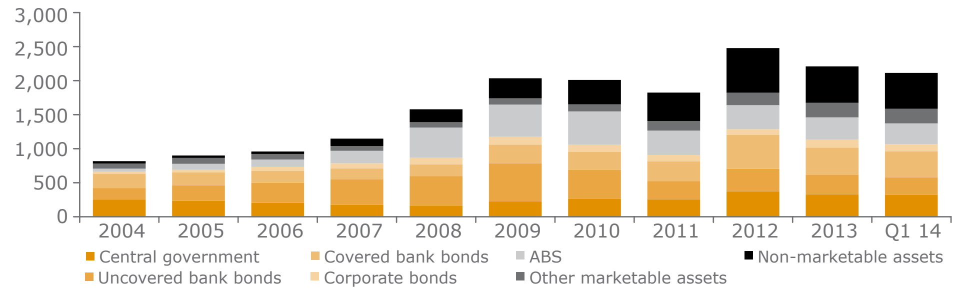
The use of covered bank bonds in the Eurosystem repo operations dropped from 26% in 2004 to 11% in 2008. Since then it increased again and stood at 18% as of Q1 2014.

The share of uncovered bank bonds (which included general law based covered bonds) has significantly dropped from 32% in 2007 to just 12% as of Q1 2013.

ABS grew from 6% in 2004 to 28% in 2008 before stabilising at 23% and 24% in 2009 and 2010 respectively. Their level decreased again to 15% as of end Q1 2014.

Figure 6 also shows the large rise in the main and long-term refinancing operations of the Eurosystem banks in autumn 2008 and then an even larger increase during the course of 2009. Total usage stabilised in 2010 and declined in 2011 before marking new heights in 2012 at EUR 2.5 trn. As of Q1 2014, the volume has dropped again to EUR 2.2 trn.

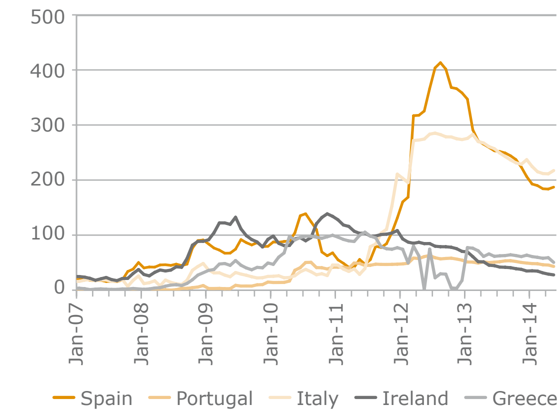
> Figure 6: Actual use of collateral by asset type, EUR bn



Source: ECB, RBS

Only some of the European central banks publish figures relating to the national usage of repo facilities. Nonetheless these clearly show that whilst banks increased their usage of the ECB facility since the beginning of the credit crunch, with the onset of the sovereign crisis 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 periphery. Figures by the national central banks show that the usage of the central bank facilities by banks out of Europe's periphery has significantly increased since 2011 until the peak of June 2012. The ECB remains one of the major funding channels for many peripheral banks, which have seen their share consistently increase on a relative basis, even as absolute levels declined. The two huge LTROs conducted in December 2011 and February 2012 further boosted the repo volumes, but are now petering out.

> Figure 7a: Composition of Eurosystem lending to euro area credit institutions, EUR bn



> Figure 7b: Total Eurosystem lending to euro area credit institutions, EUR bn

Source: Eurosystem, Bloomberg, HSBC

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 to 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 measure has been postponed on a number of occasions. In late 2011 the ECB announced two 3-year LTROs that were conducted as fixed rate tender procedures with full allotment at the end of December 2011 and in February 2012. In May 2013 the ECB announced it would continue conducting its Main Refinancing Operations (MROs) as fixed rate tender with full allotment for as long as necessary, and stated in June 2014 that this means at least until the end of December 2016. Furthermore, the ECB will conduct the three-month LTROs until the end of in December 2016 as fixed rate tender procedures with full allotment.

Targeted LTRO

In June 2014, the ECB announced its plans to conduct a series of targeted longer-term refinancing operations (TLTROs) over a window of two years which are designed to enhance the functioning of the monetary policy transmission mechanism by supporting bank lending to the real economy. Eurosystem counterparties will be entitled to an initial TLTRO borrowing allowance equal to 7% of the total amount of their loans to the euro area non-financial private sector, excluding loans to households for house purchase, outstanding on 30 April 2014. In two successive TLTROs to be conducted in September and December 2014, counterparties will be able to borrow an amount that cumulatively does not exceed this initial allowance. Moreover, during the period from March 2015 to June 2016, counterparties will be able to borrow additional amounts in a series of six TLTROs conducted quarterly. These additional amounts can cumulatively reach up to three times each counterparty's net lending to the euro area non-financial private sector, excluding loans to households for house purchase, provided between 30 April 2014 and the respective allotment reference date in excess of a specified benchmark. The benchmark will be determined by taking into account each counterparty's net lending to the euro area non-financial private sector, excluding loans to households for house purchase, recorded in the 12-month period up to 30 April 2014[8].

The interest rate on the TLTROs will be fixed over the life of each operation at the rate on the Eurosystem's main refinancing operations (MROs) prevailing at the time of take-up, plus a fixed spread of 10 basis points. Interest will be paid in arrears when the borrowing is repaid.

All TLTROs will mature in September 2018. Starting 24 months after each TLTRO, counterparties will have the option to repay any part of the amounts they were allotted in that TLTRO at a six-monthly frequency. Counterparties that have borrowed under the TLTROs and whose net lending to the euro area non-financial private sector, excluding loans to households for house purchase, in the period from 1 May 2014 to 30 April 2016 is below the benchmark will be required to pay back borrowings in September 2016.

In the TLTROs, the same Eurosystem collateral rules apply (in relation to eligibility criteria, valuation, haircuts and rules on the use of eligible assets) as in other refinancing operations.

Conclusion on covered bond treatment

The ECB, to a greater extent than any of its central bank peers, has both outlined and demonstrated its support in the past for the covered bond market. This was most obviously the case with its highly successful EUR 60 bn covered bond purchase programme in 2009/2010, but also with the creation of the EUR 40 bn second purchase programme in late 2011 although this was used only modestly. Perhaps even more important is the ECB's positive stance towards covered bonds, which the institution maintains for several reasons.

Firstly the ECB has focussed on the importance of covered bonds as a means for banks of accessing long term funding: "Issuing covered bonds enhances a bank's ability to match the duration of its liabilities to that of its mortgage loan portfolio, enabling a better management of its exposure to interest rate risk. Other secured funding products, such as repos, are unlikely to have the same asset-liability matching attributes offered by covered bonds. All these issues are all the more important today given the increasing role of short-term refinancing in banks' balance sheets. In certain instances, rolling over short-term funding might be less expensive or better in terms of reputation, but this could pose challenges to the management of assets and liabilities at some point. In addition to improving banks' structural asset-liability mismatch, covered bonds offer a wider

8 For banks that had positive eligible net lending in the twelve-month period to 30 April 2014, the benchmarks are always set at zero. For banks that had negative eligible net lending in the year to 30 April 2014, different benchmarks apply. These are set as follows: the average monthly net lending of each bank in the year to 30 April 2014 is extrapolated for 12 months until 30 April 2015. For the year from 30 April 2015 to 30 April 2016, the benchmark monthly net lending is set at zero.

geographical diversification, as issuers tap into a larger European market."[9] Moreover, a further key advantage comes from the absence of effective risk transfer and the desirable incentives this creates for the originating banks. As former ECB president Trichet 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."[10]

Such positive attitude is reflected both in the ECB's current favourable treatment of covered bonds within its repo operations, - they are allocated in a very favourable liquidity category (Jumbo covered bonds rank alongside the debt of the ESM, EIB and the explicitly guaranteed German agency KfW) and in the ongoing changes the ECB implements to these operations, for example the re-classification of liquidity category and more favourable haircuts now applied to 'structured covered bonds' and 'multi-issuer covered bonds' since the beginning of 2011. At the same time, the ECB has tightened the requirements back in November 2012 to ensure the quality of the covered bonds posted as collateral.

III. THE UK: ELIGIBILITY CRITERIA FOR BANK OF ENGLAND OPERATIONS

Latest changes to the framework

In October 2013, following a review, the BoE announced changes to the Sterling Monetary Framework (SMF) which came into force in 2014. A number of changes to the liquidity insurance toolkit have been implemented to increase its availability and flexibility by providing liquidity at longer maturities and against a wider range of collateral than before and at a lower cost. The changes include:

> An extension of the monthly Indexed Long-Term Repo operations (ILTR) by amount, term and to the full range of collateral;

> A repricing of the Discount Window Facility (DWF) and extension of the lag of disclosure of DWF drawings;

> The retention of the Extended Collateral Term Repo facility (used in market-wide stress conditions) which has been renamed the Contingent Term Repo Facility (CTRF).

The Bank of England is currently examining the case for extending the access to the SMF also to some non-banks.

Covered bonds under the Sterling monetary framework

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 degree for its monetary operations: (1) level A collateral set, (2) level B collateral set, (3) level C collateral securities as well as level C loan collateral.

Within the Sterling monetary framework operations, covered bonds are only included within the Level B and Level C collateral securities sets, both of which are eligible for the following facilities: (1) Indexed Long-Term Repo OMOs, (2) Discount Window Facility, (3) Contingent Term Repo Facility as well as (4) the Funding for Lending Scheme.

The eligibility criteria for covered bond inclusion can be found below:

9 European Central Bank, "Covered Bonds in the EU Financial System", December 2008.
10 Keynote address by Jean-Claude Trichet, Munich, 13 July 2009.

> Figure 8: Bank of England's covered bond eligibility criteria

	Level B	Level C Collateral Securities
Eligible currencies	GBP, EUR, USD, AUD, CAN, CHF, and SEK	
Geography	UK, French, German and Spanish regulated Covered Bonds	No specification if underlying assets are UK or EEA public sector debt, residential mortgages or social housing loans; UK, US and EEA for CBs backed by commercial mortgages, SME or ECA guaranteed loans
Rating Requirements	Broadly equivalent to AAA	Broadly equivalent to A3/A- or higher
Minimum Size	At least £1bn or €1bn (depending on issue currency)	n/a
Own Name Covered Bonds	No	Yes
Underlying assets	UK or EEA residential mortgages, social housing loans or public sector debt	UK, EEA residential mortgages, public sector debt, social housing loans, as well as SME loans, commercial mortgages & certain ECA guaranteed loans (US, UK & EEA Covered Bonds only)

Source: Bank of England, RBS

Rating references are only used to indicate the broad standards of credit quality that are expected by the Bank of England and are no longer prerequisites for eligibility. The BoE rather forms its own independent view of the risk in the collateral taken and only accepts collateral that it can value and where the risk can be effectively managed.

For the Level B collateral set, only a subset of the covered bond universe is eligible. The criteria are based on a combination of both credit quality (hence underlined by the AAA rating-equivalent 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 Level B Collateral Set, whereas Spanish covered bonds are generally included but probably do not fulfil the minimum rating (equivalent) requirement at the moment. Meanwhile under the current guidelines, even for some of the UK banks, mainly their Euro covered bonds would be eligible, given that many Sterling covered bonds fall below the minimum issue size threshold of GBP 1bn.

Covered bonds do not qualify for the Bank of England's Level A collateral set which is restricted to Gilts (including gilt strips), Sterling Treasury bills, Bank of England securities, HM Government non-sterling marketable debt and Sterling, euro, US dollar and Canadian dollar-denominated securities (including associated strips) issued by the governments and central banks of Canada, France, Germany, the Netherlands and the US.

In 2011, bonds issued in domestic currency or in sterling, euro or US dollars from Australia, Austria, Belgium, Denmark, Finland, Italy, Japan, Luxembourg, New Zealand, Norway, Portugal, Slovenia, Spain, Sweden, and Switzerland, as well as supranational debt, were moved from the "narrow" (now called Level A) to the "wider" (now called Level B) collateral set and are therefore not eligible for short term repo operations. Thus, even some AAA countries such as Norway, Denmark or Finland are no longer eligible for short-term repos under the Level A collateral definition. These amendments were the result of a previous internal review by the BoE, reflecting a stronger focus on liquidity and credit risk.

As mentioned above, the Bank of England conducts a number of different monetary policy and liquidity insurance operations. Figure 9 below shows the eligibility of different collateral sets for the various operations and facilities:

> Figure 9: Eligibility of different collateral sets for the various operations and facilities

Sterling Monetary Framework operations & lending facilities	**Level A**	**Level B**	**Level C**
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**	**Yes**
Discount-Window Facility	Yes	**Yes**	**Yes**
Contingent Term Repo Facility	Yes	**Yes**	**Yes**
Funding For Lending Scheme	Yes	**Yes**	**Yes**

Source: Bank of England, RBS

Operational Standing Facilities

The Operational Standing Lending Facility provides a ceiling for the overnight interest rates through its overnight lending facility (against the Level A collateral set), which is usually set at 25bp above the Bank of England rate. The Operational Standing Deposit Facility is an unsecured overnight deposit with the central bank, which is currently set 50 bps below the Bank of England rate. This is designed to limit volatility in overnight interest rates by providing an arbitrage mechanism to prevent money market rates moving far from the bank rate and allowing participating banks to manage unexpected frictional payment shocks.

Short-term Open Market Operations (OMOs)

Short-term Open Market Operations (OMOs) are designed to supply the quantity of reserves consistent with the aggregate target set by the banks for that maintenance period (the period over which compliance with reserve requirements is calculated) under the reserve averaging process. These operations have been suspended since March 2009 as a result of the BoE's asset purchase scheme (QE), so the supply of reserves is currently determined by the level of reserves. At the moment the BoE is operating a "floor system" where all reserves are remunerated at the Bank Rate.

Indexed Long-term Repo Operations

Indexed long-term repo operations are provided by the Bank of England to provide indexed liquidity insurance without distorting banks' incentives for prudent liquidity management and to minimise 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 three collateral sets: Levels A, B and C. Levels B and C include covered bonds meeting the aforementioned criteria. Level C collateral must be pre-positioned.

The BoE typically offers funds in long-term repo operations once a month. Since 2014 the term of all ILTR lending has been extended to six months (from one operation with a three month and one with a six month maturity previously).

The BoE does not provide a simple schedule of long-term operations, as is the case for the ECB. Instead it operates a unique auction design. 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 Level A collateral or against Level B and C collateral (where covered bonds are eligible). Multiple bids can be placed against either of the three collateral sets[11].

11 There is no restriction on the number of bids, the aggregate value of bids or the total value of bids received from a single participant.

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.[12] The BoE specifies the clearing spreads for all the three collateral sets. Bids are ranked and accepted in descending order of the bid spread until the BoE's supply preferences have been met. 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 Levels B and collateral sets in the auction. Crucially, the auction is flexible as both the proportion of the total amount allocated to each collateral set as well as the total quantity of funds are based on the pattern of bids received. This determines the amount of liquidity, against which covered bonds can potentially be pledged. So in this system the amount of liquidity on offer against the Level B and C collateral sets depends not only on demand for long-term repos on these assets but also on those in the Level A collateral set.

The discount window facility

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. Drawings have a 30-day maturity and can be rolled for longer temporary liquidity needs.

Collateral, which can be pledged, encompasses all the collateral sets Level A, B and C. 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.

For lending provided in return for Gilts[13] the fees (in basis points) for the different categories of collateral are set out below:

> Figure 10: Overview of the fees for the different categories of collateral

Fees (basis points)			
Collateral% of Eligible Liabilities	**Level A**	**Level B**	**Level C**
Up to 5%	25	50	75
5-15%	Marginal cost rises linearly with quantity borrowed		
at 15%	75	125	300
Over 15%	Prices agreed bilaterally with the Bank of England		

Source: Bank of England, RBS

Contingent Term Repo Facility (CTRF)

The CTRF is a contingency liquidity facility that the BoE can activate in response to actual or prospective exceptional market-wide stress to undertake operations against the full range of eligible collateral (Levels A, B, C). This includes own-name covered bonds. Collateral is expected to be pre-positioned prior to an operation.

The Funding for Lending Scheme (FLS)

The FLS was launched on 13 July 2012 and is intended to encourage banks and building societies to increase their lending to UK households and corporates. Participants can borrow UK Treasury Bills against all collateral eligible under the DWF (i.e. Levels A, B & C). Both the fee and the amount participants can borrow will depend on their lending growth. The drawdown period started on 1 August 2012 and was extended up to the end of

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

13 In the event that cash is lent instead, then the fee is the indexed bank rate in addition to the fees shown in the Figure 10; though such fees can vary at the bank's discretion.

January 2015. As part of this extension (on 24 April 2013) the FLS was also expanded to count lending by certain non-bank providers of credit to the UK real economy. On 31 January 2014, the first phase of the FLS ended. Since then, household lending no longer generates any additional borrowing allowances.

> Figure 11: Summary of the BoE's monetary operations

	Operational Standing Facilities	Indexed Long-term Repo	Discount Window Facility (DWF)	Contingent Term Repo Facility	Funding for Lending (Extension)
What is the primary purpose of the operation?	Monetary policy implementation Bilateral liquidity insurance to deal with frictional payment shocks	Liquidity insurance	Bilateral liquidity insurance	Liquidity insurance	Boost lending to the UK real economy
What is being borrowed?	Deposit facility: n/a Lending facility: sterling cash	Sterling cash	Gilts	Sterling cash	Treasury Bills
Eligible Collateral	Deposit facility: n/a Lending facility: Level A	Level A, B and C	Level A, B and C	Level A, B and C	Level A, B and C
Fee	Deposit facility: 0% Lending facility: 0.75%	Auction determined uniform spread indexed to Bank Rate	Fee dependant on size of drawing and collateral delivered	Auction determined uniform spread indexed to Bank Rate	Flat rate of 0.25%
Maturity	Overnight	6 months	30 days	Terms set according to market conditions	4 years
Frequency	Available daily, all day	Typically monthly	Available daily, all day	Upon notice	Available daily, up to 12pm
Minimum bid/offer amount	n/a	£5mln	n/a	-	£1mln
Minimum bid/offer increment	n/a	£1mln	n/a	-	£0.1mln
Settlement date of the operation	T+0	T+2	T+0	-	T+0

Source: Bank of England, RBS (as of July 2014)

Additional disclosure requirements for residential mortgage covered bonds

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

Since December 2012, any covered bonds backed by mortgages which do not fulfil the criteria became ineligible for use in any of the Bank of England's monetary policy operations[14].

Loan-level reporting also includes "the requirement for credit bureau score data" to be made available. This needs 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

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

information on a 'comply or explain' basis. Where issuers are not able to provide certain data fields, this will not render a transaction ineligible automatically; instead the BoE will look at the rationale before determining eligibility and may choose to add additional haircuts. Nonetheless the BoE expects that ultimately all the mandatory information will need to be provided. These additional transparency requirements do not apply to public sector covered bonds.

IV. 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 three rounds of asset purchases (quantitative easing), the first consisting of Treasury securities, GSE debt and GSE-guaranteed MBS, the second solely of Treasuries and the third of agency MBSs, 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 SOMA operations, which are restricted to US Treasury Bills, Notes and Bonds (including TIPS), Federal Agency securities[15] and MBS guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae; all of which must be denominated in USD. None of the additional operations put in place during the first stage of the financial crisis are currently still in place, meaning the only significant other monetary operation is the discount window.

Covered bonds and the discount window

Only a very small list of covered bonds are eligible for the discount window, namely: **US 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 covered bonds.

"In general, the Federal Reserve seeks to value securities collateral at a fair market value estimate. Margins are applied to the Federal Reserve's fair market value estimate and are designed to account for the risk characteristics of the pledged asset as well as the volatility of the value of the pledged asset over an estimated liquidation period. Securities are typically valued daily using prices supplied by external vendors. Eligible securities for which a price cannot readily be obtained will be assigned an internally modeled fair market value estimate based on comparable securities, and they will receive the lowest margin for that asset type."

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, supranational paper or GSE bonds. Nonetheless this reflects a positive stance of the Fed on 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. All other covered bonds effectively appear to be treated in the same manner as unsecured bank debt, i.e. they are excluded from the discount window. Even other well-developed legislation-based covered bond types, such as Obligations Foncières or any of the various Nordic covered bonds have not been included.

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

> Figure 12: Overview of the eligibility criteria

		% 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	5.0
	STRIPs/Zero Coupon	2.0	4.0	8.0
GSEs	Bills/Notes/Bonds	2.0	4.0	6.0
	Zero Coupon	3.0	5.0	9.0
Foreign Government Agencies	USD Denominated	2.0	4.0	9.0
	Foreign Denominated- AAA rated	6.0	7.0	9.0
Foreign Government, Foreign Government Guaranteed and Brady Bonds	USD Denominated- AAA rated	2.0	4.0	6.0
	USD Denominated- BBB-AA rated	3.0	5.0	8.0
	Foreign Denominated	6.0	8.0	9.0
Supranationals	USD Denominated	2.0	4.0	6.0
	Foreign Denominated- AAA rated	6.0	7.0	9.0
	Zero Coupon	3.0	5.0	9.0
Corporate Bonds	USD Denominated- AAA rated	2.0	5.0	7.0
	USD Denominated AA-BBB rated	4.0	7.0	8.0
	Foreign Denominated- AAA rated	8.0	9.0	12.0
US Issued Covered Bonds	**AAA rated**	**2.0**	**5.0**	**7.0**
	AA-BBB rated	**4.0**	**7.0**	**8.0**
German Jumbo Pfandbriefe	**AAA rated - USD Denominated**	**2.0**	**4.0**	**6.0**
	AAA rated - Foreign Denominated	**6.0**	**7.0**	**8.0**
Asset Backed Securities	AAA rated	2.0	6.0	10.0
	AA-BBB rated	4.0	13.0	23.0
	CDOs- AAA rated	17.0	18.0	22.0
	CMBS- AAA rated	5.0	11.0	15.0
Agency Backed Mortgages	Pass throughs	2.0	4.0	6.0
	CMOs	2.0	4.0	6.0
	Private-label CMOs- AAA rated	11.0	12.0	15.0
	Trust Preferred Securities	11.0	12.0	13.0
	Trust Deposit Facility- Term Deposits	0	n/a	n/a
	CDs, Bankers' Acceptances, CP, ABCP	2.0	n/a	n/a

Source: Fed (applicable as of 1 July 2014), RBS

There is also a separate schedule for the percentage margin applied to loans, a number of categories of which are also eligible for the discount window facility. A further stipulation from the Fed is that obligations of the pledging depository institution (or of an affiliate) are not eligible collateral. On our understanding, this rules out own-name covered bonds.

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

SNB monetary policy operations

Under its monetary policy framework, the Swiss National Bank (SNB) sets a 100 bps target range for the 3-month Swiss Franc LIBOR rate, with SNB targeting the middle of this range. Repos are its preferred open market operation used to achieve this target. These are conducted in parts by auctions, which are typically held every day, either in the form of a volume tender (fixed rate tender, which is the norm) or by variable rate tender. The SNB can also conduct bilateral repo operations to affect money market operations during the course of the day. All these repo transactions must be 100% collateralised. The terms are set on a daily basis and the maturity of the operations may vary from one day to twelve months. Hence the SNB does not have distinct long-term repo operations in the same manner as the ECB or the BoE. Furthermore, the SNB can issue its own debt certificates (SNB Bills) as a means of absorbing liquidity through its money market operations when targeting the policy rate (or range). Such debt certificates can also be posted back to the SNB in the context of 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 predetermined allotment volume, the SNB reduces the amounts offered proportionally. Each one of the counterparties receives the interest rate they bid. SNB Bill auctions are, as a rule, conducted in the form of a variable rate tender. Counterparties submit their offers comprising the amount of liquidity they are willing to provide and price at which they would 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[16]." 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). The SNB can also create, purchase or sell derivatives on receivables, securities, precious metals and currency pairs.

Covered bonds and other collateral eligible for SNB repo operations

For 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 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:

> be 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).

> the issuer must be domiciled in Switzerland or in the European Economic Area (EEA), if the security is denominated in a foreign currency

> have a fixed principal amount with an unconditional redemption

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

> have a fixed rate, floating rate or zero coupon

> have a minimum volume of CHF100mln for securities denominated in Swiss Francs or CHF 1 bn for securities denominated in foreign currencies

> be traded on a recognised exchange or a representative market in Switzerland or member of the EEA with price data published on a regular basis; and

> 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 (or a subsidiary abroad) with the exception of the domestic mortgage bond institutions (Pfandbriefanstalten). 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:

> Figure 13: Eligibility criteria for Swiss Franc and foreign currency securities

	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 m	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 1 bn equivalent (at time of issuance)	

* Securities of supranational organisations may be eligible irrespective of rating of country of domicile.

** Swiss public authorities, domestic mortgage bond institutions (Pfandbriefanstalten), the central issuing office of Swiss municipalities and Swiss issuers with explicit guarantee from Swiss Confederation are excluded from this requirement.

Source: SNB, RBS

All securities contained in the list of collateral eligible for SNB repo transactions form part of the SNB GC Basket. Based on their characteristics, the securities in this collective basket are assigned to three different baskets. The CHF GC Basket contains the securities denominated in Swiss francs. Securities in foreign currencies issued by sovereign countries and central banks make up the Government GC Basket (GOV GC Basket). The International GC Basket (INTL GC Basket) contains all other foreign currency securities. Securities in Swiss francs with a minimum volume of CHF 1 bn and a minimum rating of AA-/Aa3 are eligible for two baskets: the CHF GC Basket and either the GOV GC Basket or the INTL GC Basket. As is the case with all central banks, the SNB can decide on a case-by-case basis which securities are eligible for its repo operations. Its rules explicitly state that it "may reject the inclusion of securities or withdraw securities that were previously included in the list, without providing any justification."

Own-name covered bonds

The SNB publicly states that it does not accept counterparties' own securities or "those issued by persons or companies that form an economic unit with the counterparty". It defines an enterprise as belonging to the same economic unit as the counterparty if 20% of the capital or voting rights are held. Nonetheless it explicitly states that "this 20% rule does not apply to participations in mortgage bond banks or similar institutions". Although it is not explicitly stated in official documents, SNB officials confirmed to us that own name covered bonds cannot be included within the boundaries set by the definition of eligible collateral.

Changes to the eligibility guidelines as of 1 January 2015

Following the adoption of the Swiss Liquidity Ordinance (LiqV) which translates the BIS' LCR framework into Swiss law, applicable from 1 January 2015, the SNB has also redefined its collateral policy aligning it to the new liquidity provisions from 2015 onwards.

The SNB is implementing the changes in order to ensure that all collateral eligible for SNB repos also fulfils the criteria for high-quality liquid assets (HQLA) under the new Liquidity Ordinance. As per the new criteria, bonds issued by financial institutions domiciled outside Switzerland or by domestic insurance companies will now be excluded. An exception to this exclusion is covered bonds issued by foreign financial institutions and domestic mortgage bond institutions. Furthermore, the credit rating requirements for securities in Swiss francs have been brought into line with those for securities in foreign currencies, ie. the minimum rating will be increased from A/A2 to AA-/Aa3. In order to be LCR-eligible under the Swiss Liquidity Ordinance, Covered Bonds must be subject by law to public special supervision to protect bondholders (similar to the UCITS criterion). Non-domestic assets (including Covered Bonds issued outside Switzerland) are only eligible under the Swiss LCR if these assets are eligible under their respective domestic LCR regulations.

VI. NORWAY: ELIGIBILITY CRITERIA FOR NORGES BANK OPERATIONS

Norges Bank monetary policy operations

The policy rate of Norges Bank is the sight deposit rate: the rate of interest banks receive on their overnight deposits (up to a quota) at Norges Bank. As from 3 October 2011, a set volume of bank reserves in Norges Bank (a quota) started bearing interest at the key rate. Deposits in excess of this quota bear interest at a lower rate, the reserve rate (new liquidity management system). 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 forms a floor for very short-term money rates, whilst the overnight lending rate charged to banks for overnight loans (for "D-Loans", see below) is the other though less important interest rate, which forms a ceiling for very short-term money rates. This is typically set 100bp above the key policy rate. Norges Bank uses F-deposits (fixed-rate deposits) to remove unwanted liquidity from 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 as 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 all counterparties paying their respective bid price. Such loans also must be 100% collateralised.

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 facilities in the past. F-loans are provided for a number of different maturities, much like the longer-term ECB-refinancing operations. 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" as 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).

Covered bonds and other collateral eligible for Norges Bank repo operations

In order to be eligible as collateral, securities must be listed on Norges Bank's website and have to fulfil the following eligibility criteria:

Type and Jurisdiction

> Bonds, notes and short-term paper issued from Norwegian and foreign issuers;

> Securities issued outside the EEA may be accepted provided that Norges Bank has legal confirmation that there are no problems associated with the realising of the collateral;

> Norwegian bond and money market funds (confined to investing in bonds, notes and short-term paper) are eligible as collateral provided that they are managed by a management company registered in Norway whose unit holdings are registered with the VPS and that Norges Bank has access to price information from Oslo Børs Informasjon.

Credit rating

> Securities issued by foreign issuers and bonds, notes and short-term paper issued by Norwegian private entities are subject to credit rating requirements.

> Covered bonds issued under Norwegian law are exempt from the rating requirement if they are backed by domestic mortgage loans. For securities issued by Norwegian entities a credit rating of the issuer is sufficient.

> Norges Bank accepts credit ratings from S&P, Fitch and Moody's. A best rating approach is used, i.e. a satisfactory credit rating from just one of these three agencies is sufficient. The lowest acceptable credit rating for bonds with foreign issuers is A/A2, while the lowest acceptable credit rating for bonds issued by Norwegian issuers is BBB-/Baa3[17].

Listing

Securities issued by private entities are subject to listing requirements.

> Private securities must be pledged in the VPS, must be listed on a stock exchange or other market place approved by Norges Bank.

> Securities pledged as collateral in another securities depository approved by Norges Bank must be listed on a stock exchange.

> The listing requirement does not apply to notes and short-term paper.

Requirements relating to minimum volume outstanding

Securities issued by private entities are subject to requirements relating to minimum volume outstanding:

> Securities in NOK must have a minimum outstanding volume of NOK 300 m, whilst securities in a foreign currency must have a minimum volume equivalent to EUR 100 m.

> If a security issued by a private entity is denominated in a foreign currency, a bank may not pledge more than 20% of the loan's outstanding volume to Norges Bank. The same applies to Asset-Backed Securities (ABS) denominated in NOK.

17 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.

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

> 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 (ABS) 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% of the volume outstanding of any deal.

> An ABS may be rejected if the pledging bank has close ties to the special purpose vehicle of an ABS (for example in the form of agreements on interest rate or currency swaps, lines of credit or the servicing of loans).

> Collateralised debt obligations (CDOs) are not eligible as collateral.

> Unsecured securities issued by banks and other financial institutions, or unsecured bonds issued by companies where banks or other financial institutions indirectly or directly own more than 33% are not eligible. Securities that are directly or indirectly linked to credit derivatives and zero-coupon bonds with a residual maturity of more than 7 years are not eligible as collateral. Nor will instruments such as convertible bonds, inflation-linked bonds, inverse floating rate bonds, FRN Caps or subordinated loans be eligible.

Own-name covered bonds

A bank may pledge covered bonds and ABS as collateral even if the securities are issued by the bank itself or by an entity that is part of the same corporate group as the bank. Own-name covered bonds are subject to an additional haircut of 5%.

Haircuts

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

> Figure 14: Norges Bank Haircuts by Category and Residual Maturity (% of market value)

Liquidity Category	Liquidity Category I		Liquidity Category II		Liquidity Category III		Liquidity Category IV	
Eligible Collateral	> AAA rated Government Bonds > Money market and bond funds confined to investments in the above securities		> Government bonds rated AA+ to A > *Covered bonds rated AAA to AA-* > Norwegian local government paper > Foreign local government paper rated A or better > 0% RW paper > Government-guaranteed paper > AAA rated corporates		> *Covered bonds rated A+ to A* > Corporate bonds rated AA+ to A > Units in eligible money market and bond funds		> Norwegian *covered bonds* rated A- or lower and unrated > Norwegian corporate bonds rated A- to BBB-	
Maturity	Fixed	Floating	Fixed	Floating	Fixed	Floating	Fixed	Floating
0-1 year	1.0	1.0	3.0	3.0	4.0	4.0	8.0	8.0
1-3 years	3.0	1.0	5.0	4.0	6.0	5.0	11.0	10.0
3-7 years	5.0	1.0	7.0	5.0	10.0	7.0	17.0	14.0
7+ years	7.0	1.0	10.0	6.0	13.0	9.0	22.0	17.0

Source: RBS, Norges Bank

Notes: Securities in foreign currencies and own-name covered bonds are subject to a further 5% haircut. ABS are subject to a 15% haircut, regardless of maturity. Additional haircuts apply on FRNs if no price information is available.

Temporary Norges Bank monetary policy operations: a unique swap arrangement

Another monetary policy instrument used by Norges Bank, which is somewhat unique in the context of covered bonds, is a swap arrangement where banks can swap covered bonds in return for government securities. The arrangement was put in place in November 2008 for NOK 230 bn. The maturity of the swaps was originally three years but was subsequently extended to five years. In December 2009 auctions were cancelled until further notice.

Access to Norges Bank lending facilities by covered bond mortgage companies

In a statement published in May 2013, Norges Bank argues that "covered bond mortgage companies should not be given general access to the central bank lending facility" since "the granting of liquidity loans is expressly restricted to commercial banks and savings banks." It has to be noted however that "Norges Bank's ability to extend liquidity support to financial institutions in extraordinary cases is not limited by whether the institution has ordinary access to the lending facilities."

VII. AUSTRALIA: ELIGIBILITY CRITERIA FOR RESERVE BANK OF AUSTRALIA (RBA) OPERATIONS

The Reserve Bank of Australia (RBA) expresses its desired stance on monetary policy through an 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 ("domestic market operations"). The same collateral set is also applicable to the longer-term operations provided.

When the RBA buys securities under repurchase agreement it does so in two broad classes of securities: government-related securities 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 in available government debt and taking into account the changing structure of financial markets.

Covered bonds and RBA eligible securities for reverse repos

In order to be considered as eligible 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 lowest credit rating assigned to a security or its issuer by any of the major rating agencies will be used to assess eligibility and eventual haircut. For covered bonds only security ratings are considered as long as at least two ratings are available. Otherwise minimum issuer ratings will also be considered.

> **Structured bonds**: "Highly structured" securities are not eligible.

> **Own name bonds**: "Unless otherwise advised" securities issued by the bank itself 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, including members of the same group and where one entity owns more than 15% of another. The lists of eligible securities denotes the related parties for specific securities or programmes. This 'related party exemption' also applies to covered bonds and, as such, "own name covered bonds" are not eligible for RBA repo operations.

The current set of eligible securities and the respective minimum rating requirements are given below:

> FIGURE 15: ELIGIBLE SECURITIES AND MINIMUM RATING REQUIREMENTS

	Minimum Rating
General Collateral	
Commonwealth Government Securities	n/a
Semi-governments Securities	n/a
Issues by Supranationals and Foreign Governments	AAA*
Securities with an Australian Government Guarantee	n/a
Securities with a Foreign Sovereign Government Guarantee	AAA*
Private Securities	
Securities (including Covered Bonds) issued by authorised deposit-taking institutions (ADIs)	
Residual maturity of 1Y or less	Any public rating
Residual maturity > 1Y	BBB+
Asset Backed Securities	
Standard	A-1 or AAA
Other	A-1 or AAA
Other Private Securities	A-1 or AAA

* Minimum rating requirement waived for securities issued and/or guaranteed by the New Zealand government

Source: RBA, RBS

These mainly comprise covered bonds denominated in AUD and issued in the Kangaroo market (i.e. onshore) to be eligible for Repo transactions with the RBA. The RBA is willing to accept "other AAA assets" which include 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. As is the case with all central banks, the RBA retains the right to reject any particular security or securities from any issuer and specifically states that it will not accept "highly structured" securities. This does not apply to covered bonds, but to CDOs or similar structures.

Figure 16 below shows the margin ratios used by the RBA to discount the market value of securities purchased under reverse repos. They are applied according to the following formula:

purchase price = market value / (1 + margin / 100)

> FIGURE 16: MARGIN RATIOS USED BY THE RBA TO DISCOUNT THE MARKET VALUE OF SECURITIES PURCHASED UNDER REVERSE REPOS

	Minimum Rating	Margins			
		0-1 years	1-5 years	5-10 years	>10 years
Government-related Securities					
Commonwealth Government Securities	n/a	1	2	2	2
Semi-Government Securities	n/a	1	2	2	2
Securities Issued by Supranationals & Foreign Governments	AAA	2	3	4	4
Securities with an Australian Government Guarantee	n/a	2	3	4	4
Securities with a Foreign Government Guarantee	AAA	2	3	4	4
Private Securities					
ADI-issued Securities including Australian Covered Bonds	AAA	6	7	8	10
	AA–	10	12	14	16
	A–	12	14	16	18
	BBB+	15	17	20	23
	Other rated	20	n/a	n/a	n/a
Asset Back Securities					
> Standard	A-1 or AAA	10	10	10	10
> Other	A-1 or AAA	15-20	15-20	15-20	15-20
Other Private Securities	A-1 or AAA	6	7	8	10

Source: RBA, RBS

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

RBNZ monetary policy operations

Since March 1999 the RBNZ has implemented monetary policy by setting the Official Cash Rate (OCR), which is reviewed eight times a year. 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 FX Swaps and Basis Swaps operations. 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; and

> 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 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 electronic media and the conditions applying to the operation are included. Purchases may be for the RBNZ's own account or on behalf of the Crown.

Covered bond eligibility for RBNZ operations

As explained above, covered bonds are eligible for the RBNZ's overnight repo transactions within the Liquidity Operations and the Bond Lending Facilities, as long as they fit the following criteria:

Rating

> Issues are rated AAA by at least two acceptable rating agencies. In case of more than two issue ratings, at least two agencies must rate the issue 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 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 is available on at least 80% of days via the NZFMA's NZ Credit Market Daily Pricing Service. Pricing is 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 lodgement 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 of 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 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 (or New Zealand subsidiaries of foreign banks using domestic loans). Nonetheless, if a foreign issuer were to have eligible loans in the pool (and fulfil all the other criteria), their covered bonds could also be eligible. Covered bonds are also subject to the strict requirement of being NZD-denominated, consistently with the rules for all other securities; even bonds issued or guaranteed by foreign governments must be NZD-denominated. Therefore, US Treasuries or Bunds in their domestic currencies would technically not be eligible for the RBNZ's operations.

The full haircuts matrix 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, and everything else, apart from AAA bank and corporate debt and state-owned enterprise bonds. In fact, the haircut of 5% for securities below 3-years is even lower than the 6% haircut applied to NZD-denominated government guaranteed securities. In effect only Kauri and New-Zealand government securities (and RBNZ bills) receive lower haircuts. Ultimately, the eligibility criteria for repo are strict but eligible covered bonds receive a highly favourable treatment.

> Figure 17:

Eligible Security	Minimum Rating	Haircut	
		< 3 years	≥ 3 years
NZ Government & RBNZ			
Treasury Bills	AA+	1%	3%
Bonds			
Inflation-linked Bonds			
RBNZ Bills	n/a	1%	3%
Acceptable Kauri issues (NZD)	AAA	3%	5%
	AA- to AA+	6%	8%
	A- to AA+	10%	15%
Bank Securities (NZD)			
Bank bonds - NZ Registered Banks only	AAA	5%	8%
	AA- to AA+	8%	10%
	A- to A+	10%	15%
	BBB- to BBB+	15%	20%
NZ Registered Bank RCD's	A-1+	10%	n/a
	A-1	15%	n/a
	A-2	20%	n/a

Eligible Security	Minimum Rating	Haircut	
		< 3 years	≥ 3 years
Local Authorities (NZD)			
Bonds	AAA	5%	8%
	AA- to AA+	8%	10%
	A- to A+	10%	15%
	BBB- to 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- to AA+	8%	10%
	A- to A+	10%	15%
	BBB- to 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- to AA+	8%	10%
	A- to A+	10%	15%
	BBB- to 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	AA+	6%	8%
	A-1+		
Securities issued/guaranteed by Foreign governments (NZD)			
Bonds	AA+ to AAA	6%	8%
CP	A-1+		
Asset Backed Securities			
Bonds	AAA	10%	15%
CP	A-1+	10%	n/a
RMBS (NZD- on a single name basis)			
Bonds	AAA	19%	
CP			
Covered Bonds (NZD)			
Bonds	AAA	5%	8%

Source: RBNZ, RBS

IX. CANADA: ELIGIBILITY CRITERIA FOR BANK OF CANADA MARKET OPERATIONS

The Bank of Canada uses a number of permanent facilities to conduct market operations:

> **SPRA/SRAs**: The Bank conducts Special Purchase and Resale Agreements (SPRAs) and Sale and Repurchase Agreements (SRAs) to implement its monetary policy framework in the Large Value Transfer System (LVTS) environment. SPRAs and SRAs are used to reinforce the target overnight rate at the mid-point of the operating band.

> **Overnight Standing Purchase and Resale Agreement**: The Bank makes this standing facility available to Primary Dealers on an overnight basis at the upper limit of the operating band (Bank Rate).

> **Term Repo for Balance Sheet Management Purposes**: The Bank may acquire assets temporarily in the secondary market to manage short-term changes in the Bank's balance sheet, which is typically due to seasonal fluctuations in the demand for bank notes.

> **Securities Lending Program**: The Bank supports the liquidity of Government of Canada securities by providing a secondary and temporary source of securities to the market through a tender process for a term of one business day.

> **Standing Liquidity Facility**: The Bank of Canada provides Large Value Transfer System (LVTS) advances, which are collateralised overnight loans to direct participants in the LVTS. The same assets eligible for the Bank's Standing Liquidity Facility (SLF) are also eligible to obtain intraday liquidity for participants in the LVTS.

> **Bank of Canada Margin Call Practice for Domestic Market Operations**: For transactions outstanding against securities purchased or sold under a term purchase and resale agreement, the Bank values the securities daily, and compares that value to the contract valuation in order to ensure the Bank is adequately protected. The Bank may initiate a margin call, requesting the counterparty to deliver additional securities to cover any shortfall.

The Bank of Canada provides access to liquidity through its Standing Liquidity Facility (SLF), to institutions participating directly in the Large Value Transfer System (LVTS). Under the provisions of the Bank of Canada Act, the Bank's LVTS advances (the overdraft loans) are required to be made on a secured basis. The collateral used to secure these loans must be acceptable to the Bank of Canada, and an appropriate margin is applied. Notwithstanding the eligibility criteria listed below, the Bank of Canada retains the right of refusal for any asset or programme.

In December 2012, the Bank of Canada added Canadian covered bonds as eligible assets to the list of collateral that can be pledged under its Standing Liquidity Facility. The covered bonds have to fulfil the following criteria and conditions:

> Only covered bonds from programmes that are registered with the Covered Bond Registrar (CMHC) and are compliant with the federal legislative framework for covered bonds are eligible, i.e. Canadian Registered Covered Bonds.

> The issuer must have a minimum of two credit ratings from two major credit rating agencies, the second highest of which is at least A(low) by DBRS, A- by Fitch, A3 by Moody's, or A- by S&P.

> Eligibility is restricted to covered bonds **denominated in Canadian Dollars**. This requirement is not limited to covered bonds but is applicable to all asset classes with the exception of US Treasuries denominated in US dollars.

> Covered bonds are subject to a 5% issuer concentration limit.

> No more than 20% of an institution's pledged collateral may be comprised of municipal government or private sector securities including Covered Bonds. Securities issued by other LVTS participants (also including Covered Bonds) are subject to a 10% limit.

> Banks cannot submit their own covered bonds as collateral.

> Haircuts will be based on the second-highest issuer credit rating.

> FIGURE 18: HAIRCUTS FOR VARIOUS ASSET CLASSES AND MATURITY BRACKETS

Collateral type	up to 1 year	>1-3 years	>3-5 years	>5-10 years	>10-35 years	>35 years
Securities issued by the Government of Canada	0.5%	1.0%	1.5%	2.0%	2.5%	3.0%
Government of Canada - stripped coupons and residuals	0.5%	1.0%	1.5%	2.0%	3.0%	11.5%
Securities guaranteed by the Government of Canada (including Canada Mortgage Bonds and NHA mortgage-backed securities)	1.0%	1.5%	2.0%	2.5%	3.5%	4.0%
Government of Canada guaranteed - stripped coupons and residuals	1.0%	1.5%	2.5%	4.0%	4.5%	13.0%
Securities issued by a provincial government	1.5%	2.0%	2.5%	3.0%	4.0%	4.5%
Provincial government – stripped coupons and residuals	1.5%	2.0%	3.0%	4.5%	6.0%	14.5%
Securities guaranteed by a provincial government	2.0%	2.5%	3.0%	3.5%	4.5%	5.0%
Provincial government guaranteed – stripped coupons and residuals	2.0%	2.5%	3.5%	5.0%	6.5%	15.0%
Securities issued by a municipal government minimum rating by DBRS: R-1(mid) / AA(low) Fitch: F-1+ / AA- Moody's: Aa3 S&P: A-1(high) / AA-	2.5%	3.0%	3.5%	4.0%	5.0%	5.5%
Securities issued by a municipal government minimum rating by DBRS: R-1(low) / A(low) to A(high) Fitch: F-1 / A- to A+ Moody's: P-1 / A3 to A1 S&P: A-1(mid) / A- to A+	4.5%	5.0%	5.5%	6.0%	7.0%	7.5%
Bankers' acceptances, promissory notes, commercial paper, including those of foreign issuers rated by DBRS: R-1(mid) or better Fitch: F-1+ S&P: A-1(high)	3.0%					

Collateral type	up to 1 year	>1-3 years	>3-5 years	>5-10 years	>10-35 years	>35 years
Bankers' acceptances, promissory notes, commercial paper, including those of foreign issuers rated by DBRS: R-1(low) Fitch: F-1 Moody's: P-1 S&P: A-1(mid)	5.0%					
Asset-backed commercial paper (minimum of two ratings: R-1(high) by DBRS, F-1+ by Fitch, P-1 by Moody's, or A-1+ by S&P)	7.5%					
Covered bonds (based on issuer rating) rated by DBRS: AA(low) or better Fitch: AA- or better Moody's: Aa3 or better S&P: AA- or better	3.0%	3.5%	4.0%	6.5%	8.5%	9.0%
Covered bonds (based on issuer rating) DBRS: A(low) to A(high) Fitch: A- to A+ Moody's: A3 to A1 S&P: A- to A+	5.0%	5.5%	6.0%	8.5%	10.5%	11.0%
Corporate and foreign-issuer bonds rated by DBRS: AA(low) or better Fitch: AA- or better Moody's: Aa3 or better S&P: AA- or better	3.0%	3.5%	4.0%	6.5%	8.5%	9.0%
Corporate and foreign- issuer bonds rated by DBRS: A(low) to A(high) Fitch: A- to A+ Moody's: A3 to A1 S&P: A- to A+	5.0%	5.5%	6.0%	8.5%	10.5%	11.0%
Securities issued by the United States Treasury**	1.0%	1.0%	1.5%	3.0%	4.5%	

* For securities with a remaining maturity of up to one year, margins are adjusted by term divided by 365.

** An additional 4% (not adjusted for term divided by 365) will be added to the margin requirements for securities issued by the US Treasury to account for foreign exchange risk.

Notes: Non-mortgage loan portfolio: The Bank will provide a collateral-to-portfolio value of 60%; i.e. 60% of the reported value of the loan portfolio, implying a haircut of 40%.

Source: Bank of Canada, RBS

X. 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. In our opinion, this is driven by the macro-economic benefits of covered bonds through the provision of cheap residential (and commercial) mortgages and by giving banks a stable and relatively low-cost additional funding channel. However, there is no uniform approach and stances towards covered bonds by the various central banks differ considerably. Broadly speaking, covered bonds receive more favourable treatment in those countries where they play a more pivotal role in the funding of the domestic banking sector. This applies primarily in terms of eligibility of covered bonds as collateral for repo operations, but also in terms of the haircuts.

2.4 COVERED BONDS VS. OTHER ASSET CLASSES

By Florian Eichert, Crédit Agricole and Jan King, RBS

I. INTRODUCTION

In the past, a traditional ranking of bond spreads would have always had sovereign spreads trade the tightest followed by sub-sovereigns and agencies, and then covered bonds followed by senior unsecured debt. However, with the financial crisis and the subsequent sovereign debt crisis, this ranking as well as the differences between these products has been profoundly shaken up.

Instead of trading with a significant pick-up compared to the respective sovereign, covered bonds in countries such as Spain, Portugal or Italy started to trade at levels significantly inside their respective sovereign and sub- sovereign debt while senior unsecured debt at first widened to levels vs. covered bonds well in excess of their pre-crisis levels only to come back to trade even inside covered bonds in some cases.

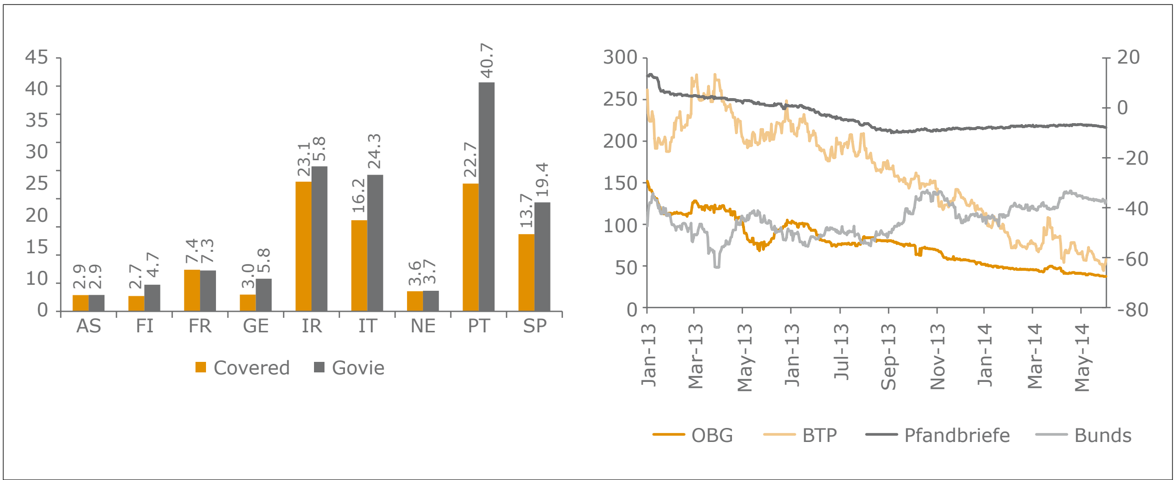
In this article we will take a look at how spreads have evolved between these products. We will assess what the rationale is for the differences and show how investors deal with the situation and why they buy at the levels they buy.

II. SPREAD OVERVIEW COVERED BONDS VS. SOVEREIGN DEBT AND SENIOR UNSECURED

The last months have been characterized by a general spread compression theme across asset classes. This has driven absolute spread levels down but also reduced the spread differences between covered bonds, senior unsecured and sovereign debt. One of the main strengths covered bonds have shown throughout the crisis has been pushed somewhat into the background – their superior spread stability compared to senior and sovereign debt.

Looking back to the more volatile times during the crisis though, covered bond spreads had held up remarkably well if compared to sovereign debt. They were much slower to react when markets were widening and the ultimate widening was less pronounced than that in sovereign space (the downside to this has been that in tightening periods they were lagging as well). When looking at rolling 90d standard deviations of 5Y covered bond as well as sovereign spreads, covered bonds showed the lower volatility in almost all markets in the sample.

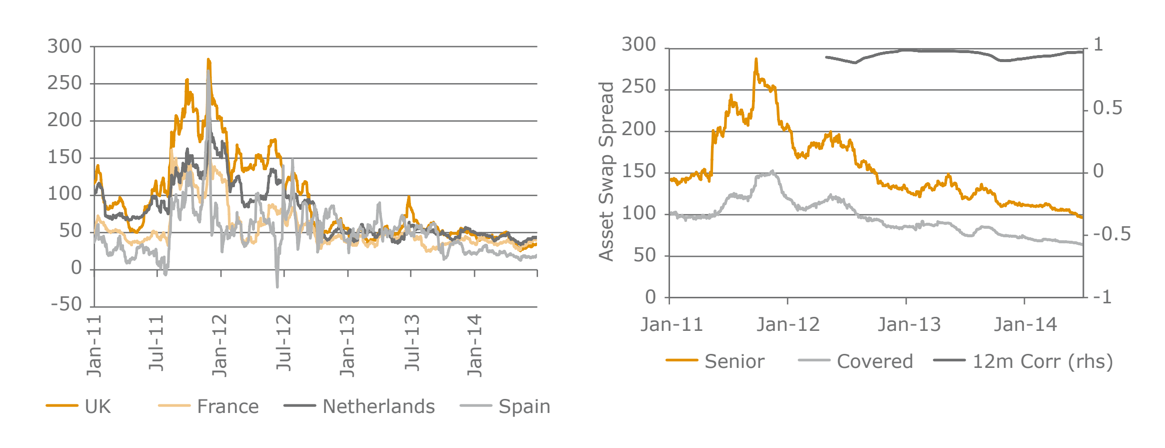
> FIGURE 1: ROLLING 90 DAY STANDARD DEVIATION ASSET SWAP SPREADS 5Y COVERED AND SOVEREIGN BONDS 2011-2014



Source: Bloomberg, Crédit Agricole CIB

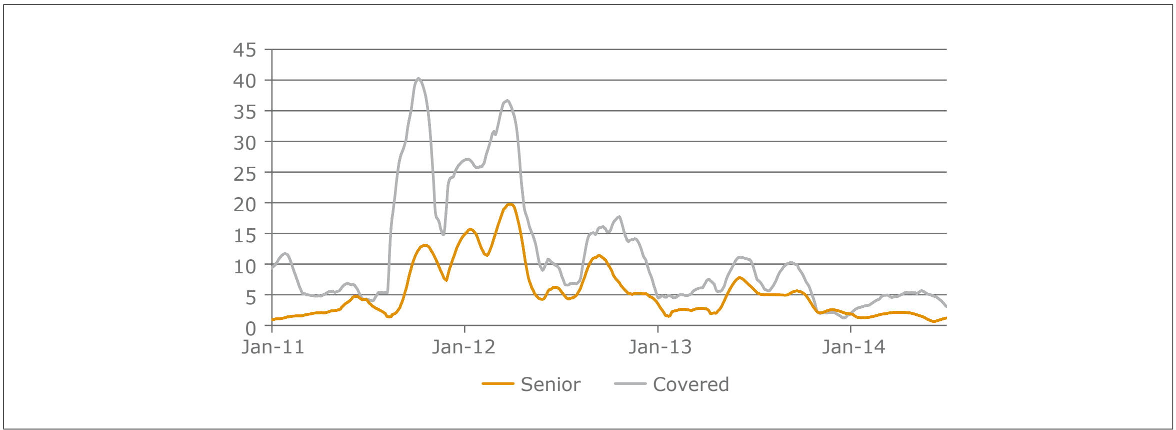
Volatility of the average spread differentials between covered bonds and corresponding senior unsecured paper across various jurisdictions has eased over the past couple of years as a result of the expansive monetary policy in the euro area. Nevertheless, spread differentials between senior unsecured debt and covered bonds can vary considerably between individual issuers, reflecting idiosyncratic risks in the Probability of Default (PD), different levels of structural subordination, or rating differentials. However, the correlation between both asset classes is strongly positive. In Figure 2 below, we compare individual bond pairs with 2017 maturity, allowing a maximum maturity mismatch of three months within each pair. The rolling 12-month correlation has fluctuated between 0.85 and 0.98 over the past couple of years – both at the short-end (shown in the figure) and the medium part of the maturity spectrum. A comparison of 90-day rolling standard deviations of the respective asset swap spreads shows greater stability of covered bond spreads than of senior unsecured paper, particularly in times of severe market stress such as in late 2011 as well as early and mid-2012.

> Figure 2: Senior unsecured minus covered bond spreads by country (left) and senior unsecured vs covered Bond Spreads, 2017 maturities vs 12-month rolling correlation (right)



Source: Bloomberg, RBS

> Figure 3: 90-day standard-deviation of senior unsecured ASW vs covered bond ASW



Source: Bloomberg, RBS

Central bank haircuts

Before going into the fundamental factors driving each product pair (covered vs. senior and covered vs. sovereign debt), we want to provide a brief overview of how the various products are treated for repo purposes (see also Article 2.3).

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 a counterparty's default. These measures encompass initial margins, valuation haircuts, variation margins, limits, additional guarantees and exclusions. The value of the underlying asset is calculated as the market value of the asset less a certain percentage ("valuation haircut").

> FIGURE 4: EUROSYSTEM REPO HAIRCUTS

	Liquidity categories								
	I		II		III		IV		V
AAA to A-	Government Bonds		Local & Regional Govt, Supras & Agencies, Jumbo Covered Bonds		Traditional Covered Bonds, Structured Covered Bonds, Multi-Issuer Covered Bonds, Corporate Bonds		Unsecured Bank Bonds		ABS
Residual maturity (years)	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed / Zero coupon
0-1	0.5	0.5	1.0	1.0	1.0	1.0	6.5	6.5	10.0
1-3	1.0	2.0	1.5	2.5	2.0	3.0	8.5	9.0	10.0
3-5	1.5	2.5	2.5	3.5	3.0	4.5	11.0	11.5	10.0
5-7	2.0	3.0	3.5	4.5	4.5	6.0	12.5	13.5	10.0
7-10	3.0	4.0	4.5	6.5	6.0	8.0	14.0	15.5	10.0
>10	5.0	7.0	8.0	10.5	9.0	13.0	17.0	22.5	10.0
Retained CB	**+13% (+5% for non marketable + 8% for retained)**								
BBB+ to BBB-									
Residual maturity (years)	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed / Zero coupon
0-1	6.0	6.0	7.0	7.0	8.0	8.0	13.0	13.0	22.0
1-3	7.0	8.0	10.0	14.5	15.0	16.5	24.5	26.5	22.0
3-5	9.0	10.0	15.5	20.5	22.5	25.0	32.5	36.5	22.0
5-7	10.0	11.5	16.0	22.0	26.0	30.0	36.0	40.0	22.0
7-10	11.5	13.0	18.5	27.5	27.0	32.5	37.0	42.5	22.0
>10	13.0	16.0	22.5	33.0	27.5	35.0	37.5	44.0	22.0
Retained CB	**+17% (+5% for non marketable + 12% for retained)**								

Notes: Please note that for Credit Quality Step 3 (BBB+ to BBB-), ABS (liquidity category V) are eligible for repo operations on a temporary basis. This is part of the ECB's package of temporary policies in response to the crisis; in 'normal times', this specific asset class is not eligible for repo operations with the ECB.

Source: Eurosystem, CréditAgricole CIB

The ECB applies different valuation haircuts for covered bonds and senior unsecured debt as shown in the figure above. While covered bonds belong to liquidity categories II and III, unsecured bank bonds are in liquidity category IV with substantially higher haircuts. Moreover, covered bonds have been exempt from the

ECB's close-link prohibition under which a bank cannot submit its own senior unsecured bonds as collateral. Own-name covered bonds are accepted, subject to additional haircuts.

When comparing covered bonds vs. sovereign debt on the other hand one can see that sovereign debt still gets the most favourable treatment by the Eurosystem. Covered bonds are not far behind though. For a 5Y AAA jumbo covered bond in category 2, the haircut differential is a mere 2% while for a covered bond from category 3 the difference is 2.5%.

For repo purposes we thus still have the old traditional ranking between asset classes. Sovereign debt is treated best, covered bonds follow closely behind and senior unsecured exposure has the highest haircuts and the most limitations (close link rule).

III. WHICH FUNDAMENTAL FACTORS DRIVE COVERED BONDS VS. SENIOR UNSECURED?

Comparing covered bonds and senior unsecured bank debt is ultimately a choice of where to invest within a bank's capital structure. Both asset classes are senior bank liabilities. Senior unsecured debt is structurally subordinate to covered bonds due to covered bond holders' preferential claim on the cover pool, on which senior unsecured creditors have a claim on only after covered bond holders and other preferred creditors have been fully repaid.

The relative value between both asset classes is driven by various aspects:

> **Probability of default**: Covered bonds are structured to survive an issuer event of default and not to accelerate automatically. As a result, the *conditional* probability of default (PD) of a covered bond (the product if the issuer's PD and the probability of payment interruptions on the covered bonds post issuer default) should typically be lower than the senior unsecured PD, which represents the cap for the covered bond PD. The strength of the covered bond framework plays a major role here. This includes provisions for an effective segregation of cover assets and privileged derivatives in an insolvency scenario as well as (structural) features to mitigate liquidity risks such as liquidity buffers or different repayment structures.

> **Recovery rate**: Different recovery rates are a major determinant between covered bonds and senior unsecured paper. In a default scenario, covered bond holders benefit from the double recourse to both the cover pool and to the issuing bank, ranking *pari-passu* with senior unsecured investors should the cover pool be insufficient for a full recovery. Senior secured issuance structurally subordinates senior unsecured creditors, reducing their recovery expectations. Not only the over-collateralisation ratio but also the quality of the collateral is a decisive factor for the expected recovery of covered bond holders relative to senior unsecured creditors.

> **Bail-in risk**: Systemic support has been the main determinant for the very low default rates on senior unsecured bonds despite a number of bank failures that occurred during the financial crisis. However, bail-in risk has become a new factor to the relative value equation. Market participants and rating agencies are both still in the process of assessing the likelihood of burden-sharing for senior unsecured creditors in a resolution scenario. While covered bonds have been generally exempt from bail-in under the European bank resolution framework, for example (with the exception of any under-collateralised part), senior unsecured creditors could be subject to (mandatory) burden-sharing before resolution funds can be tapped or taxpayer money injected.

> **Regulatory treatment**: Covered bonds are treated favourably to senior unsecured paper in a number of regulatory frameworks, such as the Capital Requirements Regulation (CRR) where lower risk-weights are assigned to covered bonds, the liquidity coverage framework where senior unsecured paper is not eligible, and Solvency II where covered bonds benefit from lower risk factors or the UCITS Directive allowing for higher investment limits in covered bonds. Unfavourable regulatory treatment can either exclude certain investor groups or lead to higher spreads being demanded as compensation for additional cost on the investment in senior unsecured bonds relative to covered bonds.

> **Central bank repo eligibility and haircuts**: For bank investors, central bank repo eligibility is an important factor when structuring their liquidity portfolios. If eligible, central banks apply higher haircuts to senior unsecured bank paper than covered bonds. Higher haircuts increase banks' funding costs as the haircut part of the bond posted as collateral needs to be funded using alternative sources.

> **Rating stability and differential**: Rating agencies generally link their rating on covered bonds to the issuer/senior unsecured rating (with few exceptions). The senior unsecured rating is the floor for the covered bond rating, with the uplift depending on asset-liability mismatches, recovery rates, and legal and structural aspects. Covered bond ratings tend to be less volatile than senior unsecured bonds. As most regulations as well as most central bank eligibility criteria contain rating references, the rating differential becomes even more relevant.

> FIGURE 5: PROS & CONS OF COVERED BONDS VS. SENIOR UNSECURED FROM AN INVESTOR'S POINT OF VIEW

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 CRR-eligible 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 > Certain covered bonds (likely) to be eligible as liquid assets under CRR > no risk of bailing-in of the secured claim	> higher yield (although 'spread give up' is currently at low levels) > less benchmark supply at the moment (but plenty of non-benchmark issuance) > often high turnover despite smaller deal sizes (due to lower portion of buy-and-hold investors)

Source: RBS

1. Differences in regulatory treatment

Liquidity Coverage Ratio

The liquidity coverage ratio which was first introduced by the Basel Committee on Banking Supervision in December 2009 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.

At the time of writing, the final rules on the eligibility criteria for the Liquidity Coverage Ratio under the European CRD IV/CRR framework implementing Basel III are still pending. While highly-rated covered bonds are likely to form part of the set of liquid assets, senior unsecured bank bonds will not qualify. The same difference in treatment has been applied in other jurisdictions including, for instance, Canada and Switzerland. In the US, covered bonds are not permitted as liquid assets, according to the latest available proposal.

Bank treasuries require additional spreads to invest in senior unsecured bank paper given that no credit is given towards the LCR as opposed to covered bonds, which will be eligible under most frameworks. Relative value and the break-even spread will further be influenced by the haircut applied to covered bonds under the final rules. Please refer to Article 1.2 of the Key Themes Section and Article 2.2 of the Generic Section for further detail on the Liquidity Coverage Ratio.

Risk-Weights

In times of rising minimum requirements for regulatory capital, risk-weights applied for the calculation of a bank's stock of risk-weighted assets have gained further importance. Regulatory capital is a bank's most expensive source of funding and bank investors are optimising their portfolios taking into account the capital consumption of their positions.

Bank investors based in the European Economic Area (EEA) can apply preferential risk-weights for covered bonds, fulfilling the criteria laid down in Article 129 CRR compared to senior unsecured bank bonds. A lower risk-weight means that banks have to hold less regulatory capital against a given position which benefits the average funding cost and thus the spread which is required. Covered bonds not fulfilling those criteria receive the same treatment as senior unsecured bonds. Please refer to Article 2.2 of the Generic Section, for details on the determination of risk-weights for covered bonds.

Bail-in

In the EU, the Bank Recovery and Resolution Directive (BRRD) was adopted in Q2 2014 together with the Single Resolution Mechanism (SRM). The BRRD defines the triggers for a resolution of a failing bank in the EU and provides the necessary tools while the SRM centralises the decision-making process for the large and cross-border banks in the Euro Area. At the heart of the BRRD lies the bail-in tool. From 2016 on, bail-in of 8% of own funds and bail-in-able liabilities including senior unsecured is mandatory before taxpayer money can be injected. The possibilities for governments to support banks will be narrowed considerably and senior unsecured is at risk of burden-sharing after equity and sub debt.

Covered bonds have been excluded from the list of bail-in-able liabilities. Where appropriate, resolution authorities could exercise bail-in powers to a part of a secured liability that exceeds the value of the assets, i.e. any undercollateralised part or senior unsecured residual claim. On the influence of bail-in on the relative value between covered bonds and senior unsecured, please refer to Article 1.6 of the Key Themes Section.

2. Ratings

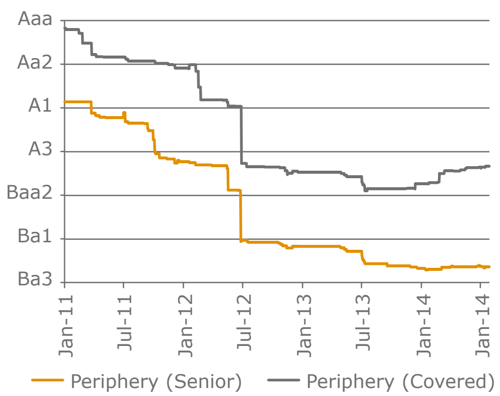
Rating stability

Although investors' rating sensitivity has reduced over the past few years as the market has become accustomed to downgrades during the financial crisis and investment guidelines have partly been adapted to the changing environment, ratings remain a constraint and a significant spread determinant, not least since most regulatory frameworks, indices and central banks use rating references in their eligibility and valuation criteria.

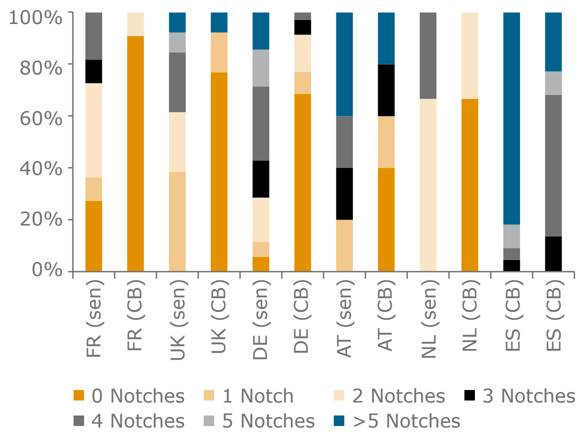
Covered bond ratings are (with few exceptions) not independent from issuer ratings. The issuer rating forms the floor for the covered bond rating and limits its upside due to a linkage to the issuer rating (or the senior unsecured/deposit rating) within the rating methodologies of the major rating agencies. Since 2009, ratings of covered bonds have been negatively affected by issuer downgrades across all countries. Moreover, in some cases, covered bond ratings have been capped due to low sovereign ratings and resulting sovereign ceilings (mainly in peripheral Europe).

Nevertheless, covered bond ratings have shown greater stability than senior unsecured ratings in the downward path of the current rating cycle. This is due to the uplift granted by rating agencies generating a buffer for covered bond ratings against issuer downgrades. The figures below show the average (Moody's) rating trends between senior unsecured and covered bond ratings in the European periphery (Figure 6) as well as the number of notches of rating difference between January 2009 and July 2014 for senior unsecured and covered bond ratings, by number of programmes (Figure 7). The core segments show greater relative stability of covered bond ratings since these have not been affected by country ceilings and therefore could use the available downgrade cushion.

> Figure 6: Trends between senior secured and covered bond ratings



> Figure 7: Notches of rating difference between senior unsecured and covered bond ratings



Source: Moody's, RBS

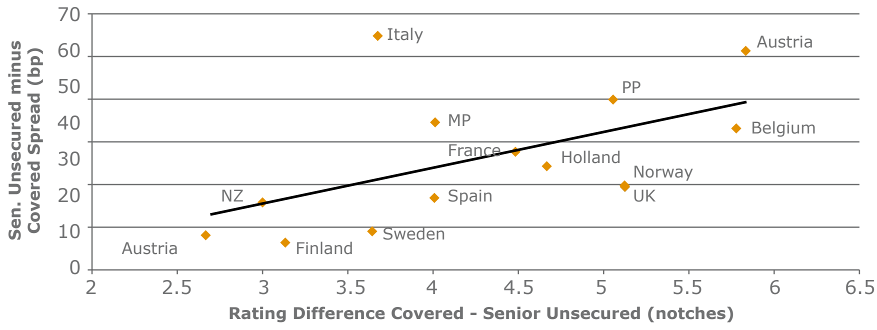
Rating differential

The rating differential between covered bonds and senior unsecured paper is likely to increase further by the time the bail-in tool becomes applicable for senior unsecured bank liabilities in 2016. This regime shift has led rating agencies to review their assumptions for systemic support in banks' senior unsecured/issuer ratings. A large number of banks in the EU, where ratings are based on support on top of their stand-alone credit strength, have been put on negative outlooks. Over the coming 1.5 years, rating agencies will assess the likelihood and the extent to which timely support will be reduced (or whether authorities will try to use loopholes in the Directive to provide support fearing contagion and financial instability risks) and adjust senior unsecured ratings accordingly with a converging trend towards the stand-alone credit quality of the issuer, including group support.

Since covered bonds are not part of the bail-in-able liabilities and have generally been excluded, rating agencies have refined (or are in the process of amending) their methodology to provide additional uplift above the senior unsecured rating depending on the amount of bail-in-able cushion as an additional layer of protection for the covered bonds. The net effect for covered bond ratings depends on the amount of sovereign support that is eventually withdrawn (can be multiple notches in some cases) compared to the additional uplift (1 or maximum 2 notches) and could still be negative.

The likely increase of the differential between covered bond and senior unsecured ratings from the status quo is another sign of covered bonds' higher rating stability and results from a) current leeways being reduced as a consequence of potentially lower issuer ratings if support uplifts are reduced and b) additional uplifts in covered bond ratings following recent (and pending) amendments of covered bond rating methodologies following the adoption of the BRRD.

> FIGURE 8: AVERAGE SENIOR UNSECURED MINUS COVERED BOND SPREAD VS AVERAGE RATING DIFFERENCE



Source: Bloomberg, RBS

Structural subordination

Differences in recovery expectations are another main determinant of the relative value between covered bonds and senior unsecured. Against this backdrop, rising concerns from senior unsecured investors about structural subordination have been a factor supporting the covered bond market. The increased use of covered bond funding by banks over the last several years means that more assets were ring-fenced. As assets in the cover pool are not available to cover the claims of senior unsecured investors in case of issuer insolvency[1], market participants 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 has been exacerbated by rating agencies' demands for higher over-collateralisation levels, which in most cases significantly exceed the legal over-collateralisation requirements and further reduce the amount of assets available for investors outside the cover pool.

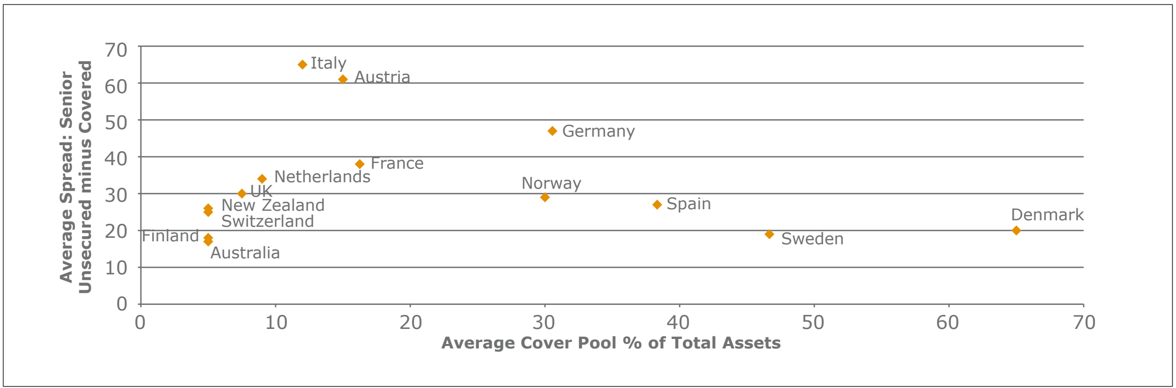
While we understand the concerns in the market, we think asset encumbrance discussions often tend to overstate the problem arising from structural subordination through covered bonds while ignoring other sources of encumbrance (including *contingent* encumbrance when a bank's financial situation deteriorates) such as central bank repos/liquidity assistance as well as 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. Moreover, the potential issuance volume of covered bonds is not unlimited. The availability of eligible assets is a restricting factor for covered bond issuance, putting a cap on the actual issuance potential. Also the aforementioned requirements from rating agencies, of high over-collateralisation levels, further reduce the available headroom for covered bond issuance.

1 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 overcome 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.

Fitch's study on the use of covered bonds published in June 2014 showed that 70% of the covered bond issuers rated by Fitch have a cover pool encumbrance (defined as cover pool in % of adjusted total assets) of less than 20%. Only about 10% of the issuers have a cover pool encumbrance of more than 50%, most of which are specialised mortgage or public-sector subsidiaries of larger banking groups. On average, cover pool encumbrance has remained broadly stable from 2011 to 2013, averaging 10%, according to Fitch data.

Based on the data provided in Fitch's study, taking the mid-point of the range given for individual issuers, we compare the average cover pool as a percentage of total adjusted assets to the average spread differential between covered bonds and senior unsecured, aggregated by country. Figure 9 does not show a direct, isolated correlation between cover pool encumbrance and covered-senior unsecured spread differential which suggests that investors take into account differences in business models (also regarding the strategic importance of covered bond funding) and include offsetting factors mentioned above as well as other sources of encumbrance.

> Figure 9: Comparison of the cover pool as a percentage of total adjusted assets to the spread differential between covered bonds and senior unsecured



Source: Fitch, Bloomberg, RBS

Covered bonds are probably the most transparent but certainly not the only source of asset encumbrance. In order to allow for improved comparability, the EBA published guidelines on the disclosure of unencumbered and encumbered assets (as well as associated liabilities). These guidelines are intended as a first step towards a consistent and harmonised disclosure enhancing comparable information available to investors. Regulators and financial institutions "must make every effort to comply with the guidelines." The template includes a box where institutions are given the possibility to explain the importance of secured funding for their business model and elaborate on the evolution over time with a view to structural and cyclical factors influencing the funding mix. However, the guidelines have been modified to ensure that encumbrance to central banks and central bank liquidity assistance cannot be detected, taking into account concerns about "unwanted effects" such a level of disclosure might have on financial stability. In accordance with Article 433 CRR, asset encumbrance information shall be disclosed at least annually based on median values of at least quarterly data on a rolling basis over the previous 12 months, in conjunction with financial statements. The first disclosures will be made together with FY2014 reports. More extensive guidelines will follow in 2015, which will then eventually be transformed into binding technical standards the EBA has been mandated to set up by 2016.

IV. WHICH FUNDAMENTAL FACTORS DRIVE COVERED BONDS VS. SOVEREIGN DEBT…?

Despite the fact that covered bonds in a number of countries trade well inside their sovereign debt, sovereign risk does fundamentally impact covered bonds. In fact sovereign risk impacts covered bonds to at least some extent in all aspects of the product. The issuer, the cover pool and pool assets, liquidity and refinancing risk in the structure as well as ratings are all impacted by sovereign risk.

> Issuers especially those with a strong domestic presence are directly impacted by a weakening sovereign. Their business prospects deteriorate as a weaker sovereign and a weaker economic situation go hand in hand. In addition to this, many bank treasuries hold substantial volumes of their own sovereign debt making them directly susceptible to widening sovereign spreads.

> Cover pool assets are impacted as well. Weaker economic growth usually means higher unemployment and thus higher NPL ratios. And if one were to spin this scenario all the way to a sovereign default, international demand for housing would most likely collapse with all consequences for house prices and LTVs.

> With very few exceptions, covered bonds are no pass-through securities. Bullet bonds refinance granular loan portfolios and there are mismatches that need to be refinanced via external liquidity. Should a sovereign run into trouble, issuers will find it harder and harder to refinance liquidity mismatches either via further issuance, third party liquidity lines or portfolio sales. Covered bond programs backed by pools that might not even have any problems credit quality wise could thus be impacted negatively.

> For rating agencies sovereigns play a major role in rating covered bonds. They for example link issuer ratings to that of the sovereign unless an issuer has a substantial presence in other countries as well. They factor in sovereign bond spreads into their cash flow cover pool models thus driving up OC requirements in times of sovereign stress. And last but not least, Fitch, Moody's and S&P all operate with sovereign ceilings for structured finance instruments including covered bonds.

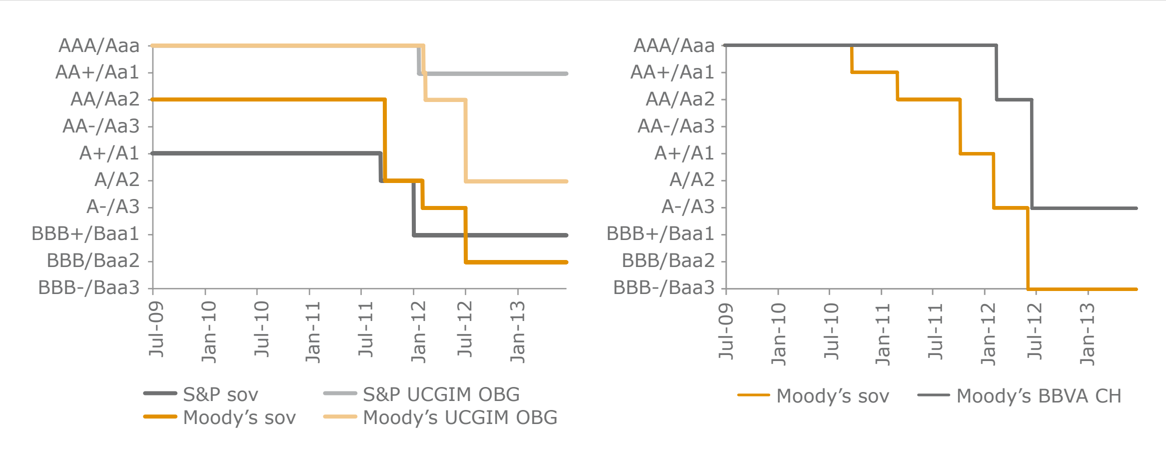
Bottom line is that sovereign risk does play too big of a factor in covered bond structures to just ignore it. Nonetheless there are reasons why in some cases covered bonds can very well trade inside their respective sovereign bond curves.

Rating stability

Despite rating agencies factoring in sovereign ratings into covered bond ratings, they do allow for a certain rating uplift above the sovereign. The maximum uplift depends on the rating agency and collateral type but it can reach up to 6 notches for mortgage backed covered bonds with S&P. Thanks to this uplift covered bond ratings do not react as fast as their respective sovereign ratings. Especially when sovereign ratings start to come under pressure, covered bonds often see their ratings remain stable. Only once the maximum uplift above the sovereign is used up to they start to move as well.

S&P's OBG ratings of Italian national champions for example are still rated 6 notches above the Italian sovereign while Moody's grants three notches of uplift. In addition, the OBG ratings have been much more stable historically than the Italian sovereign.

> FIGURE 10: COVERED BOND VS. SOVEREIGN BOND RATINGS



Source: Bloomberg, CréditAgricole CIB

In Spain, the sovereign is rated Baa2 by Moody's while the Cedulas of at least the better issuers are by now back to A1. And in Portugal, investors that are prohibited from holding non-investment grade debt have Portuguese covered bonds as one alternative as most of them do have investment grade ratings.

Spread stability

Especially when spreads to sovereign debt are positive or only marginally negative, covered bonds offer exposure with a fairly high correlation to sovereign debt in case sovereign debt tightens while protecting investors better against significant spread widening.

One of the reasons for this lagging of covered bonds is certainly the different investor base and less active trading in covered bonds. Buy and hold investors play a much more important role in covered bonds whereas trading accounts are more active in sovereign debt.

Spread volatility is less of a problem for long term buy and hold investors but certainly causes problems for asset managers valuing their funds' assets on a daily basis. It also causes problems for banks VAR calculations. While European banks don't have to hold capital for European sovereign debt, they do have to hold capital to cover the volatility of their trading assets. And the more volatile a certain asset is, the more capital banks have to hold. Spread stability of covered bonds has thus a very feasible economic value and reduces the overall capital consumption difference to sovereign debt.

ECB repo efficiency

Bank investors are a major investor base in both sovereign debt as well as covered bonds. One of the main things bank treasuries focus on when investing is the repo efficiency of an investment. The lower the haircuts and the less volatile prices, the better.

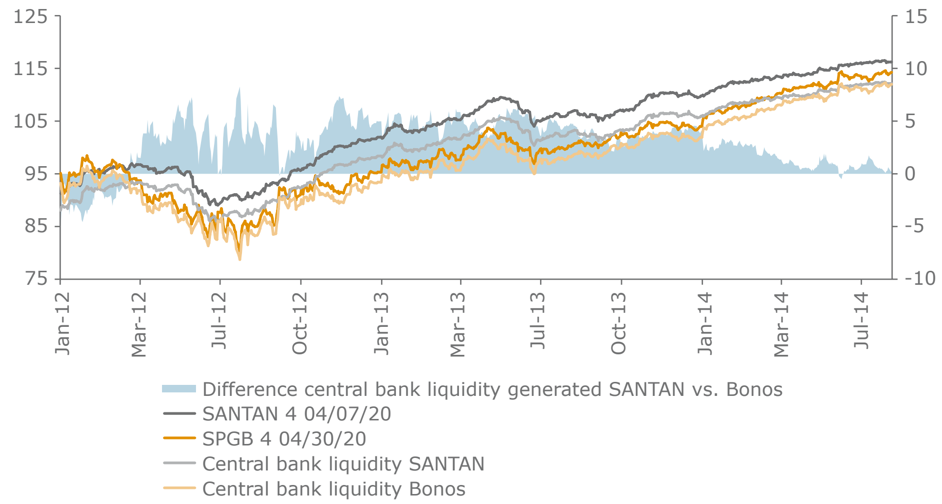
As mentioned above, repo haircuts for covered bonds are fairly similar to those of sovereign debt as long as both are rated at least A- by one rating agency (the best rating is relevant for this purpose). Currently most covered bonds in the market fall into the lower haircut table, even if in some cases they only benefit from this thanks to their DBRS rating. The haircut for a 4Y jumbo covered bond is 3.5% while the equivalent sovereign bond has a haircut of 2.5%. In case of below 1bn benchmark covered bonds, the haircut is slightly higher at 5% but this doesn't materially change the outcome of our comparison.

If we look at two bonds with identical coupons and similar maturities, the one with the significantly tighter spread is trading at the higher price and thus generating more central bank liquidity (liquidity is measured based on market price minus haircut). When running this comparison between sovereign bonds and covered bonds, sovereign debt is the clear winner in virtually all core countries thanks to slightly lower haircuts but most of all lower spreads and higher prices.

However, in some peripheral countries, covered bonds have been able beat their sovereign pendants when it comes to ECB liquidity generated throughout the crisis. The liquidity advantage was also highest whenever the degree of stress in the market was highest, which is exactly when banks require stable central bank liquidity the most.

The SANTAN 4 07/2020 Cedulas Hipotecarias was generating almost 6 points more cash from repoing it with the Eurosystem than the SPGB 4 03/2020 at the height of the sovereign crisis. And what adds to the argument is the higher degree of price stability of Cedulas. Not only was it generating more liquidity, it was generating the more stable liquidity.

> FIGURE 11: LIQUIDITY GENERATED FROM REPOING 7Y SANTANDER CEDULAS VS. 7Y BONOS



Source: Bloomberg, Eurosystem, CréditAgricole CIB

This rationale obviously only works for covered bonds, that are already trading deeply inside sovereign debt as mentioned and only in instances where coupons and maturities are comparable. It does not work for covered bonds in core sectors where sovereign debt is still the more ECB repo efficient tool in general. And even in the periphery, the situation is very rating dependent. Below A-, the pendulum swings back towards sovereigns even in countries such as Spain as the repo haircut differences become bigger. Last but not least, one could argue that the liquidity argument is more a reaction to than a cause for negative covered-sovereign spreads.

Bottom line is repo efficiency is not something that would drive covered bonds deeply into negative spread territory relative to sovereign debt. But it is certainly a factor in stabilising spreads once they get there, as it becomes a self-enforcing factor which weighs more the deeper negative spreads are.

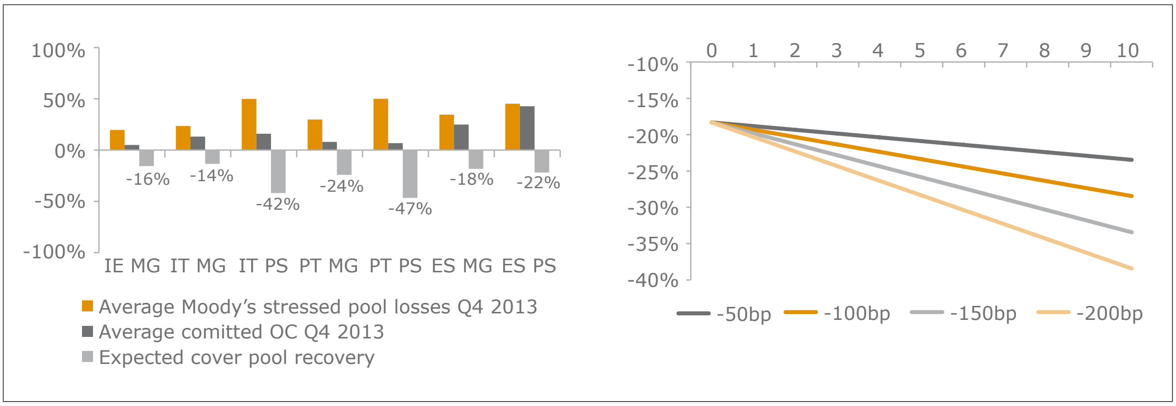
Tail risk – expected recoveries

One of the most powerful arguments that can be brought forward to defend negative covered-sovereign bond spreads is the expectation that tail risk in covered bonds is less than it is in sovereign debt. Especially many long term investors such as insurance have started to feel more comfortable with the collateralised claim than the sovereign debt during the sovereign crisis.

When making this argument, it is important however to go one step further as the validity of this statement depends on the actual pool backing the covered bonds, the framework regulating it and most importantly as well the issuer itself. Chances that this view will prove right are much higher for high quality residential mortgage backed covered bonds from a country with a strong framework that are issued by a systemically important bank than lower quality public sector backed covered bonds issued by a small non-systemically important issuer. Another important aspect is that the stronger a sovereign is the less relevant are considerations about tail risks and recoveries while they become much more important where sovereigns are in a difficult situation.

It is hard to estimate cover pool recoveries based on issuer reporting. Rating agencies such as Moody's however publish the results of their own cash flow modelling of cover pool assets and liabilities. Moody's stressed pool losses are the loss the agency expects should a cover pool be wound down. One can use this number and apply it to a pool which is left with legal minimum OC to come up with an estimated recovery rate. For Spanish mortgage cover pools for example the estimated loss is in the region of 20% (committed OC of 25% and stressed pool losses of 35%).

> Figure 12: Committed OC, Moody's stressed pool losses, and required sovereign haircut to be better off with covered bonds



Source: Moody's, Crédit Agricole CIB

This estimated pool recovery figure can be used to either estimate cash prices below a purchase should result in a positive return even if both the bank and the covered bonds default. It can however also be used as a proxy for the required haircut on a sovereign bond that would make the covered bond the better option. In the Spanish case for example, if a sovereign haircut on Spain were to be in excess of 20%, the expected recovery on the Cedulas would be higher. If investors believe the haircut is lower, sovereign debt would be the better option.

If one adds the negative covered-sovereign spread in Spain to the equation, for example in case of Cedulas levels 100bp inside Bonos, the Bonos obviously produces 100bp extra carry p.a. which in effect means that the Bonos investor builds up an additional buffer or 1% p.a. and that this expected recovery moves by 1% to the disadvantage of covered bonds per year. In other words, the better recovery on covered bonds has its price and at some point, the balance shifts to the sovereign debt depending on the cover pool quality, strength of the bank and framework.

What this calculation does not take into account though is the probability that some banks can very well survive a sovereign debt restructuring (via capital support by the domestic sovereign or a European entity and liquidity support by the Eurosystem) and that, irrespective of potential pool recoveries, covered bonds could be the better choice. Countries need to maintain a basic level of banking services and sovereigns would most likely re-capitalise at least some of the country's large retail banks immediately after the sovereign debt restructuring. National Bank of Greece is the best example for this.

IMF comments

The International Monetary Fund (IMF) published a document last year called "Sovereign debt restructuring – recent developments and implications for the fund's legal and policy framework". One of the results of the review is a call for an earlier as well as more frequent involvement of private sector investors in sovereign debt restructurings. The IMF even discusses making private sector involvement a pre-condition for IMF involvement:

> "For example, a presumption could be established that some form of a creditor bail-in measure would be implemented as a condition for Fund lending in cases where, although no clear-cut determination has been made that the debt is unsustainable, the member has lost market access and prospects for regaining market access are uncertain."

The IMF does tone down this statement by saying that they would be mainly focussing on maturity extensions rather than outright debt write-downs and that they want to cushion the impact via other measures. Also, for now, this is nothing but a discussion paper by the IMF's, not a final policy document.

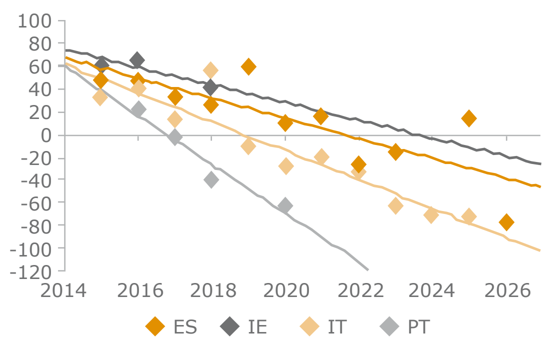
The bottom line is however, investors holding sovereign debt could be involved more frequently and at an earlier stage if things go wrong. Also don't forget collective action clauses that have been inserted in sovereign bond documentations. Covered bonds on the other hand have so far survived all sovereign rescues the IMF was involved in starting from Ireland, to Portugal, Greece and Cyprus.

As such, especially in weaker countries these discussions should profit covered bonds relative to sovereign debt and be looked at as an additional rationale for negative covered bond – sovereign bond spreads. Will they drive Pfandbrief – Bund spreads? Highly unlikely.

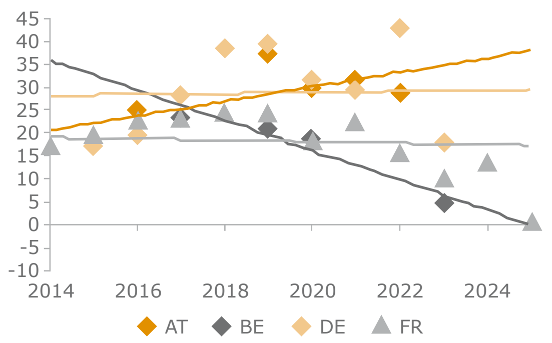
How should the covered – sovereign differential be priced…?

There are specific factors which drive the covered bond vs senior unsecured relationship, there are fundamental factors driving the covered bonds – sovereign debt relationship as well. In a very simplified approach, on the one end there is the higher liquidity of sovereign debt compared to covered bonds while on the other end, spread stability and potential recoveries speak in favour of covered bonds. The liquidity argument pro sovereign debt is valid across the curve. However while spread stability as well as recoveries are no major topics at the very short end, these topics become more and more relevant the longer a bond is. Consequently covered bond – sovereign bond spread curves should slope downwards over time. And the weaker the sovereign, the stronger the cover pool and the less volatile a covered bond program is the steeper should the curve slope downwards.

> FIGURE 13: COVERED GOVIE SPREAD CURVES PER COUNTRY (BP)



> FIGURE 14: COVERED GOVIE SPREAD CURVES PER COUNTRY (BP)



Source: Bloomberg, CréditAgricole CIB

There are a number of countries where we can witness a negative slope in the market. And the curve steepness is also steeper in peripheral markets compared to core sectors.

This does not yet say anything about the absolute level of covered-sovereign spread that is acceptable to investors. In the current low yield and very squeezed environment, spreads between the two products have moved sideways between 15 and 30bp for months while in the periphery they have come back to around -20 to flat.

V. HOW DO INVESTORS MANEUVER BETWEEN THE PRODUCTS?

Covered-senior

We believe that one of the reasons for dislocations in spreads between unsecured and secured bank debt has been the limited overlap of senior unsecured and covered bond investors. Many investors still cannot directly play opportunities that arise between both asset classes. The main reasons for the limited overlap are in our view: (1) central banks and sovereign wealth funds are large buyers of covered bonds but not of senior unsecured debt, (2) banks are one of the biggest investor groups in covered bonds and regulatory provisions favour covered bonds, (3) asset managers and pension funds often have higher limits for covered bonds than for senior unsecured bank debt, and (4) both asset classes are usually bought for different dedicated portfolios. In addition, covered bonds are sometimes used to enhance the yield of sovereign bond portfolios without diluting the average rating, or added to genuine credit portfolios to improve the portfolio rating quality.

Anecdotal evidence from analysing order books over time, however, suggests that the overlap in the investor base has increased in recent years due to a higher participation of credit investors in new covered bond issues. We expect this trend to continue over the coming years and credit investors to account for a growing portion of covered bond order books going forward, not least because of the bail-in risk for European senior unsecured debt with maturity dates of 2016 and beyond and the relative value opportunities this will create between these two asset classes.

Furthermore, in the current low-yield environment, spreads between covered bonds and senior unsecured paper are to a large extent driven by technicals which maintain spreads at a level below fundamental values. Investors' current behaviour on senior unsecured bonds seems to be driven by short-term yield hunting and in general by a rather squeezed market which is also due to banks' focus on equity and subordinated debt issuance to shore up their regulatory capital ratios ahead of the ECB's asset quality review and stress test.

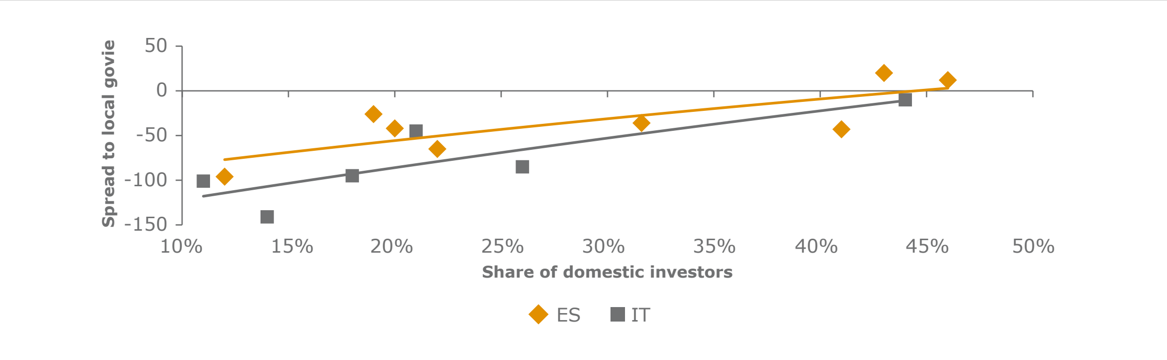
Covered-sovereign

The last year or two have seen a major shift in opinion on the part of investors when it comes to the acceptance of negative covered – sovereign bond spreads. What was initially laughed at as a technical market anomaly and then slowly accepted in secondary markets is by now broadly accepted for especially stronger issuers from the peripheral markets amongst investors even in primary markets.

It is important to note at this point though that not all investors focus on the spread to local sovereign debt. Similar to some senior unsecured investors not caring much about covered bond levels and buying at very tight levels relative to covered bonds, there are investors that will not focus on the sovereign spread. The biggest focus on this relationship can probably be found amongst domestic investors. For many of them the sovereign is still the relevant benchmark and buying into products that produce a significant negative carry vs. the own benchmark is always problematic.

Consequently, when looking at investor distributions of 5-7Y EUR benchmark covered bonds from Spain and Italy in 2011-13, the share of domestic investors has become smaller the deeper inside sovereign debt a new issue was priced. What is relevant for domestic investors is in some cases not relevant for international accounts though.

> Figure 15: Share of domestic investors and new issue spread to local sovereign debt 2011-2013



Source: Bloomberg, The Cover, Covered Bond Report, IFR, CréditAgricole CIB

In our experience there are two kind of investors buying covered bonds well inside sovereign debt – those who are forced to do so while not being convinced of the rationale for negative spreads and there are those who actively build up exposure as they feel negative spreads are fundamentally justified.

There have been benchmarked investors that were literally forced into covered bonds even at deeply negative spread levels to the respective sovereign. These accounts often received fresh cash inflows and as they didn't want to fall behind their benchmark weights had to invest. During much of the last months, covered bond secondary markets have been bid only, especially in the periphery so buying in the primary market was virtually the only choice to build up exposure. These investors did buy but they did so reluctantly rather than out of a very strong conviction. Should net supply become more positive again and the squeeze in secondary markets become somewhat less pronounced, these accounts will very likely move back to buying only with a positive spread to sovereign debt.

The other group of accounts does however accept the negative spreads because they fundamentally believe that they make a lot of sense. Bank treasuries have bought to diversify their sovereign holdings and save VAR limit space while only needing marginally more capital. Asset managers and especially some insurance companies have increasingly taken the view that the tail risk in covered bonds is lower than it is in sovereign debt and that covered bonds can in fact be the least risky asset in a distressed country. This has been especially relevant when talking about covered bonds issued by systemically important banks and backed by residential mortgages (which are the most politically protected cover asset type there is).Examples such as National Bank of Greece covered bonds and the Greek sovereign debt has led to a reassessment on the potential outcomes if things go really bad and supports this strategy.

These investors therefore allocate a bigger portion of their long term buy and hold investments in especially the higher risk countries towards covered bonds and away from sovereign debt. And if one thinks in recovery terms and ignores the liquidity premium of covered bonds (as many of these investors would intend to hold to maturity anyways), the flexibility to accept a negative spread to the sovereign bonds becomes very large all of a sudden.

VI. WRAP UP

We are currently living in a low interest rate, low volatility and low issuance environment. The strengths of covered bonds do not particularly shine during such times. Consequently much of the spread moves of the last months across asset classes have been the result of squeezed markets and the low yield environment and this combination has pushed investors to look for carry wherever they could find it. For the time being the biggest strength of covered bonds – their stability - has been pushed to the background.

When looking at the covered bond – senior unsecured spread relationship this hunt for yield has clearly been the dominating theme. The benefits covered bonds offer to investors and the changing regime for senior unsecured debt coupled with lower ratings have been pushed back to a big extent as senior markets were even more undersupplied than covered bond markets while they were still offering a slight pickup.

When looking ahead the ECB’s TLTRO announcement is likely to cement this status quo for yet even longer. Situations such as BES however should make it clear for everyone that it doesn’t even need a bail-in at the senior level to be worse off with senior unsecured debt. The current carry simply offers little protection against normal market volatility.

In the covered bond – sovereign bond relationship, there has been a strong squeezy element as well that has enabled covered bond issuers to issue well inside their respective sovereign curves. There has however also been an element of fundamental belief by some investors in covered bonds being the most stable and least risky debt type from a distressed country.

More and more investors have in fact been giving covered bonds a bigger role in the strategic asset allocation, representing a stable core exposure to a certain country. Sovereign debt has increasingly been used as a tool for tactical asset allocation and for implementing trading strategies. Obviously we are not talking about a sudden shift, rather a gradual process but it is happening nonetheless.

2.5 USD AND GBP DENOMINATED COVERED BOND MARKETS

While new issuance has been on hold YTD, both the USD- and GBP-denominated markets remain strategic for covered bonds offering notably diversification opportunities. They benefit from different dynamics than the EUR-denominated market as detailed below. This is notably driven by differences in terms of regulatory treatment (e.g. with respect to Basel's Liquidity Coverage Ratio). From an investor perspective, USD- and GBP-denominated covered bonds may also offer cross-currency arbitrage opportunities depending swap costs which are worth monitoring.

2.5.1 USD DENOMINATED COVERED BOND MARKET

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

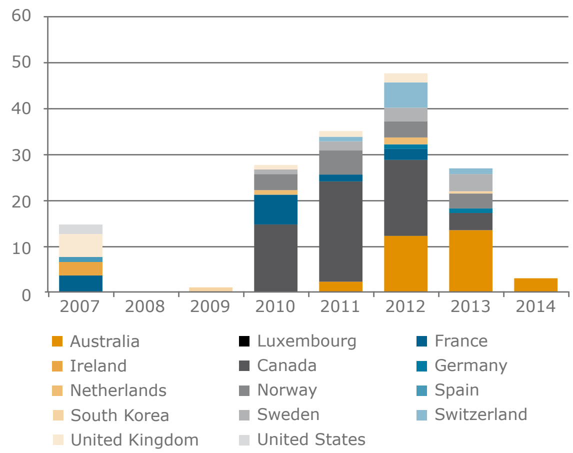
USD ISSUANCE FALLING, BUT STILL A KEY MARKET WITH GREEN SHOOTS

Issuance of USD-denominated covered bonds declined in 2013, with USD27bn of benchmark bonds issued, compared with USD48bn in 2012 (fixed rate, benchmark size, public issuances). Issuance looks set to fall further in 2014, with only two USD-denominated bonds issued up to June 2014, totalling USD3bn.

Prior to 2013, Canadian banks had been the main issuers of USD covered bonds, but they have issued very little since 2013 as they have been adjusting their programmes to comply with the new legal framework, which was finalised in December 2012. Although Canadian issuers have resumed issuance under the new framework, this was mainly in the EUR-denominated market during 2H13-1H14. However, since May 2014, USD issuance appears to be becoming less expensive relative to EUR issuance (taking into account swap costs), which may prompt greater USD issuance from Canada and other countries, as detailed below.

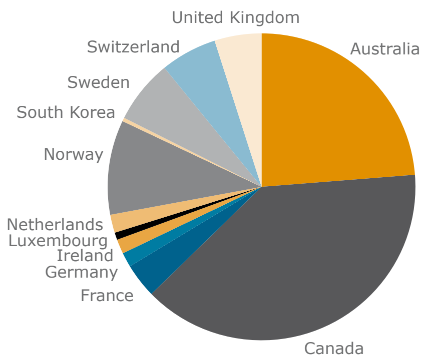
Despite the shrinking issuance, the USD market remains the second-largest covered bond market. Along with the potential resumption of Canadian issuance, Asian issuers may increasingly use this market going forward given the significant USD usage for trade and borrowing in several Asian countries. Both Singapore and South Korea have finalized their covered bond legislation. Furthermore, although technicals have been favourable for EUR issuance, in part because of a regulatory preference for covered bonds in Europe, as well as a beneficial (but narrowing) currency basis for EUR issuance, European issuers can also be expected to attempt to maintain a USD curve, in part to remain a familiar name with USD investors.

> FIGURE 1: USD-DENOMINATED BENCHMARK ISSUANCE BY COUNTRY (USD BN) [1]



Source: BofA Merrill Lynch Global Research;
[1] Ecluding FRNs, public deals only; 2014 is as of end-June

> FIGURE 2: USD-DENOMINATED OUTSTANDING BENCHMARKS BY COUNTRY END-JUNE 2014 (USD BN) [2]



Source: BofA Merrill Lynch Global Research;
[2] Including taps; excluding FRNs, public deals only

NOTABLE DIFFERENCES WITH THE EUR MARKET

We believe several differences distinguish the USD covered bond market from its EUR counterpart, including:

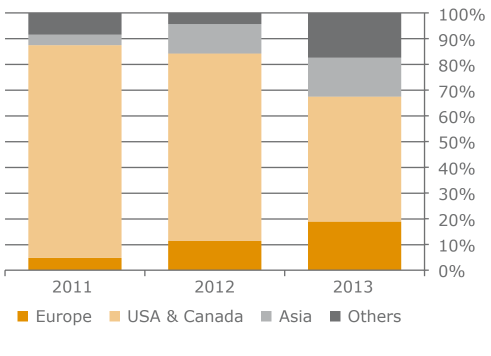
> **Issuers:** Initially, the USD covered bond market was a funding alternative for the largest European banks, helping to diversify funding currencies and the investor base. Since the sovereign debt crisis, the market has largely been restricted to the strongest European banks, in part because of the largely AAA nature of the USD market, which generally remains an investor requirement for now. On the other hand, Canadian and Australian banks have increased their market share, having avoided the sovereign debt issues that afflicted many European issuers.

> **Covered bond characteristics:** USD covered bonds are typically large, and are usually "jumbo" like, exceeding USD1bn. This is in contrast with the EUR market, where sub EUR1bn bonds are frequently issued. The average size in 2013 (when the USD market was still active) reached USD1.4bn vs. EUR0.9bn. USD covered bonds are also typically shorter than EUR covered bonds, with an average original maturity of 4.7 years for USD bonds compared with 6.8 years for EUR bonds issued in 2013. USD covered bonds are mainly issued in the 144a format. Given the limited issuance of USD covered bonds, the more restricted investor base for 144a bonds does not appear to have a material impact on liquidity or the pricing of these bonds compared with SEC bonds.

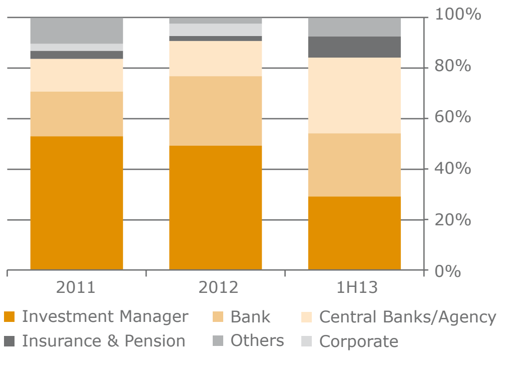
> **Regulation:** covered bonds receive different regulatory treatment around the world. For example, they are in principle going to be favourably treated under the EU implementation of Basel's Liquidity Coverage Ratio (LCR), which has supported demand especially for EUR covered bonds given European banks' asset-and-liability profiles (ALM). Canadian banks can also include covered bonds in their LCR, which is positive for USD covered bonds, while Canadian covered bonds denominated in CAD remain limited. In contrast, covered bonds are not included in the LCR under its US implementation (see separate box below), so the weaker technicals of the USD market are likely to persist. Australia has chosen a similar path as AUD covered bonds are only eligible in the event of asset shortage for the approved liquidity line with the central bank.

> **Investor base:** the majority of investors buying USD covered bonds has been US-based. However, some diversification has been visible in recent years, especially in 2013 with European investors being more active taking advantage of new issuance and/or pricing prospects. Buyers of USD covered bonds have been more opportunistic than in the EUR market as their regulatory treatment has been more in line with other debt instruments.

> FIGURE 3: ALLOCATION OF NEW USD BENCHMARK ISSUED BY GEOGRAPHY



> FIGURE 4: ALLOCATION OF NEW USD BENCHMARK ISSUED BY INVESTOR TYPE

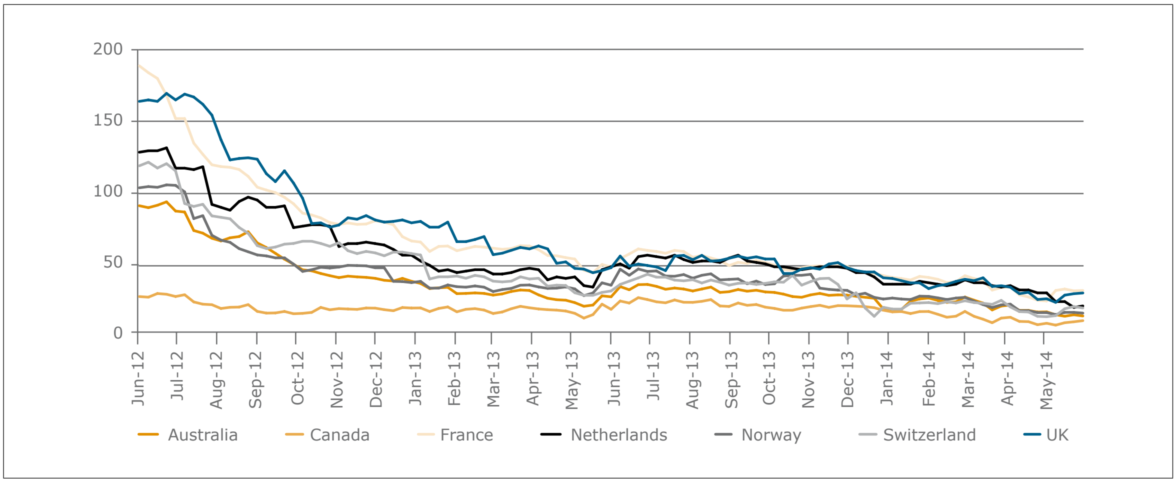


Source: BofA Merrill Lynch Global Research

ARBITRAGE OPPORTUNITIES FADING IN THE SECONDARY MARKET

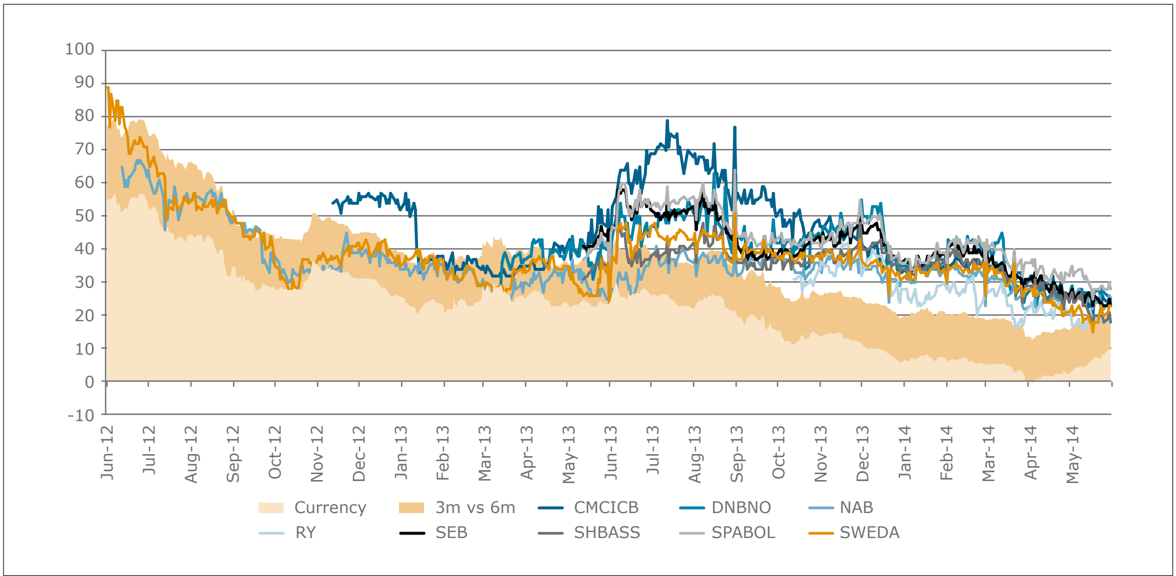
In the secondary market for USD covered bonds, some tiering remains across countries, but the differences have narrowed significantly since 2012. Canadian bonds tend to trade at the tightest levels, followed by Australian bonds (see Figure 5). Bonds from European issuers tend to trade at wider spread levels, though bonds from the stronger European markets (such as the Scandinavian and Swiss markets) only trade a few basis points wide of Australian and Canadian bonds on average.

> FIGURE 5: AVERAGE 1-3YR USD COVERED BOND ASSET SWAP SPREADS BY COUNTRY



Source: BofA Merrill Lynch Global Research

> FIGURE 6: USD MINUS EUR ASSET SWAP SPREAD AND INDICATIVE SWAP COSTS (3-4YR BONDS)



Source: BofA Merrill Lynch Global Research, Bloomberg

We believe that, in general, USD bonds offered value compared with EUR bonds for much of late 2013 and early 2014, after taking into account swap costs. For example, as Figure 6 shows, USD bonds appeared to offer higher spreads than similar-duration EUR bonds from the same issuers, once the cost of swapping currencies and swapping 3M payments typical for USD bonds to 6M payments typical for EUR bonds is taken into account. Our indicative swap costs are based on EUBS4 and EUBSV4 on Bloomberg for swapping currencies and tenor, respectively.

This spread pick-up appears to have narrowed since May 2014, which makes USD bonds relatively less attractive for investors than in prior months, though may prompt increased USD issuance. However, as the figure shows, relative value between the two markets switches from time to time, meaning potential opportunities between the two markets frequently emerge.

U.S. LCR PROPOSAL – IMPACT ON COVERED BONDS

By Jerry Marlatt, Morrison & Foerster LLP

On October 23, 2013, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (the Agencies) published a notice of proposed rulemaking[1] addressing quantitative liquidity requirements for large domestic bank holding companies, savings and loan holding companies, depositary institutions and nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve Board. The notice proposes a liquidity coverage ratio for internationally active depositary institutions and depositary institution holding companies[2] and depositary institution subsidiaries that have USD10 billion or more in total consolidated assets (covered banking organizations).

While covered bonds are eligible as high quality liquid assets (HQLA) for the liquidity coverage ratio under the Capital Requirements Directive in the European Union, covered bonds would not be eligible assets under the proposed U.S. rule.

Under the proposed U.S. rule, the definition of an eligible asset for HQLA expressly excludes any obligation of a regulated financial company, investment company, non-regulated fund, pension fund, investment adviser, identified company[3] or any consolidated subsidiary of the foregoing. The definition of regulated financial company includes a foreign bank. Accordingly, covered bonds issued by a foreign bank would not qualify as eligible assets HQLA because they are obligations of a regulated financial company.

Moreover, in the proposing release the Agencies stated that:

> "The proposed rule likely would not permit covered bonds and securities issued by public sector entities, such as a state, local authority, or other government subdivision below the level of a sovereign (including U.S. states and municipalities) to qualify as HQLA at this time. While these assets are assigned a 20 percent risk weight under the standardized approach for risk-weighted assets in the agencies' regulatory capital rules, the agencies believe that, at this time, these assets are not liquid and readily-marketable in U.S. markets and thus do not exhibit the liquidity characteristics necessary to be included in HQLA under this proposed rule."[4]

A number of comment letters have been filed in response to the proposal requesting eligibility for covered bonds as HQLA and in some cases proponents have met with the Agencies to make the request. The Agencies do not seem disposed at this time to permit covered bonds as eligible assets for HQLA.

1 78 FR 71818 (Nov. 29, 2013).
2 More than $250 billion in total assets or more than $10 billion in on-balance sheet foreign exposure.
3 Any company that an Agency has determined should be treated the same as a regulated financial company, investment company, non-regulated fund, pension fund, or investment advisor.
4 78 FR 71827.

This leaves U.S. banks with little regulatory incentive to buy covered bonds. Not only would covered bonds not qualify for HQLA, but covered bonds do not have the benefit under U.S. rules of the favorable capital treatment for bank investors that is provided in Europe.

The covered bond market in the U.S. is still developing. The market began in 2010 and currently has approximately US$150 B of bonds outstanding. As the market continues to grow and mature, it is possible the Agencies will reconsider the eligibility of covered bonds as HQLA.

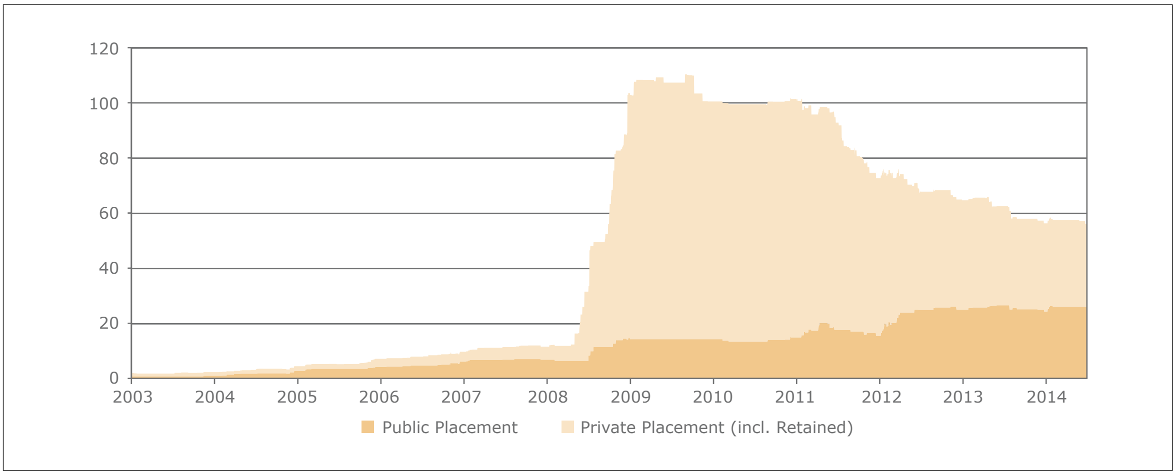
2.5.2 GBP-DENOMINATED COVERED BOND MARKET

By Jan King, RBS

GBP PRIMARY MARKET: STILL IN ITS NASCENT STAGE

After two years of expansion alongside the USD-denominated market with record new issuance volumes, the GBP covered bond primary market has remained fairly quiet since 2013. Total outstanding publicly placed GBP-denominated covered bonds amount to c.GBP26bn, or around 47% of the overall volume (c.GBP56bn), which also includes private placements and retained issuance. Total outstanding volume peaked in 2009, following high issuance volumes of retained covered bonds at the height of the financial crisis, of which large parts have subsequently been redeemed or matured in the following three years.

> FIGURE 7: OUTSTANDING VOLUME OF GBP-DENOMINATED COVERED BONDS OVER TIME IN GBP BN

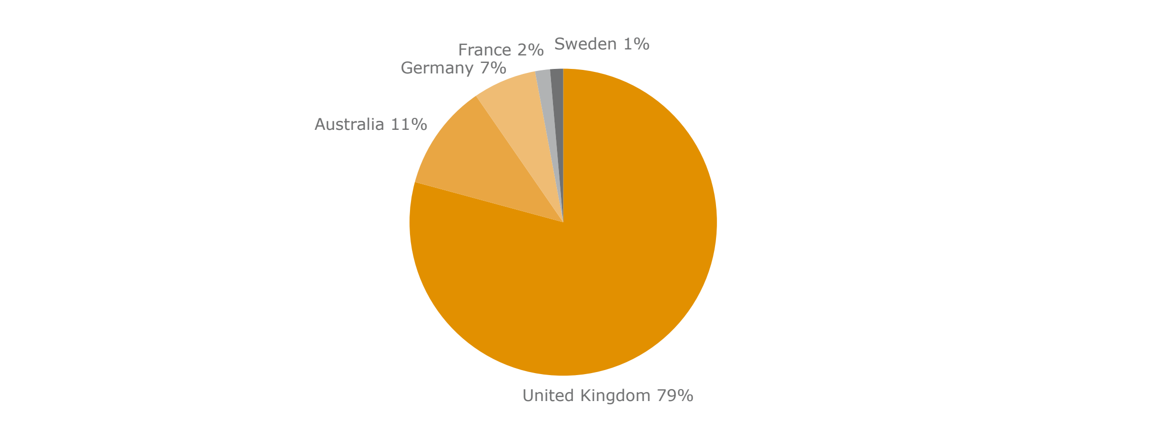


Source: Dealogic, Bloomberg, RBS (data as of 30 June 2014)

In 2012, publicly placed covered bond supply in GBP reached a record volume of about GBP13bn, double the volume of the previous year, driven by strong demand from insurance companies at the long end of the curve, as well as money market funds and bank treasuries at the short end. The GBP market is still in its nascent stage, however, with total supply still a fraction of the issuance amounts we have seen in the EUR or USD segment.

Over the past few years, further non-domestic issuers from Australia, Germany, Sweden and France have chosen to issue in GBP. Issuance in non-domestic currencies has a number of advantages from a covered bond issuer perspective. Besides opportunistic issuance depending on the basis swap valuations to optimise the funding mix, issuers are able strategically to broaden their investor base. Another advantage for issuers is that non-EUR issuance, for instance, reduces the supply in EUR, which should support the valuations of the outstanding EUR benchmarks of the particular issuer and might free up credit lines at investors. Last but not least, issuance in non-domestic currencies can be used to hedge foreign-currency denominated assets in the cover pool without the need to swap currency risk.

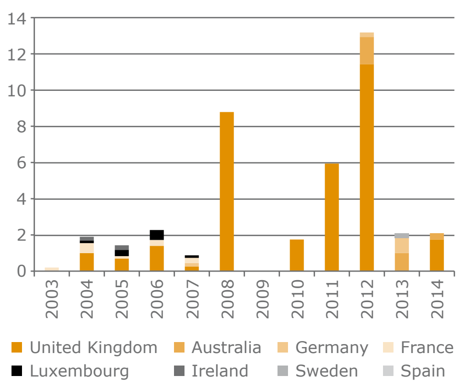
> FIGURE 8: OUTSTANDING VOLUME OF PUBLIC DEALS BY COUNTRY



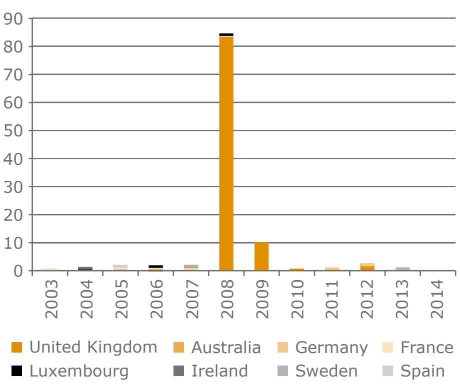
Source: Dealogic, Bloomberg, RBS (data as of 30 June 2014)

The figures below show issuance patterns in GBP covered bond segment since 2003, separated into publicly placed deals and private placements (according to the definition by the ECBC Statistical working group), using Dealogic data.

> FIGURE 9: PUBLICLY PLACED GBP-DENOMINATED COVERED BOND ISSUANCE (GBP BN)



> FIGURE 10: GBP-DENOMINATED COVERED BOND PRIVATE PLACEMENTS INCL. RETAINED ISSUANCE (GBP BN)

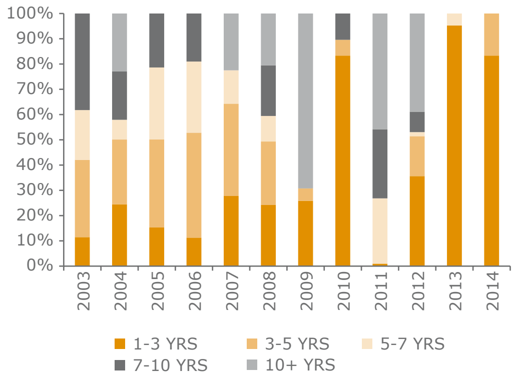


Source: Dealogic, RBS (data as of 30 June 2014)

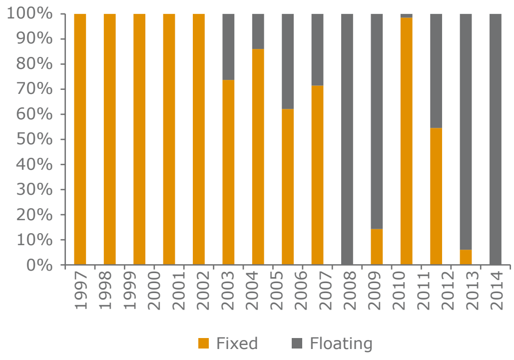
As shown in the Figure 10, large volumes of GBP-denominated covered bonds were issued in 2008 (c.GBP85bn) and 2009 (c.GBP10bn) that were not publicly placed in the market. Most of these issues were retained by the issuers at a time when the Bank of England provided funds under the Special Liquidity Scheme in response to the financial crisis. These retained covered bonds were used as collateral.

In the years up to 2008 only a small percentage of new issuance came with maturities longer than seven years. With the exception of 2009 when no syndicated publicly placed issues were sold, demand for long-dated GBP-denominated covered bonds picked up in 2011 and 2012, while the more recent deals in 2013 and 2014 were almost exclusively issued at the short end of the curve, with floating-rate coupons.

> Figure 11: Maturity breakdown of new issuance (public and private placements)



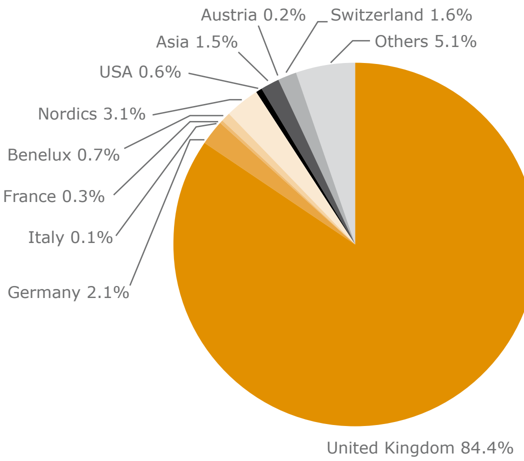
> Figure 12: Breakdown between fixed and floating rate coupons (public placements only)



Source: Dealogic, RBS (data as of 30 June 2014)

Investors in GBP-denominated covered bonds are largely based in the UK. Analysing deal allocation statistics of primary market transactions since January 2011 shows that almost 85% has been placed with UK investors with the remainder spread almost equally across Europe and overseas.

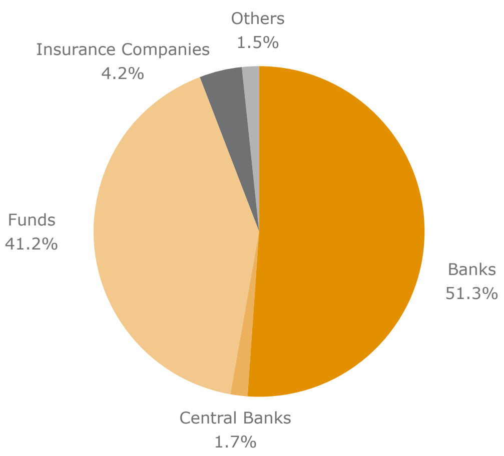
> Figure 13: Investor Participation by geography



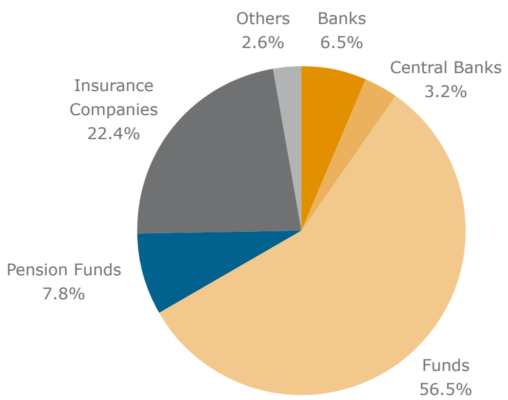
Source: Publicly available deal allocation statistics, RBS (data as of 30 June 2014)

The breakdown of investor base by type varies considerably between floaters and fixed-coupon bonds. While asset managers have a large share of both (41% of FRNs, 57% of fixed-coupon bonds), banks have bought only 7% of fixed rate paper compared to 51% of FRN issues since 2011. Insurance companies and pension funds account for just over 30% of fixed rate covered bonds. This is to a large extent due to the fact that the majority of privately placed fixed-rate bonds in the record years 2011 and 2012 were issued at the long end of the maturity spectrum.

> FIGURE 14: INVESTOR PARTICIPATION BY TYPE (FRN)



> FIGURE 15: INVESTOR PARTICIPATION BY TYPE (FIXED)



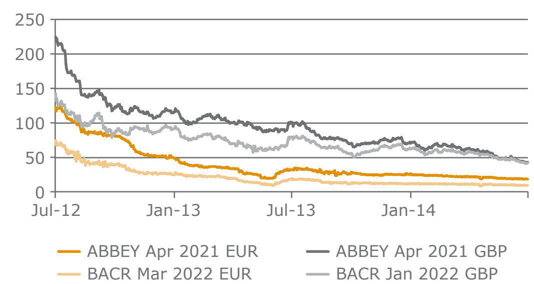
Source: Publicly available deal allocation statistics, RBS (data as of 30 June 2014)

SECONDARY MARKET CROSS CURRENCY OPPORTUNITIES

The direct overlap between the EUR and the GBP markets is relatively small in the publicly-placed benchmark segment. The GBP-denominated market is largely split between the short-end, with mostly floating-rate issues, and the long-end of the curve; while the biggest part of the corresponding EUR-benchmarks have maturities of less than ten years. Nevertheless, there have been arbitrage opportunities between direct comparables in both segments. The figure below shows the Asset Swap Spread developments of bond pairs of similar maturities and coupons issued in both markets.

Relative value between GBP and EUR-denominated covered bonds is driven by the developments in the cross-currency basis as well as 3-month vs 6-month swaps. In the recent past, for example, EUR-investors have been able to earn additional spread by buying GBP-denominated covered bonds and hedging the currency risk, compared to making an outright investment in a corresponding EUR covered bond. Different investor bases as well as restrictions in investor guidelines that prevent the exploitation are amongst the reasons why such arbitrage opportunities exist.

> FIGURE 16: GBP VS EUR COVERED BOND ASW SPREADS



> FIGURE 17: EUR-GBP BASIS SWAP DEVELOPMENT

Source: Bloomberg, RBS (data as of 30 June 2014)

THE WAY FORWARD

Issuance volumes of GBP covered bonds in 2013 and the first six months of 2014 have been subdued, partly driven by the lower funding needs of the UK banks, which have proved to be the backbone for GBP-covered bond supply over the last few years. The Bank of England's Funding for Lending Scheme and the lower loan demand, combined with a general deleveraging trend in the industry, has resulted in much lower funding needs for UK banks. The supply from non-domestic covered bond issuers highly depends on the basis swap environment which has proved to be very volatile over the years. For domestic issuers, the basis swap currently favours EUR issuance over GBP. Moreover, the two ECB long-term LTROs significantly lowered the wholesale funding needs of euro-area banks, and also affected GBP covered bond supply from those entities.

The final eligibility rules for the Prudential Regulation Authority's liquidity guidance framework could be supportive for GBP-denominated covered bonds. Covered bonds are not eligible under the current Liquid Assets Buffer rules in BIPRU 12.7. In autumn 2013, however, the PRA extended the list by an interim definition of level 2 assets limited to 40% of the liquidity requirement and subject to a 15% haircut. CRR-compliant covered bonds issued by credit institutions domiciled in the EEA, Australia, Canada, Japan, Switzerland and the US are included, subject to a minimum rating of AA- and a minimum volume of £/$/€250m, are included in Level 2. The PRA intends to consult on switching its liquidity guidance framework to the Liquidity Coverage Ratio (LCR) guidelines once the respective EU legislation comes into force in 2015. An inclusion of covered bonds into Level 1 with a lower haircut than the interim 15% could make it more attractive for UK banks to cover their liquidity needs with GBP-denominated covered bonds, which could also be a positive catalyst for the primary market.

CHAPTER 3 - THE ISSUER'S PERSPECTIVE

3.1 AUSTRALIA

By Alex Sell, Australian Securitisation Forum

I. FRAMEWORK

The legal framework is principally a contractual one in nature, with a statutory overlay that makes certain provisions for the prudential regulator to make regulations in relation to issuers' covered bond programmes, as well as provisions for minimum overcollateralisation levels (103% at all times).

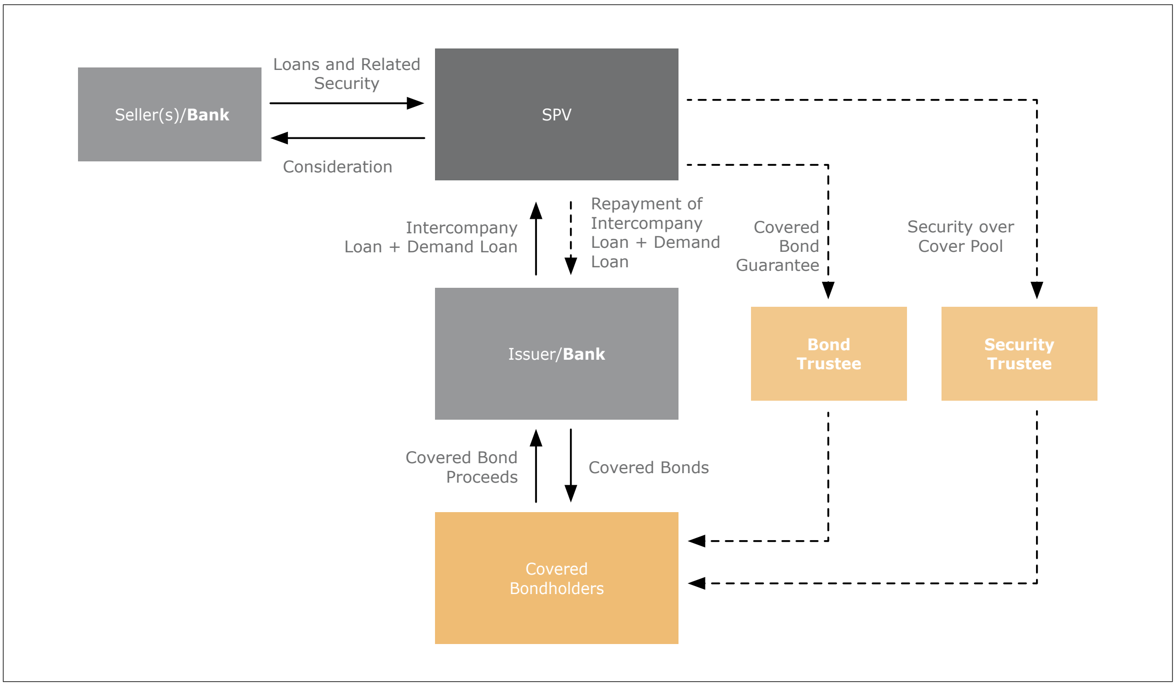
Prior to the introduction of amending legislation, the prevailing view among the regulatory community was that the Banking Act 1959 prohibited banks from placing any other class of creditors above depositors. The amendment to the Banking Act in November 2011 permitted this to occur, subject to an encumbrance limit of 8% (or such other percentage as may be prescribed by regulations) of an issuer's *assets in Australia*, as defined.

II. STRUCTURE OF THE ISSUER

Australian banks are the issuers of covered bonds; not SPVs or any other entity. However, the issuer makes an inter-company loan to the cover pool SPV to enable the SPV to acquire the cover pool and therefore provide a guarantee over the issuer's obligation to bond holders. This guarantee will be called upon in an event of default in respect of the issuer. The cover pool permits the SPV to continue to make scheduled payments on the bonds following an issuer event of default and the bond holders' benefit from security granted by the SPV over the cover pool to secure the SPV's obligations, including in respect of the guarantee. At present, the cover pool assets may not exceed 8% of an issuer's *assets in Australia*. With the exception of the fixed 8% maximum, the Australian covered bond resembles the British and New Zealand models. The charge over the assets of the cover pool does not, however, remove any claim creditors may wish to also make on the estate of the bank issuer.

Under the Banking Act, the cover pool cannot exceed 8% of the issuer's *assets in Australia*. An Authorised Deposit-taking Institution (**ADI**) must not issue a covered bond if the combined value of assets in cover pools securing covered bonds issued by the ADI would exceed this 8% but there may be voluntary overcollateralisation (e.g. in the form of a demand loan) that takes the total value of assets held by the SPV over 8%. The voluntary overcollateralisation may rank equally with covered bonds (thus forming part of the cover pool and subject to the 8% cap) or senior to the covered bonds (thus outside the 8% cap). In keeping with other jurisdictions the voluntary overcollateralisation serves as a management buffer in order to avoid inadvertent contractual breaches in respect of the Asset Coverage Test and to make ongoing covered bond issuance more efficient. Where the voluntary overcollateralisation ranks senior to the covered bonds (i.e. it is not part of the cover pool) such voluntary overcollateralisation remains part of the bank's estate and may be returned to the bank at any time. Further, whilst the bank can exceed the 8% maximum, it will attract a deduction from its regulatory capital base equal to the value that exceeds 8%.

Any amount recovered against the insolvency estate (and for which bondholders rank equally with all other senior unsecured creditors but behind depositors) will be paid over to the SPV to be held as additional collateral which is used to make payments under the guarantee. Any excess of assets in the SPV over and above the amount of the bonds issued – once repaid – will, after the satisfaction of other secured liabilities of the SPV, be paid to the insolvency estate of the issuer by way of repayment of the amount outstanding under any remaining intercompany loan amounts. However where voluntary overcollateralisation ranks senior to covered bond payments, the voluntary overcollateralisation will be returned to the issuer ahead of payments on the covered bonds.



III. COVER ASSETS

The Banking Act 1959 - Section 31[1] sets out the assets that can be included in the cover pool. These are:

a. an at call deposit held with an ADI and convertible into cash within 2 business days;

b. providing no greater than 15% of the total cover pool, a bank accepted bill or certificate of deposit that:

   1. matures within 100 days; and
   2. is eligible for repurchase transactions with the Reserve Bank; and
   3. was not issued by the ADI that issued the covered bonds secured by the assets in the cover pool;

c. a bond, note, debenture or other instrument issued or guaranteed by the Commonwealth, a State or a Territory;

d. a loan secured by a mortgage, charge or other security interest over residential property in Australia;

e. a loan secured by a mortgage, charge or other security interest over commercial property in Australia;

f. a mortgage insurance policy or other asset related to a loan covered by paragraph (d) or (e);

g. a contractual right relating to the holding or management of another asset in the cover pool;

h. a derivative held for one or more of the following purposes:

   1. to protect the value of another asset in the cover pool;
   2. to hedge risks in relation to another asset in the cover pool;
   3. to hedge risks in relation to liabilities secured by the assets in the cover pool.

1 http://www.austlii.edu.au/au/legis/cth/consol_act/ba195972/s31.html

At the time of publication, all Australian covered bond issuers have limited themselves contractually to excluding any commercial mortgage collateral in their cover pools.

IV. VALUATION AND LTV CRITERIA

Contractually, cover pool assets are subject to revaluation every month by way of indexation, which varies between programmes. Please refer to each issuer's individual website for details of the index used and the methodology applied.

LTV criteria – in addition to indexation – are contained in Section 31A[2] of the Banking Act. Specifically, they are as follows:

> Residential mortgages – if the mortgage exceeds 80% of the value of the property then the value of the loan is reduced by the amount of the excess.

> Commercial mortgages - if the mortgage exceeds 60% of the value of the property then the value of the loan is reduced by the amount of the excess.

V. ASSET - LIABILITY MANAGEMENT

This is principally a matter for the credit rating agencies in relation to timely payment and their opinions on the value of the pool in liquidation scenarios. The issuers have regard to ECAI's methodologies and criteria to seek to ensure maintenance of AAA ratings.

VI. TRANSPARENCY

Since August 2012, an Australian Transparency Template has been in force, followed by each of the five Australian covered bond issuers. It is in line with the guidelines of the ECBC's Covered Bond Label Initiative, and covers the following areas of each issuer's programme:

- Legend
- Dates
- Parties
- Asset Coverage Tests Bond Issuance
- Prepayments
- Pool Summary
- Mortgage Pool
- Contact
- Disclaimer
- Terminology
- Ratings Compliance Tests

Please refer to the Australian Securitisation Forum's covered bonds landing page[3] to access the template in full as well as web links to individual issuer's programmes.

2 http://www.austlii.edu.au/au/legis/cth/consol_act/ba195972/s31a.html

3 http://www.securitisation.com.au/cbprofile

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Prudential Standard APS 121 - Covered Bonds[4] contains the regulations set by the administrator (regulator) of the Banking Act in Australia.

The cover pool monitor is appointed by the bank issuer but must be independent and must provide reports in respect of the cover pool to the bank regulator on request. Specific tasks it must perform, and report on, biannually are:

> No breach of the 103% statutory minimum overcollateralisation

> Assess compliance by the issuer with assets permitted to be in the cover pool under the Banking Act

> Confirm that the covered bond pool asset register is being maintained in line with regulation (APS121)

> Contractually, also obliged to check the arithmetic accuracy of asset coverage tests on an annual basis

The bank regulator has the power to instruct – publically or secretly – a bank to cease topping up its cover pool should it wish to invoke its broad powers under the Banking Act, in the event that it has broader concerns about the bank's prudential condition.

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

Cover pool assets are sold by the bank issuer to the SPV, backed by contract. The security interest held over the cover pool assets is recognised at law and will not be jeopardised in the event of the bankruptcy/insolvency of the issuer.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Not in compliance with UCITS because Australian issuers are not domiciled in member states of the EEA.

Risk weighting varies depending upon the jurisdiction concerned, pending standardised risk-weights from the EBA and the outcome of the current Basel consultation.

Covered bonds issued by Australian issuers are currently not eligible assets for repurchase agreements with the ECB or NCBs, or the BoE.

Covered bonds issued by Australian issuers and denominated in Australian dollars are repo eligible with the Reserve Bank of Australia. They are however, deemed to be Level III LCR assets (under the Australian Prudential Regulation Authority's implementation of Basel III LCR guidelines) and an application for repurchase eligibility with the Reserve Bank of Australia must be made separately for each covered bond issue.

There are no special Australian federal or state investment regulations regarding Australian covered bonds.

X. ADDITIONAL INFORMATION

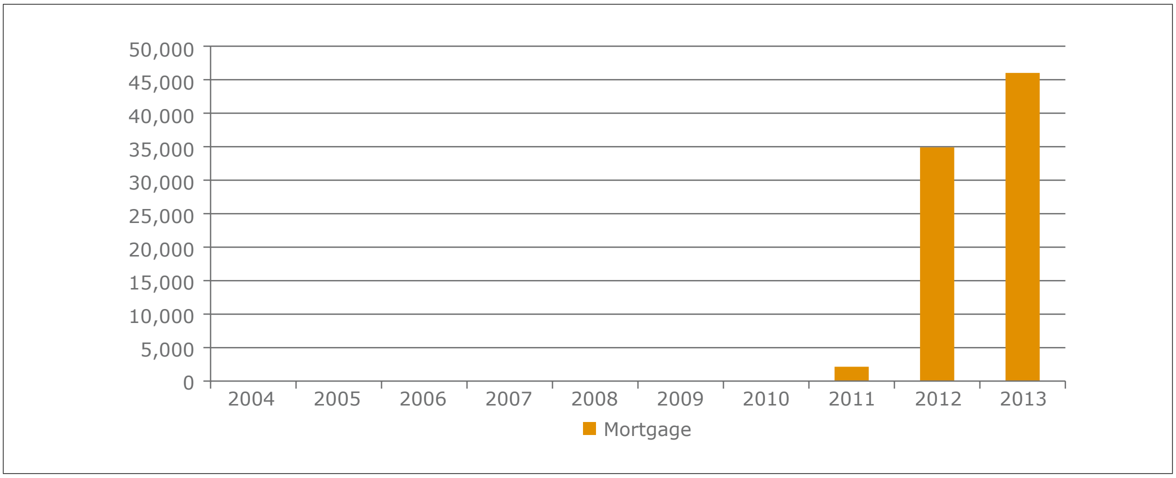
The development of the Australian covered bond market largely came about due to the financial crisis and the effective seizure of non-sovereign global capital markets through this period. After the events of 2008 and 2009, the Australian Federal government recognised the need for increasing funding diversity within the Australian banking system. The Australian Federal government subsequently passed changes to the Banking Act, enabling banks to prioritise claims subject to the regulators interpretation of the changes to the Act. The first covered bond issues from Australian banks occurred in late 2011, with issuance volumes increasing dramatically through 2012 as issuers properly established their programs in global bond markets. Covered bond issuance in 2013 was much lower than that for 2012, as issuers moved from ramping up their programs towards an ongoing program maintenance mode.

4 http://www.apra.gov.au/adi/PrudentialFramework/Documents/120719-APS121-Covered-bonds-final2.pdf

In principle, Australian ADIs have three primary term funding options for their balance sheets: senior unsecured bonds, residential mortgage backed securities and covered bonds. In practice, the larger institutions have effective access to all three options while smaller institutions principally used senior unsecured bonds and residential mortgage backed securities for term funding. Interestingly, it appears that Master Trusts have been practically excluded from the potential funding mix due to regulatory constraints on the capacity of issuers to pre-define call dates on all liabilities excepting covered bonds.

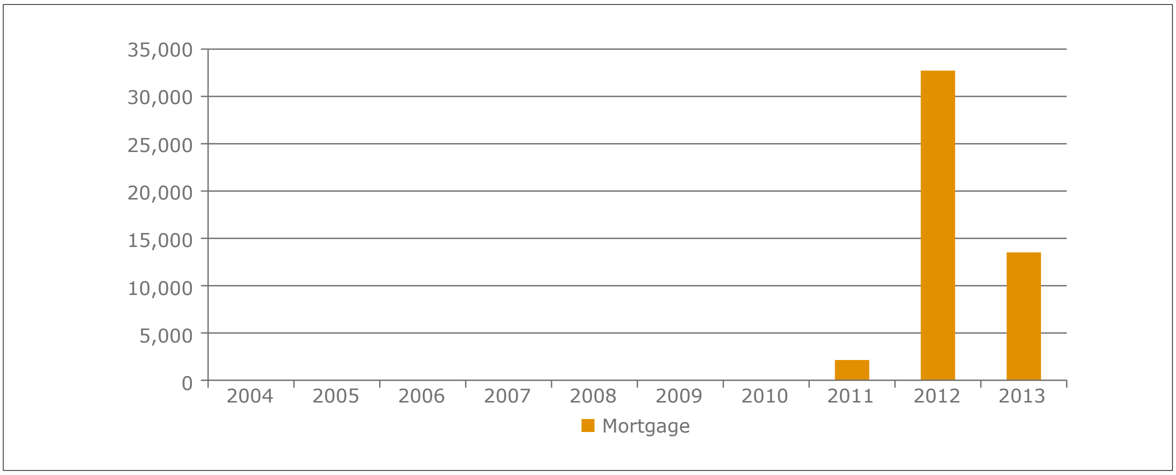
In the future, it is expected that Australian covered bond issuers will use their issuance capacity sparingly; balancing maintaining a global market presence against the higher all-in funding costs associated with covered bonds and program management costs (in comparison to funding through senior unsecured bonds or residential mortgage backed securities), and the need to be able to respond quickly to deterioration in funding conditions. Feedback from a range of market participants suggests that this funding strategy may drive a scarcity premium in terms of the relative valuation of Australian covered bonds against other forms of Australian bank secured financing and other global covered bond markets.

> FIGURE 1: COVERED BONDS OUTSTANDING 2004-2013, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2004-2013, EUR M



Source: EMF/ECBC

Issuers: At present there are five issuers of Australian covered bonds. These are Westpac Banking Corporation, National Australia Bank Limited, Australia and New Zealand Banking Group Limited, Commonwealth Bank of Australia and Suncorp Bank. It is unlikely that other Australian ADIs will be seeking to issue Australian covered bonds. The reason for this is due to the legislative asset encumbrance limit restriction of 8%. This is perceived by many issuers as compromising their ability to support a sufficiently broad market in a prospective programme.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/98/Australian_Covered_Bonds

3.2 AUSTRIA

By Alexa Molnar-Mezei, Erste Group Bank and Friedrich Jergitsch, Freshfields Bruckhaus Deringer

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) "Pfandbriefe"
2. Gesetz betreffend fundierte Bankschuldverschreibungen: Law on Secured Bank Bonds (Law of 12/27/1905) „FBS"
3. Pfandbriefgesetz: Mortgage Bond Act (Law of 12/21/1927) "Pfandbriefe"

Each of these was last amended in 2010.

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 suggested by Austria's banks to the legislator with the aim of further harmonizing/unifying Austrian Pfandbrief legislation in a single Act, and including, for example, an improved risk management system and standardised reporting requirements to achieve more transparency that offer investors a high level of security in terms of frequency and scope of the reports and ensure that investors receive clearly defined data relating to the cover assets.

II. STRUCTURE OF THE ISSUER

All three laws provide that only duly authorized credit institutions, with a special license to such effect, may issue covered bonds.

The Mortgage Banking Act stipulates a specialist banking provision and this would apply to any new mortgage bank. However, the only 2 issuers under the Mortgage Banking Act currently are universal banks into which former specialised issuers were merged.

The Mortgage Bond Act applies to public-sector "Landes-Hypothekenbanken", which used to be owned by the Austrian provinces and some of which have been privatised.

The Law on Secured Bank Bonds applies to all banks that have a license allowing them to issue covered bonds.

Under all frameworks, the issuer holds the cover assets on its balance sheet (unless it uses another bank's assets as cover, which is permitted under pooling rules contained in all three laws) 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 (solely) on the cover assets. In the case of insolvency of the issuer, the cover assets will form a pool which is separate from the issuer's other assets and a special cover pool administrator will be appointed to manage the cover assets. The covered bond holders have a preferential claim on the cover assets.

III. COVER ASSETS

Eligible cover pool assets are loans secured by (predominantly) first-ranking mortgages and public-sector assets. ABS/MBS are not eligible. Pfandbriefe backed by mortgage loans are commonly referred to as "Hypothekenpfandbriefe", while Pfandbriefe backed by public sector assets are referred to as "öffentliche Pfandbriefe".

The Law on Secured Bank Bonds allows mixed cover pools consisting of mortgage loans and public-sector assets but in practice, issuers under that law form separate pools with mortgages and public-sector assets, too, each backing a separate class of covered bonds.

The geographical scope of eligible mortgage assets is restricted to EU / EEA countries and Switzerland.

USA, Canada and Japan are not eligible. For eligible countries that do not recognise the bondholders' insolvency privilege, a 10% limit is in place. For "öffentliche Pfandbriefe", the geographic scope of assets is the same as for "Hypothekenpfandbriefe".

The limits for FBS are similar. In addition to mortgage loans and public-sector assets, FBS may also be backed by assets which, by law, are suitable for investment of a ward's assets ("Mündelgelder"). This includes certain local public bonds, or Austrian Pfandbriefe.

Derivative contracts are allowed in the cover pool if they are entered to hedge interest rate, currency and credit default risks. Derivatives are only allowed for hedging and there is no limit in place on the volume of derivatives in the cover pool.

So-called substitute cover assets are limited to 15% of the amount of covered bonds outstanding and may 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. One condition is a 60% LTV (loan to value) limit for residential and commercial mortgages based on the so-called "mortgage lending value" (which is a conservatively assessed value).

For Mortgage Bond Act issuers, the 60% LTV limit is stipulated in the statutes of each issuer for historical reasons.

There is no explicit provision for property valuation for FBS but – to our knowledge – issuers mostly adhere to the 60% LTV limit stipulated in the Mortgage Bank Act.

In practice, monitoring of the property value is done by the issuer and regular audits of the cover register are undertaken. Valuation guidelines mostly follow the guidelines prepared by each issuer for solvency purposes, which are approved by the regulator.

V. ASSET - LIABILITY MANAGEMENT

All Austrian covered bond laws contain the matching principle whereby the total volume of assets in the cover pool must at least cover the total nominal amount of outstanding covered bonds, the interest payable on the outstanding covered bonds and potential running costs in case of insolvency of the issuer (expressed under the Mortgage Bank Act and Mortgage Bond Act as mandatory overcollateralization of 2% which must be held in highly liquid substitute cover assets).

In addition, issuers may opt in their statutes to maintain cover on a net present value basis, which is used by many of the international benchmark issuers. Issuers may also provide additional over-collateral at their discretion, for instance in order to meet rating requirements and withstand stress tests.

The legislation also contains a simple maturity matching formula, limiting the issuance of bonds the maturity of which is considerably greater than the maturity of assets in the cover pool.

VI. TRANSPARENCY

The Austrian issuers organised in the Austrian Covered Bond Forum have set up a working group developing and analysing the CBIC Template Guidelines. As a result, Austrian issuers have developed a National Transparency Template –available on the Covered Bond Forum and of the Covered Bond Label websites – with quarterly updates – based on the CBIC European Transparency Standards. The cover pool reports can be found at:

One central website of Austrian Covered Bond Forum: http://www.pfandbriefforum.at/downloads.html

The National Transparency Template includes the following information:

> Programme, Issuer Senior and Covered Bond ratings;
> Overcollateralization values (based on nominal and net present values);
> The total volume of Pfandbrief outstanding as well as the related cover pools in terms of nominal, net present and stressed net present value;
> The share of further cover assets;
> The maturity structure of the Pfandbrief and cover assets;
> Information on the size of the cover assets;
> Information on the mortgages by property type/type of use, region and state;
> Information on the claims against the public sector by state and type of issuer;
> Information on the mortgages registered liens by register country;
> Summary tables including LTV, currency, interest and maturity profile;
> Information on non-performing loans (the percentage of loans more than ninety days past due);
> Information on interest rates and currencies of cover assets and outstanding covered bonds.

The National Transparency Template covers the Guidelines according to the ECBC's Covered Bond Label Initiative that have been introduced in the Transparency Template over the last year by the Austrian Covered Bond Forum. Moreover the items above disclose the information required in Article 129(7) of the Capital Requirements Regulation (CRR).

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The cover pool is monitored by a trustee ("Treuhänder" or, in the case of the Law on Secured Bank Bonds, "Regierungskomissär"), who is appointed by the Minister of Finance. The trustee is liable according to the Austrian Civil Code. The trustee has to ensure that the prescribed cover for the covered bonds exists at all times and that the cover assets are recorded correctly in the cover register. Without his or her approval, no assets may be removed from the cover pool. Any disputes between the issuer and the trustee would be settled by the regulator.

If a concern exists that the rights of the covered bond holders are being infringed, the court must appoint a joint special representative of the covered bond creditors ("Kurator").

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

The Cover Register ("Deckungsregister") in which all cover assets are entered, permits the identification of the cover assets. All mortgages, public-sector loans, substitute cover assets and derivative contracts which form part of to the cover, must be registered in the cover register.

The issuers must inform the debtors (or, as the case may be, counterparties) of the cover assets that their debt (or derivative contract) is made part of the cover pool. On that occasion the issuer must also notify the debtor that it is not allowed to discharge its debt through any set-off. An exemption from the general prohibition of set-off applies to derivative contracts, when the set-off (or netting) occurs in respect of receivables arising under one and the same Master Agreement (i.e. pertaining to the cover assets).

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

Cover assets may only be enforced upon by the covered bond creditors (or counterparties of derivative contracts which form part of the cover pool).

If the issuer becomes insolvent, the cover assets are segregated from the remainder of its assets. The cover assets form what is known as ''Sondervermögen'' (pool of special assets) and are earmarked for the claims of the covered bond holders. Any voluntary overcollateralization is also bankruptcy-remote. Only cover assets that are evidently not needed to satisfy the claims of the covered bond holders are passed back to the issuer's general insolvency estate.

The cover assets are managed by a special administrator, who is appointed by the bankruptcy court after consultation with the Austrian regulator (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 are not automatically accelerated 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 (primarily) from the cover assets. Equally, in respect of derivatives which belong to the pool, there is no (immediate) legal consequence of insolvency and the counterparty claims as derivative transactions rank pari passu with the claims of the covered bond holders.

Preferential treatment of covered bond holders

Covered bond holders enjoy preferential treatment as the law stipulates the separation of the cover assets on the one hand and the insolvency estate on the other hand. To the extent that they are not satisfied from the cover assets, the covered bond holders may also participate in the issuer's general insolvency proceedings. Only if the cover assets do not suffice to satisfy the covered bond creditors, are the covered bonds accelerated.

Access to liquidity in case of insolvency

Once appointed, the special administrator for the cover pool has the duty to manage the cover pool in order to satisfy the claims of the covered bond holders. The administrator may, for example, sell assets in the cover pool or enter into a bridge loan in order to create liquidity to service the bonds in issue.

The administrator also has access to any voluntary over-collateralisation, which is considered bankruptcy-remote. Any surplus collateral may only be transferred back to the insolvency estate to the extent that it is evident that it will not be needed to cover the claims of the covered bond holders.

Sale and transfer of mortgage assets to other issuers

By virtue of his or her appointment, the special administrator has the right to manage and dispose of the cover assets. In particular, the special administrator must collect the cover assets according to their contractual maturity.

The special administrator is also entitled to 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. If a sale is not feasible, the cover pool administrator has to continue the servicing of the cover pool and the outstanding covered bonds.

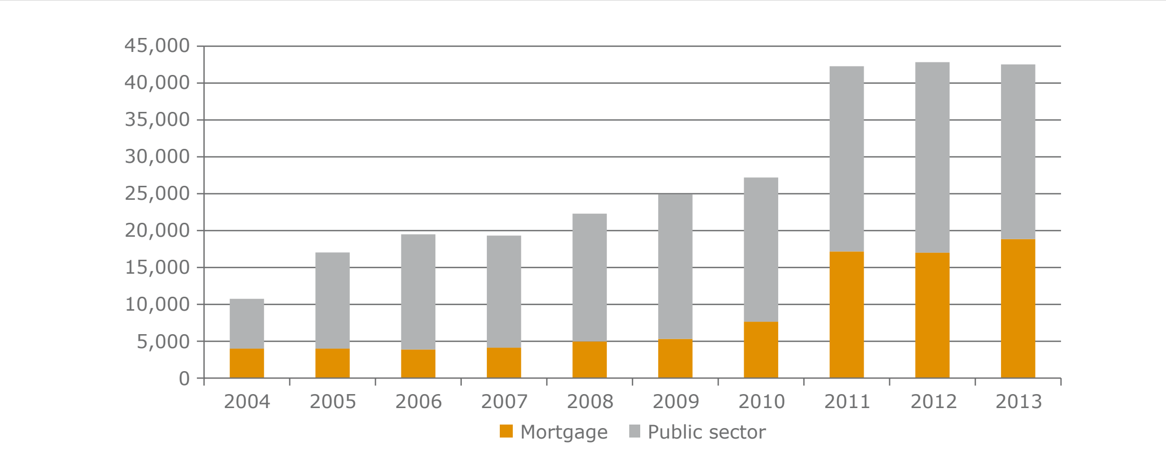
IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the CRR. Austrian Pfandbriefe, as well as Austrian covered bonds (FBS), fulfil the criteria of Article 52(4) of the UCITS Directive as well as those of Article 129 of the CRR[1]. 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.

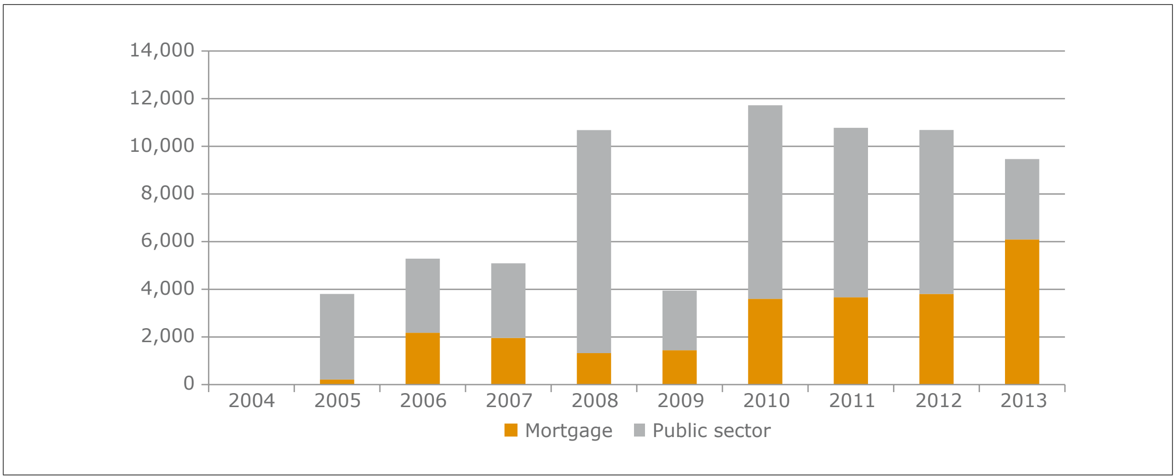
1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2004-2013, EUR m



Source: EMF/ECBC

Issuers: BAWAG P.S.K. Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse AG; Erste Group Bank AG; Allgemeine Sparkasse Oberösterreich Bank; Bausparkasse der österreichischen Sparkassen Aktiengesellschaft; Oesterreichische Volksbanken-Aktiengesellschaft; Kommunalkredit Austria AG; Raiffeisen Bank International AG; Raiffeisenlandesbank Oberösterreich AG; Raiffeisenlandesbank Niederösterreich-Wien AG; Raiffeisen-Landesbank Steiermark AG; Raiffeisen-Landesbank Tirol AG, UniCredit Bank Austria AG; HYPO NOE Gruppe; HYPO Tirol Bank AG; Vorarlberger Landes- und Hypothekenbank Aktiengesellschaft; HYPO Bank Burgenland AG; Hypo Alpe-Adria-Bank International AG; Hypo Alpe-Adria-Bank AG; Hypo Oberösterrich; Hypo Salzburg; Hypo Steiermark; BKS Bank AG; Oberbank AG; BTV-Bank für Tirol und Vorarlberg AG; Sparkasse Schwarz; OEKB OEST. KONTROLLBANK.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/8/Pfandbriefe and http://www.ecbc.eu/framework/95/FBS_-_Fundierte_Bankschuldverschreibungen

Covered Bond Label : UniCredit Bank Austria AG Credit Public Sector; UniCredit Bank Austria AG Credit Mortgage

3.3 BELGIUM

By Carol Wandels, Belfius Bank

I. FRAMEWORK

On 3 August 2012, the Belgian Parliament adopted the long-awaited legislation on covered bonds. This law provides a statutory framework for the issuance of covered bonds by Belgian credit institutions.

The legal basis for Belgian covered bonds is incorporated into the banking law, meaning the law of 25 April 2014 on the status and the supervision of credit institutions (the "Banking Law") that replaces the Act of 22 March 1993 on the status and the supervision of credit institutions. Since 11 October 2012 the banking law is supplemented by two Royal Decrees (a general Royal Decree on the issuance of covered bonds and a specific Royal Decree dedicated to the cover pool administrator) and several regulations (inter alia concerning the issuer reporting requirements).

The following gives an overview of the legislative framework for Belgian covered bonds:

> The Law of 3 August 2012 establishing a legal regime for Belgian covered bonds, which was implemented which is implemented in the Law of 25 April 2014 on the status and supervision of credit institutions (*Wet van 25 april 2014 op het statuut van en het toezicht op kredietinstellingen/Loi du 25 avril 2014 relative au statut et au contrôle des établissements de crédit*) (the "**Banking Law**");

> The Law of 3 August 2012 on various measures to facilitate the mobilisation of claims in the financial sector (the "**Mobilisation Law**");

> The Royal Decree of 11 October 2012 on the issuance of Belgian covered bonds by Belgian credit institutions (the "**Covered Bond Royal Decree**");

> The Royal Decree of 11 October 2012 on the cover pool administrator in the context of the issuance of Belgian covered bonds by a Belgian credit institution (the "**Cover Pool Administrator Royal Decree**");

> The Regulation of the National Bank of Belgium concerning the practical modalities for the application of the Law of 3 August 2012 that establishes a legal regime for Belgian covered bonds dated 29 October 2012 (the "**NBB Covered Bonds Regulation**"); and

> The Regulation of the National Bank of Belgium addressed to the statutory auditors and the cover pool monitors of Belgian credit institutions with respect to their involvement in the context of the issuance of Belgian covered bonds in accordance with Chapter VIII of the Law of 22 March 1993 dated 29 October 2012 (the "**NBB Cover Pool Monitor Regulation**").

II. STRUCTURE OF THE ISSUER

Belgian covered bonds can be issued by universal credit institutions[1] established in Belgium. However such institutions will first need to be licensed by the NBB as covered bond issuer (general authorisation as issuer) and also the covered bond program itself will need to get approval from the NBB (specific program license).

An extensive issuer license file detailing aspects like its strategy, solvency, risk management, asset encumbrance, IT systems, internal audit, etc. needs to be submitted. At program level the issuer will need to detail the impact of the covered bond issuance on its overall liquidity, the quality of the cover assets and maturity matching of assets/liabilities in the program. The statutory auditor of the issuer will need to report to the NBB on the organizational capacity of the credit institution to issue and follow up the covered bonds.

1 Existing credit institutions could decide to issue themselves or to issue from a newly created credit institution. The latter would typically but not necessarily be a subsidiary or an affiliate of the mother company.

The license 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.

An indirect issuance limit on covered bonds has been integrated in the Covered Bond Royal Decree by limiting the amount of cover assets to 8% of the balance sheet.

At program level a distinction is made between CRD IV -compliant covered bonds, i.e. "Belgian pandbrieven/ lettres de gage", and non CRD IV-compliant (but still UCITS compliant) covered bonds, i.e. "Belgian covered bonds". The denomination of both terms is protected by law. These distinct types of covered bonds will appear on two separate lists. Consultation of the NBB's website will hence give an overview of:

> Belgian credit institutions issuing covered bonds

> Belgian pandbrieven programs and its specific issuances

However the way that the Banking Law and the Royal Decree are stipulated, makes that in practice the Belgian credit institutions will only be able to issue CRD IV-compliant covered bonds. Therefore in what follows we will only concentrate on the Belgian pandbrieven.

When a credit institution issues Belgian pandbrieven, its assets will by operation of law consist of its general estate on the one hand and (one or more) separate, ringfenced "segregated estate(s)" ("patrimoine special") on the other hand (=balance sheet structure, no use of a special purpose vehicle).

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 under the specific program to which the segregated estate is joined and for the claims of other parties that are or can be identified in the issue conditions. Assets will become part of the cover pool upon registration in a register held by the issuer for that purpose. As of that moment those assets will form part of the segregated estate and are excluded from general bankruptcy clawback risk.

When insolvency proceedings are opened with regard to the issuing credit institution, by operation of law, the assets recorded in the segregated 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 (= the segregated estate) for the timely payment of their bonds but at the same time holders will continue to have a claim against the insolvent general estate. Creditors that are not related to the segregated estate will not have any recourse to these cover pool assets. Any amounts left in the segregated estate can return to the insolvent general estate, upon the request of the bankruptcy receiver and after consultation of the NBB, once it is certain that the cover assets are no longer needed.

III. COVER ASSETS

All assets and instruments that will be legally segregated for the benefit of the Belgian pandbrieven investors in a segregated 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: exposure 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; for category 3 non-EU public sector exposure will get a zero valuation, unless specified otherwise.

> with respect to the MBS/ABS as mentioned in each of the first three categories: senior ABS/MBS are eligible provided that 90% of the underlying pool is directly eligible and is originated by a group related entity of the issuer of the Belgian pandbrieven. The senior ABS/MBS must qualify for credit quality step 1 (as set out in Article 251 CRR[2]). The securitization vehicle of the ABS/MBS must be located in the EU. At last these securitization tranches only remain eligible as cover asset within the limits imposed by the CRD IV ;

> 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; Residential real estate is defined as real estate property that is destined for housing or for leasing as housing by the owner. Commercial real estate is real estate property that is primarily used for industrial or commercial purposes or for other professional activities such as offices or other premises intended for the exercise of a commercial or services activity;

> 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 article 117 CRR.;

> for category 5: derivatives, of which the counterparty has a low default risk (meaning a counterparty that qualifies for credit quality step 1 or step 2 as set out in Article 120 CRR), 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 Article 120 CRR and forms part of the EEA, and (ii) it has a (unilateral) credit support annex (CSA) in place. Note that assets posted under the CSA would belong to the separate legal estate, but are not considered as cover assets 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 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 (and accordingly for each segregated estate), 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 outstanding under such program. 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.

2 Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (the "**CRD IV**") and Regulation 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms (the "**Capital Requirements Regulation**" or "**CRR**").

IV. VALUATION AND LTV CRITERIA

- category 1: minimum of [the outstanding loan amount, 80% of the value of the mortgaged property, the mortgage inscription amount[3]]
- category 2: minimum of [the outstanding loan amount, 60% of the value of the mortgaged property, the mortgage inscription amount]
- category 3: value is equal to the book value (nominal amount outstanding), except when the counterparties are not part of the EU in which case the value will be zero. There is however an exception to this zero valuation rule for non-EU counterparty exposure:
  - a) in case the non-EU counterparties qualify for credit quality step 1, or
  - b) in case the non-EU counterparties qualify for credit quality step 2 and do not exceed 20% of the nominal amount of Belgian pandbrieven issued

  in either case the value is equal to the book value.
- category 4: no value can be given to this category unless:
  - a) the counterparty qualifies for credit quality step 1, or
  - b) in case the counterparty qualifies for a credit quality step 2, the maturity does not exceed 100 days as of the moment of registration in the cover pool

  in either case the value is equal to the book value.
- category 5: no value is given to this category.
- Additional valuation rule applicable to any category: in case of delinquencies above 30 days, the value as determined per category is reduced by 50%. In case of default (> 90 days), no value can be given anymore.

When it comes to property valuation (applicable to 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 in Belgium that the valuation is based on the report of an accredited third party appraiser. In line with the NBB Covered Bonds Regulation, the market value will have to be justified in a clear and transparent manner on the basis of a document established by a person who is independent from the persons who are in charge of granting the relevant loans. An expert report will be required for real estate which has a value of more than 3 million euro or 2% of the amount of the relevant covered bonds. Otherwise, the value of the real estate can be determined on the basis of the sales value as established in the notarial deed at the time of sale or the valuation report of the architect in the case of real estate in construction. The credit institution must apply a prudent revaluation procedure to determine the current value.

The value of the real estate has to be tested regularly. A more regular control shall occur in case of significant changes to the market conditions. To this effect, customary methods and benchmarks (such as third party indices) may be used.

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 exposure on financial institutions with a maturity above 100 days and a rating below AA-.

3 This can include Belgian mortgage mandates but upon the condition that there is a first lien mortgage inscription of at least 60% related to one and the same property.

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 (the "**85% asset coverage test**"). Secondly the value of the cover assets needs to exceed the nominal amount of Belgian pandbrieven by 5% at all times (5% overcollateralization) (the "**overcollateralization test**"). 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 due under/with regard to the Belgian pandbrieven, as well as any other obligation of the Belgian pandbrieven program (the "**amortization test**").

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 (the "**liquidity test**"). This amount has to be covered by (sufficient) liquid cover assets. In order to meet the test, 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. Liquid assets are assets that (i) meet the cover asset eligibility criteria and (ii) qualify as liquid assets under the Regulation of the Banking Finance and Insurance Commission (CBFA) of 27 July 2010 on the liquidity of credit institutions, financial holdings, clearing institutions and institutions assimilated with clearing institutions.

If an issuing credit institution fails to meet the requirements of the liquidity test, it will have 14 days to take the necessary redress measures to meet the relevant requirements. As long as an issuing credit institution has not taken the necessary redress measures, it is not allowed to issue new Belgian covered bonds.

The issuer will also be required to manage and limit its interest and currency risk related to the program and will be able to sustain severe & averse interest/exchange rate movements. Although it is the issuer's sole discretion to determine how this will be managed (e.g. adding derivatives to the cover pool is a possibility (subject to eligibility criteria) but not an obligation) it needs to be documented in the license application.

At last it is important to highlight that the tests have to be met on a daily basis.

It is the task of the cover pool monitor to verify at least once a month if the issuer is compliant with all the tests.

Other safeguard mechanism that are 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 will by law be excluded from the insolvent general estate
  - registered collections received from the cover assets before the date of bankruptcy are part of the separate estate and legally protected via the right of 'revindication'. This is a special mechanism that has been created to protect cash held by the issuer on account of the segregated estate. Pursuant to this mechanism, the ownership rights of the special estate as regards cash that cannot be identified in the general estate, will be transferred to unencumbered assets in the general estate that will be selected by taking into account criteria specified in the issue conditions.
- Set-off and claw back risk: solved through the Mobilisation Law.

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 by a cover pool monitor.

The cover pool monitor:

> is chosen by the issuer from those persons appearing on the official list of certified/statutory auditors established by the NBB;

> shall be appointed subject to prior approval from the NBB;

> cannot be the certified/statutory auditor of the issuer;

The main tasks of a cover pool monitor consist of ensuring compliance with legal and regulatory requirements, e.g. are the cover assets duly recorded in the register, do the cover assets fulfil the eligibility criteria, is the value correctly registered, etc. The cover pool monitor is required to perform these tasks not only on an on-going basis, but also prior to the first issuance of Belgian pandbrieven by the credit institution. The on-going verifications must be done at least once a month.

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 NBB at its discretion can ask the cover pool monitor to perform other tasks and verifications.

If the NBB considers that a category of Belgian pandbrieven no longer fulfills the criteria or the issuer no longer fulfills its obligations, it can withdraw the license of the issuer and consequently withdraw the issuer from the list of Belgian covered bond issuers. 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) from a claim of the creditors of the insolvent general estate and are therefore not affected by the start of insolvency proceedings against the issuer. Also, any assets that would be posted via a 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 estate return to the general estate of the issuer. Before such time, 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.

Upon the initiation of bankruptcy proceedings or the instruction of an exceptional recovery measure by the competent supervisor with regard to the credit institution, or even before whenever the NBB considers it to be necessary (e.g.at the moment the license is withdrawn), a cover pool administrator ("gestionnaire de portefeuille") will be appointed that will take over the management of the Belgian pandbrieven program from the credit institution. The cover pool administrator (appointed by the NBB) is legally entrusted with all powers that are necessary for the management of the segregated estate, and can take all such actions (some in consultation with/upon approval of both the NBB and the representative of the noteholders) 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 after the appointment of a cover pool administrator:

> noteholders would decide otherwise;

> it is clear that further deterioration of the cover assets would lead to a situation whereby it is impossible to satisfy the obligations under the Belgian pandbrieven (i.e. in a situation of insolvency of the cover pool).

The bankruptcy receiver has a legal obligation to cooperate with the NBB and the cover pool administrator in order to enable them to manage the special estate in accordance with the law.

The Cover Pool Administrator Royal Decree specifies the tasks of the cover pool administrator. These include, amongst other things, to procure the payment of interest and principal on the Belgian covered bonds, collection of moneys from the cover assets (including any enforcement), entering into relevant hedging and liquidity transactions and carrying out of certain administrative tasks. The cover pool administrator will also have to test compliance with the cover tests and inform the NBB and the noteholders' representative thereof.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

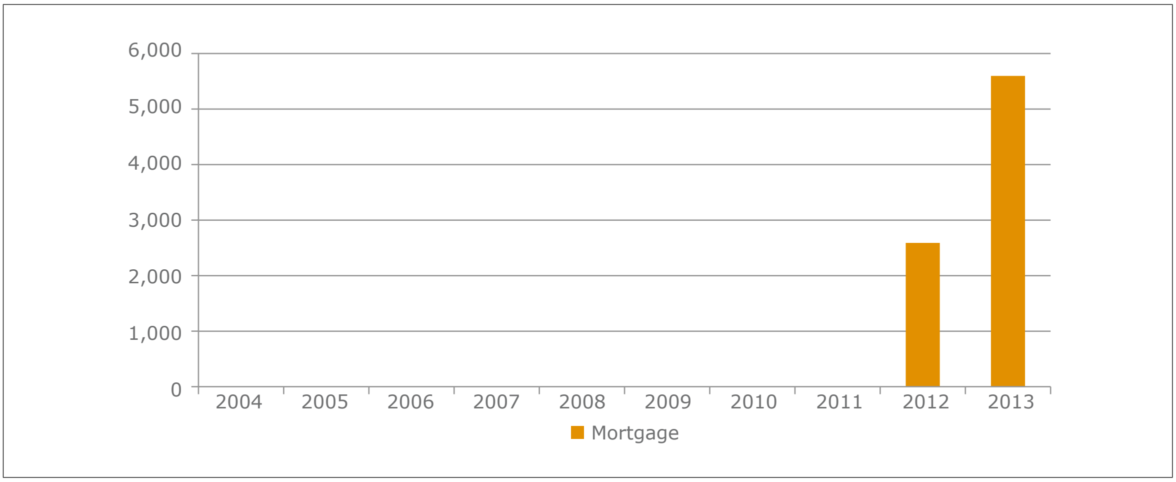
The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 CRR.[4] Belgian pandbrieven will comply with the requirements of Article 52(4) UCITS and Article 129 CRR if and to the extent they are listed by the NBB as such.

4 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2004-2013, EUR M

Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2004-2013, EUR M



Source: EMF/ECBC

Issuers: Belfius, KBC and ING Belgium.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/100/Belgium_Covered_Bonds

3.4 BULGARIA

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

I. FRAMEWORK

In Bulgaria, the legal basis for the issue of covered bonds is the Mortgage-backed Bonds Law issued by 38th National Assembly on 27 September 2000, published in the State Gazette (*Darzhaven vestnik*) issue 83 of 10 October 2000[1].

Ordinance No 8 of Bulgarian National Bank on the Capital Adequacy of Credit Institutions[2] treats the risk weighting of other types of covered bonds.

II. STRUCTURE OF THE ISSUER

Pursuant to the Mortgage-backed Bonds Law, the mortgage-backed bonds shall be securities issued by banks on the basis of their loan portfolio and secured by one or more first in rank mortgages on real estate in favour of banks (mortgage loans). Only banks may issue bonds called mortgage-backed bonds.

The real estate under the previous paragraph shall be insured against destruction and shall be of the following type:

> Housing units, including leased out;

> Villas, seasonal and holiday housing;

> Commercial and administrative office spaces, hotels, restaurants and other similar real estate; and

> Industrial and warehousing premises.

The issuing bank shall adopt internal rules on conducting and documenting mortgage appraisals of real estate which shall comply with the requirements of Article 73, paragraph 4 of the Bulgarian Law on Credit Institutions.

Securities issued under procedures other than the one laid down by the Mortgage-backed Bonds Law may not referred to with, or include in their appellation, the extension "mortgage-backed bond", or any combination of these words.

III. COVER ASSETS

The outstanding mortgage–backed bonds shall be covered by mortgage loans of the issuing bank (principal cover). To substitute loans from the principal cover that have been repaid in full or in part, the issuing bank may include the following of its assets in the cover of mortgage-backed bonds (substitution cover):

> Cash or funds on account with the Bulgarian National Bank (BNB) and/or commercial banks;

> Claims on the Government of the Republic of Bulgaria or the Bulgarian National Bank, and claims fully secured by them;

> Claims on governments or central banks of states as determined by the Bulgarian National Bank;

> Claims on international institutions as determined by the Bulgarian National Bank;

1 Amended; issue 59 of 2006; in force on the date of entry into force of the Treaty of Accession of the Republic of Bulgaria to the European Union; amended; issues 52 and 59 of 2007; amended; issue 24 of 2009; effective as of 31 March 2009

2 Adopted by the Bulgarian National Bank, published in the Darjaven Vestnik, issue 106 of 27 December 2006, in force as of 1 January 2007; amended, issue 62 of 2007; amended, issue 38 of 2008, effective as of 11 April 2008; amended, issue 21 of 2009; amended, issues 20, 85 and 102 of 2010; amended, issue 95 of 2011 (http://www.bnb.bg/bnbweb/groups/public/documents/bnb_law/regulations_8_credit_instit_en.pdf)

- Claims fully backed by government securities issued by the Government of the Republic of Bulgaria, the Bulgarian National Bank, the Governments, Central Banks or international institutions;
- Claims secured by gold; and
- Claims fully backed by bank deposits denominated in Bulgarian levs or in a foreign currency for which the BNB quotes daily a central exchange rate.

The substitution cover of mortgage-backed securities shall not exceed 30% of the total amount of liabilities of the issuing bank under that issue. Mortgage-backed Bonds cover from any issue (the sum total of the principal cover and the substitution cover) may not be less than the total amount of liabilities towards the principals of mortgage-backed bonds from that issue which are outstanding and in circulation outside the issuing bank.

The claims of the bondholders under mortgage-backed bonds from each issue shall be secured by a first pledge on the assets of the issuing bank included in the cover of that issue. The pledge is a subject of entrance in the Central Registers of Special Pledges, with the respective issue of mortgage-backed bonds being indicated as a pledge creditor.

The issuing bank shall request an entry and submit to the Central Register of Special Pledges all data required for the entry of the pledge within one month after executing a mortgage-backed bonds issue and shall update that data at least once every six months thereafter. The pledge shall remain in force until the full redemption of the liabilities of the issuing bank under the respective issue of mortgage-backed bonds without the need for any renewal. Deletion of the pledge entry shall be made upon the full redemption of the issuing bank’s liabilities under the respective issue of mortgage-backed bonds on the basis of a document issued by the bank’s auditors.

IV. VALUATION AND LTV CRITERIA

Valuation

Mortgage appraisals of property shall be performed by officers of the issuing bank or by physical persons designated by it having the relevant qualifications and experience.

For appraisals of the property the comparative method, the revenue method and the cost-to-make method shall be used for the purposes of the law.

The mortgage appraisal shall explicitly specify the method or combination of the above methods used with the relative weight of each method in the appraisal, as well as the sources of data used in the analysis and calculations.

Subsequent mortgage appraisals of property used as collateral on the loans recorded in the register of mortgage-backed bonds cover shall be made at least once every twelve months for loans which:

- Have outstanding liabilities exceeding 1% of the issuing bank’s own funds; or
- Have not been consistently classified as standard risk exposures throughout that period.

LTV criteria

LTV criteria are generally defined in the banks own lending policies depending on their risk appetite and other internal rules. No specific legal requirements are imposed by the local banking law.

V. ASSET - LIABILITY MANAGEMENT

Art.6 of the Law on Mortgage-backed Bonds stipulates that mortgage loans shall be included into the calculation of the principal cover at the value of their outstanding principal but at no more than 80% of the mortgage appraisal value of the real estate as housing units, including leased ones, and at no more than 60% of the mortgage appraisal value of the real estate as villas, seasonal and holiday housing units used as collateral on mortgage loans.

Substitution cover of mortgage-backed bonds from any issue may not exceed 30% of the total amount of liabilities of the issuing bank under that issue.

Mortgage-backed bonds cover from any issue (the sum total of the principal cover and the substitution cover) may not be less than the total amount of liabilities towards the principals of mortgage-backed bonds from that issue which are outstanding and in circulation outside the issuing bank.

In making calculations under the previous paragraph for mortgage-backed bonds and assets constituting their cover denominated in different currencies, the official foreign exchange rate for the Bulgarian lev to the respective currency quoted by the Bulgarian National Bank of the day of the calculation shall apply.

A loan recorded in the register of the cover of mortgage-backed bonds from a particular issue may be repaid at any time by bonds of the same issue at their face value.

VI. TRANSPARENCY

Banks (the only eligible issuers of mortgage bonds) produce regular reporting to Banking Supervision authority – Bulgarian National Bank (BNB), and provide and publish financial information on a monthly basis. The public banks are reporting issuers and submit all required information to the regulated market – Bulgarian Stock Exchange – Sofia (BSE), as well as to the Bulgarian Financial Supervision Commission (FSC). No additional specific measures in respect to the mortgage bonds are currently announced.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Cover pool is managed by the issuing bank which should have adopted internal rules for maintaining the cover pool, the rules for access to the cover pool data base and the regularity of the update of the cover.

Bulgarian National Bank carries out general assessment of the banks, including issued mortgage bonds as part of general banking supervision.

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

After the record of the assets in the register as a cover of mortgage-backed bonds of a particular issue may be used as collateral solely for the liabilities of the issuing bank on that issue. The issuing bank may not allow any encumbrances on its assets constituting the cover of outstanding mortgage-backed bonds. The issuing bank accounts assets recorded in the register of mortgage-backed bonds cover separately from the rest of its assets.

The issuing bank shall keep a public register of the cover of mortgage-backed bonds issued by it as the register is kept separately by mortgage-backed bonds issue.

In case of declaring the issuing bank bankrupt, the assets recorded as of the date of declaring the bank bankrupt in the register of the mortgage-backed bonds cover shall not be included in the bankruptcy estate. Proceeds from the liquidation of assets recorded in the register as a cover on a particular issue of mortgage-backed bonds are distributed among the bondholders from that issue in proportion to the rights under their bond holdings. Any funds remaining after settling the claims under mortgage-backed bonds from a particular issue is included in the bankruptcy estate.

The asset pool under the above mentioned paragraphs are managed by a holders' trustee of mortgage-backed bonds which is appointed by the bankruptcy court when it has been established that the bank has outstanding liabilities under mortgage-backed bonds. The trustee is managing the assets by individual mortgage-backed bonds issue.

The Trustee shall be a person who meets the requirements of Article 217, para.1 and 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. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Risk weighting

Exposures in the form of covered bonds are treated in article 41 of Ordinance No.8 of Bulgarian National Bank on the Capital Adequacy of Credit Institutions.

Exposures in covered bonds shall receive a risk weight one step more favourable than a senior unsecured exposure to the issuing bank in accordance with the Standardised Approach to Credit Risk.

Risk weights for exposures to covered bonds under Standardised approach:

> Risk weight of the issuer's first-rate unsecured debt of 20%, 50%, 100%, 150%;

> Risk weight of the exposure of 10%, 20%, 50%, 100%.

Risk weights for exposures to covered bonds under Foundation IRB (Internal Rating Base approach):

Loss Given Default (LGD) values for Exposures to Central Governments, Central Banks, Corporates and Institutions:

> Senior exposures without eligible collateral: 45%;

> Subordinated exposures without eligible collateral: 75%;

> Covered bonds as specified in Article 41, paragraphs 2–4 (where mortgage bonds fall): 11.25%.

Covered bonds shall be secured by any of the following eligible assets:

> Exposures to or guaranteed by central governments, central banks, public sector entities, regional governments and local authorities in the EU Member States;

> Exposures to or guaranteed by non-EU central governments, non-EU central banks, multilateral development banks, international organisations that qualify for the credit quality step 1 and step 2 as set out below:

Credit quality step	1	2	3	4	5	6
Risk weight	0%	20%	50%	100%	100%	150%

and exposures to or guaranteed by non-EU public sector entities, non-EU regional governments and non-EU local authorities that are risk weighted as exposures to institutions or central governments; where these exposures qualify for the credit quality step 2, the exposure shall not exceed 20% of the current nominal amount of issued covered bonds of the issuing credit institution;

> Exposures to institutions that qualify for credit quality step 1. The exposure shall not exceed 15% of the current nominal amount of the issued covered bonds of the issuing credit institution; exposures to EU-institutions that meet the step-2 credit quality requirement shall be included provided their residual maturity is less than 100 days;

> Loans secured by mortgage on a residential property, to the lower of the amount of the pledge or 80% of the value of the property;

> Senior shares in a special purpose (securitisation) entities governed by the laws of a Member State, securitising residential real estate exposures provided that at least 90% of the assets of such entities are composed of a mortgage of residential real estate and to the lower of:

a) Nominal value of the shares;

b) Value of the pledge;

c) 80% of the value of the property pledged.

> Loans secured by a mortgage on a commercial real estate, to the lower of the amount of the pledge and 60% of the value of the property;

> Senior shares in a special purpose (securitisation) entities governed by the laws of a Member State, securitizing commercial real estate exposures provided that at least 90% of the assets of such entities are composed of a mortgage of commercial real estate and to the lower of:

a) Nominal value of the shares;

b) Value of the pledge;

c) 60% of the value of the property pledged.

The shares under the fifth item above (securitizing residential real estate exposures) shall have an assigned credit quality step one and shall not exceed 10% of the nominal amount of the outstanding issue. Exposures caused by transmission and management of payments of the obligors of, or liquidation proceeds in respect of, loans secured by pledged properties of the senior units or debt securities shall not be comprised in calculating the 90% limit from items 5 and 7 above (securitizing residential and commercial real estate exposures). The covered bondholders' claims shall take priority over all other claims on the collateral.

Compliance with European Legislation

Mortgage-backed Bonds Law is compliant with the requirements of Art.52 par.4 UCITS Directive. The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR).[3]

X. ADDITIONAL INFORMATION

Minimum information requirements for issuance prospectuses

The offering or the draft prospectus for an issue of mortgage-backed bonds consists of data valid at the time of their preparation, such as:

> The Rules of the issuing bank concerning the contents, the entry and deletion procedures as well as the terms and procedures authorizing access to the register and its internal rules of conducting and documenting mortgage appraisals;

3 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position

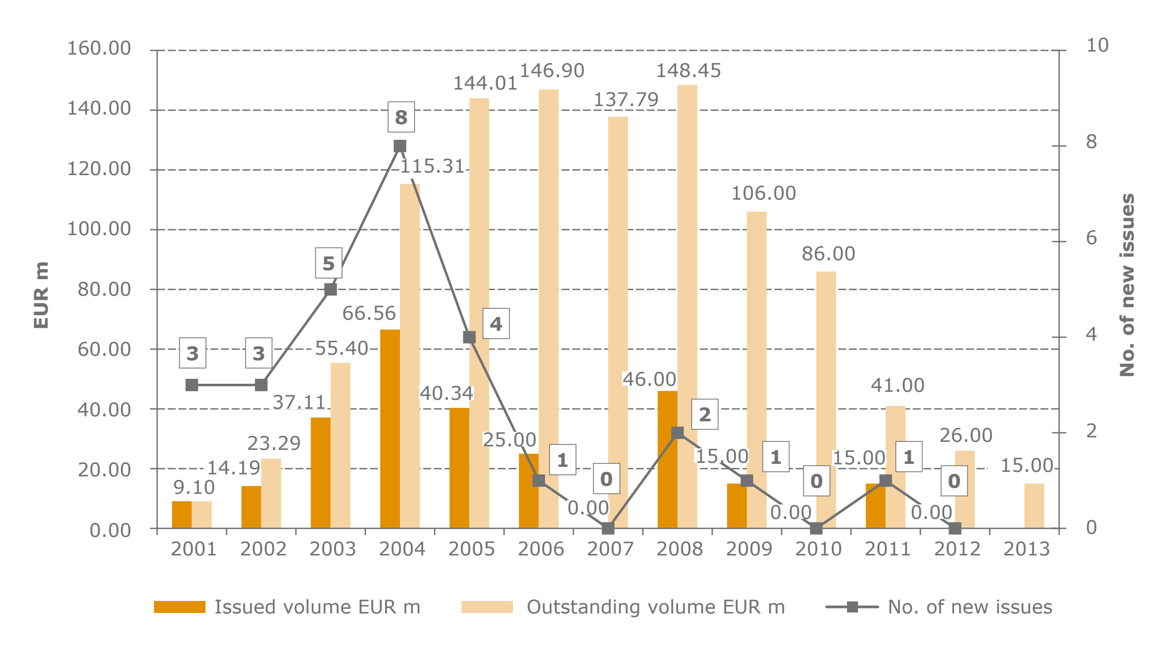
- Data on mortgage loans held in the issuing bank's portfolio on the basis of which an issue is being made, including for each loan:
  a) The size of the outstanding principal at the time of extending the loan and by the end of the most recent full quarter;
  b) Loan life at the time of extending the loan and the remaining term to maturity;
  c) Interest rates, fees and commissions on the loan;
  d) Risk classification of the loan by the end of each calendar year from the time it was extended and by the end of the most recent full quarter;
  e) Type of real estate mortgaged as collateral, their mortgage appraisal value and the ratio between the outstanding principal and the mortgage appraisal value at the time of extending the loan and by the end of the most recent full quarter;
- Characteristics of the mortgage loan portfolio on the basis of which the issue is made, including a distribution of loans by:
  a) The size of the outstanding principal;
  b) The residual term to the final repayment of the loan;
  c) Interest rate level;
  d) Their risk classification by the end of the most recent full quarter; and
  e) The ratio between the outstanding principal and the most recent mortgage appraisal value of the real estate pledged as collateral.

In public offerings of mortgage-backed bonds the provisions of the Public Offering of Securities Act (POSA) and the Ordinances on its enactment shall apply. In non-public offerings of mortgage-backed bonds the provisions of Commerce Law shall apply.

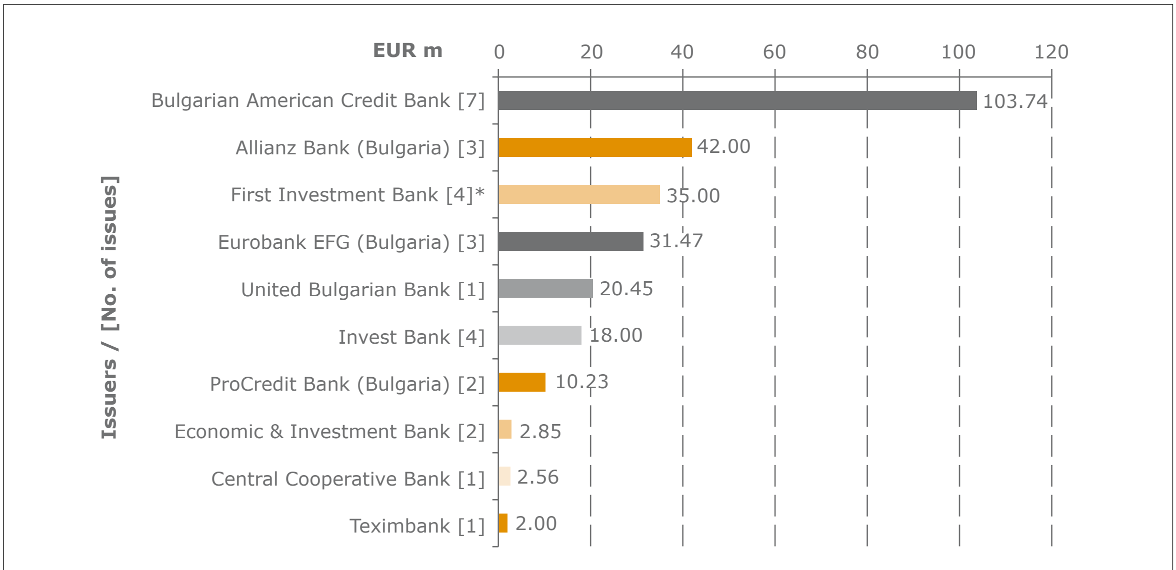
Bulgarian mortgage bond market information

Since the adoption of the Bulgarian Law on Mortgage-backed Bonds in 2000 the mortgage bond issues in Bulgaria total 28. There were no new issues in 2013. The volume of issued mortgage-backed bonds is EUR 268.3 m originated by 11 issuing banks (currently 10 banks after the merger of MKB Unionbank and First Investment Bank). As of 31 December 2013 the outstanding mortgage bonds amount to EUR 15.0 m.

> FIGURE 1: MORTGAGE BOND ISSUES IN BULGARIA, 2001-2013



> FIGURE 2: MORTGAGE BOND ISSUERS IN BULGARIA, 2001-2013



* Including a EUR 15m issue of the former MKB Unionbank

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/72/Bulgaria

3.5 CANADA

By Anne Caris, Bank of America Merrill Lynch

I. FRAMEWORK

Canada implemented dedicated covered bond legislation in 2012 with the amendment of the National Housing Act[1] in June followed by additional requirements defined by the Canada Mortgage and Housing Corporation (CMHC)[2] in December. The CMHC is responsible for the administration and supervision of Canada's new "registered" covered bonds. New covered bond issuance is restricted to "registered" covered bonds so that non-registered or structured covered bonds ("historical" bonds in the CMHC guide) will remain managed in separate programmes and amortise gradually until September 2017.

Under the new law, Canadian insured mortgages are no longer eligible as collateral. The covered bond issuance limit of 4% of total assets, which was put in place in June 2007 by the Office of the Superintendent of Financial Institutions (OSFI), is unchanged. The OSFI regulates Canadian financial institutions. Details below are related to Canadian "registered" covered bonds under the new law. For information on Canadian "contractual" covered bonds please see the 2012 ECBC European Covered Bond Fact Book.

II. STRUCTURE OF THE ISSUER

Permitted issuers of Canada's new "registered" covered bonds consist of banks, trust and loan companies, cooperative credit associations and insurance companies. A special licence must be provided by the CMHC upon fulfilment of the minimum legal requirements together with adequate over-collateralisation (OC) levels to ensure sufficient collateral and appropriate risk management systems. Furthermore, issuers must have no specific regulatory issue. The CMHC may suspend the right of issuing "registered" covered bonds in case of a breach of legal requirements that is not remedied. The seven covered bond "registered" programmes at the end of 1H14 are: Canadian Imperial Bank of Commerce, Royal Bank of Canada, Bank of Nova Scotia, National Bank of Canada, La Caisse Centrale Desjardins, Bank of Montreal and Toronto Dominion Bank.

Canadian "registered" covered bonds are direct and unconditional obligations of the issuer. In the event of issuer insolvency or default, investors have a claim over the pool of cover assets. The cover assets are held in a bankruptcy-remote special-purpose entity, the guarantor, which provides a direct, unconditional and irrevocable guarantee in respect of due interest and principal payments under the covered bonds that would otherwise be unpaid by the respective issuer. In Canada, the guarantor is either set up as a limited liability partnership or a trust (an alternative guarantor form might be allowed by the CMHC under specific conditions). A bond trustee (which has to be independent and bankruptcy remote from the issuer) must be designated to represent the views and interests (and enforce the rights) of covered bond holders.

Cover assets are segregated from the issuer through a legal true sale between the issuer and the guarantor. Legal title to the mortgages typically remains with the issuer and is only transferred to the guarantor in the case of: (1) material breach or default by the issuer; (2) impending or actual issuer insolvency; (3) material breach or default by the servicer of eligible loans; or (4) any other event as prescribed in the transaction document. Borrowers are notified of the sale of the mortgages to the guarantor upon such triggers. Each "registered" issuer must engage a bankruptcy-remote custodian with appropriate systems and knowledge of handling mortgages. The guarantor must provide the custodian with the details of eligible and substitute assets, as should the issuer (in electronic form) on a quarterly basis when solvent.

1 See National Housing Act R.S.C., 1985, c. N-11.

2 See CMHC's Canadian Registered Covered Bond programmes Guide (www.cmhc-schl.gc.ca).

III. COVER ASSETS

Eligible assets for Canadian "registered" covered bonds mainly consist of residential mortgages for properties (of no more than four residential units) located in Canada. These must be non-insured, first ranking and with a maximum 80% loan-to-value. Loans with one or more payments in arrears (whether on interest or principal) should be excluded from the cover pool and bought back by the issuer. Furthermore, to qualify as cover assets, one or more payments must have been made according to the terms of the loans (whether interest and/or principal). Eligible loans must also be originated by the issuer or meet its underwriting criteria.

Substitute assets can be included in the cover pool but cannot exceed 10% of cover assets. They must be Canadian government bonds or any other prescribed assets. The guarantor may also hold cash of a total amount not exceeding its payment obligations in the next six months.

IV. VALUATION AND LTV CRITERIA

Property values should be indexed at least on a quarterly basis. The indexation methodology for a covered bond programme is disclosed to investors in the covered bond programme prospectus and must be in line with any regulatory requirement. Loans are accounted up to the 80% LTV cap. In Canada, a property value has to be assessed during the underwriting process. Property valuation is either performed by an accredited third-party property appraiser or information on the property value is obtained from an independently maintained valuation model based on similar properties recently sold in the same area.

V. ASSET - LIABILITY MANAGEMENT

Within covered bond programmes, 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, legal frameworks typically incorporate a minimum over-collateralisation (OC) requirement. Canada has opted out of a national minimum requirement. Instead, "registered" issuers must establish a minimum and maximum OC level in their respective covered bond programme. This is more tailored-made while the maximum OC limit eliminates uncertainty regarding available OC to covered bond holders. The maximum OC level should be subject to a contractual covenant of the "registered" issuer in favour of covered bondholders and can only be amended upon the approval process prescribed by the relevant transaction document.

Furthermore, the guarantor is required to put in place covered bond collateral hedges (if not there already) at the time of each transfer of covered bond collateral or covered bond issue in order to minimise interest rate or FX mismatches. It may also enter into contingent covered bond collateral hedges, which become effective, e.g., in case of an event of default of the "registered" issuer. The guarantor carries out monthly valuations to assess market risks[3]. Hedging counterparties must meet CMHC counterparty requirements including minimum standards established by rating agencies. The terms of each transaction document must explicitly state that the guarantor may replace a specific counterparty upon rating triggers or in case of an event of default of the "registered" issuer. The CMHC must be informed of counterparty replacement, termination or resignation. Swap counterparty ranks pari passu with covered bondholders (or senior at the discretion of the guarantor).

A cash reserve might be required for the benefit of the guarantor upon specific rating triggers. It is sized to meet in full interest payments on outstanding covered bonds together with all payment obligations of the guarantor entity ranking prior to such interest payments – under the aforementioned six-month limit. It is retained in a bank account and, following an issuer event of default, the balance of the cash reserve forms part of available revenue receipts to be used by the guarantor to meet its obligations under the covered bond guarantee.

3 This measures the present value of the covered bond collateral versus the market value of the outstanding covered bonds (in Canadian dollars).

Typical of SPV structures, Canadian issuers must meet the following tests on a monthly basis:

> **Asset Coverage Test (ACT):** The ACT determines whether the issuer meets the pre-determined minimum and maximum OC levels. An asset monitor also tests the accuracy of the ACT calculation yearly, or more frequently under specific circumstances.

> **Pre-Maturity Test (PMT):** The PMT ensures that the covered bond collateral includes sufficient cash to meet in full all principal payments due under all outstanding covered bonds (together with all other payment obligations ranking in priority) for a period prescribed in the transaction documents of the specific programme.

> **Amortisation Test (AT):** Following an issuer event of default, the AT ensures that the value of cover assets is at least equal to the outstanding covered bonds.

VI. TRANSPARENCY

The Canadian covered bond legal framework is prescriptive in terms of information disclosure and reporting. Requirements (which go well beyond the minimum standards established under ECBC's Covered Bond Label) include the following:

> All material information related to a "registered" issuer and covered bond programme must be accessible on an ongoing basis, mainly through a dedicated website set up by the issuer. All transaction documents should be available on the website.

> A monthly report must be prepared within 15 business days of the end of each month and include detailed information on the covered bond programme (e.g. key parties/counterparties, ratings, event of default occurrence, credit enhancement and rating triggers, statistics related to cover asset and covered bonds, material issues and deficiencies).

Despite their detailed disclosure, Canadian covered bonds do not qualify for the ECBC's Covered Bond Label as they are not UCITS-compliant and thus not CRR-compliant.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Canadian "registered" covered bonds are supervised by the CMHC. Issuers are required to appoint a cover pool monitor (CPM) with adequate qualifications. The responsibilities of the CPM consist of ensuring the accuracy of the records regarding the cover pool and the adequacy of the required tests. Results should be reported to the CMHC and the bond trustee annually or whenever deemed reasonable. Issuers should make available all information needed by the CPM. Following issuer insolvency, the CPM remains in place for the benefits of the guarantor. "Registered" issuers must provide immediate notice to the CMHC in case of: (1) a failed ACT and/or AT; (2) awareness of a rating downgrade/ withdrawal/trigger; and (3) a breach or default under the terms of the covered bond programme.

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

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 bankrupt estate of the issuer.

> Upon an issuer event of default, the guarantor is required to meet the covered bond obligations using the cash flows generated from the cover assets. In case of insufficient cash, the guarantor is permitted to sell the cover assets, find alternative funding or enter repos. The entire pool of cover assets is available as security for all the outstanding covered bonds issued under the programme, so there is no direct link between particular assets and a specific series of covered bonds.

- > Upon a guarantor event of default, covered bonds accelerate. Preferential rights are limited to the guarantor's assets, although, if cover assets are insufficient, covered bond holders have recourse to the assets of the issuing entity ranking pari passu with ordinary depositors and unsecured debt holders. Payments are made in accordance with the applicable order of priority.

An issuer or guarantor event of default include at a minimum (other events maybe prescribed in the documentation) the following: (1) the commencement of dissolution or bankruptcy proceedings, which are not dismissed within 60 days of the filing date; (2) failure to pay the principal or any amount due under the covered bond programme; (3) failure to comply with the remedial action following a rating trigger; and (4) failure to meet the AT by a guarantor. A remedy period of 10 business days may be considered in case of default on principal payments versus 30 days on default of interest or other payment.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Canadian covered bonds are not UCITS 52(4)-compliant or CRR-compliant as Canada is not a member of the EU.[4] Therefore, they do not benefit from a preferred risk-weighting for regulatory capital purposes. Under the Standardised Approach, they are treated similarly to senior unsecured bank debt. That said, if denominated in €/£/¥/US$, Canadian covered bonds are eligible for European Central Bank repo operations, conditional on an investment-grade rating. Specific haircuts are applied depending on the rating and characteristics of the covered bond.

X. ADDITIONAL INFORMATION

1. Eligible for Level 2A assets of Basel's Liquidity Coverage Ratio (LCR)

In May 2014, OSFI confirmed the eligibility of covered bonds for the LCR as part of the Level 2A high quality assets. Eligible covered bonds must meet the following criteria:

- > Non-retained bonds issued and owned by a bank or mortgage institution subject by law to special public supervision designed to protect bond holders
- > With a minimum AA- rating and a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions: i.e. maximum decline of price or increase in haircut over a 30-day period during a relevant period of significant liquidity stress not exceeding 10%
- > Traded in large, deep and active repo or cash markets characterised by a low level of concentration

"Historical" covered bonds issued by Canadian institutions prior to the Canadian covered bond legislation coming into force on July 6, 2012 may be included as Level 2A assets if they meet the above requirements non-related to the law.

2. Canadian banks issuance capacity after re-start

In 2012-2013, covered bond issuance by Canadian banks decreased as they could no longer issue under their "historical" programmes and had to set up new "registered" ones. Issuance resumed during the summer 2013 and has been rather active in 1H14, with six of the seven covered bond issuers having issued under their programmes (TD Bank got approval for its "registered" covered bond programme by CMHC on 25 June 2014). Canadian banks remain key participants in the covered bond market, though with a preference for the € market over the US$ in 2H13 and 1H14, due mainly to a favourable basis swap and strong market technicals (see "Other currencies in the Generic Section for more details). They are still the largest issuers in the US$ market.

Canadian banks' real hurdle in terms of future issuance is the 4% limit (the strictest across covered bond markets) rather than the amount of eligible assets. Based on recent data, Canadian banks have enough uninsured mortgages on their balance sheets to issue further covered bonds. The remaining capacity for the banks is about

4 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position

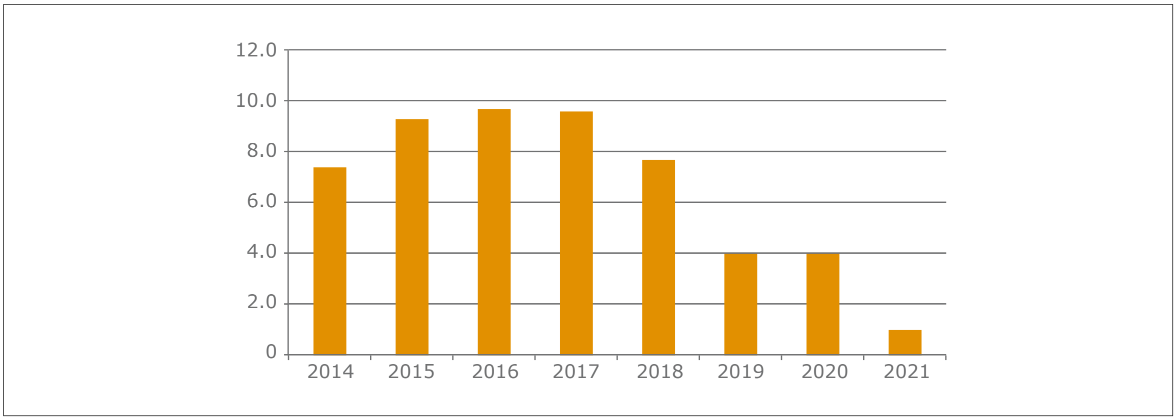
C$78.5bn (gross) at end-May 2014 (see Figure 1). Redemptions especially of "historical" covered bonds, which are spread over the next three years, should also support new issuance (see Figure 2).

FIGURE 1: CANADIAN BANKS' COVERED BOND ISSUANCE

At 31st May 2014 (C$ bn)	RBC	BMO	BNS	CIBC	CCDJ	NBC	TD[1]	Total
OSFI covered bond issuance limit	34.0	22.4	29.8	15.7	7.6	7.7	35.9	153.0
Outstanding covered bonds	20.5	9.1	13.7	12.1	4.0	5.0	10.0	74.5
- non-registered	0.0	7.6	12.2	10.3	2.5	2.0	10.0	44.6
- registered	20.5	1.5	1.5	1.9	1.5	3.0	0.0	29.9
Remaining issuance capacity (gross)	**13.5**	**13.3**	**16.1**	**3.5**	**3.6**	**2.7**	**25.9**	**78.5**

Source: Canadian banks' "registered" covered bond investor reports; [1] BofA Merrill Lynch Global Research estimate

> FIGURE 2: CANADIAN BANKS' COVERED BOND REDEMPTIONS (AS END OF JUNE 2014, EUR bn)



Source: BofA Merrill Lynch Global Research

3. Canadian property market: "Housing crash fears are overdone" by Emanuella Enenajor, our Canada Economist

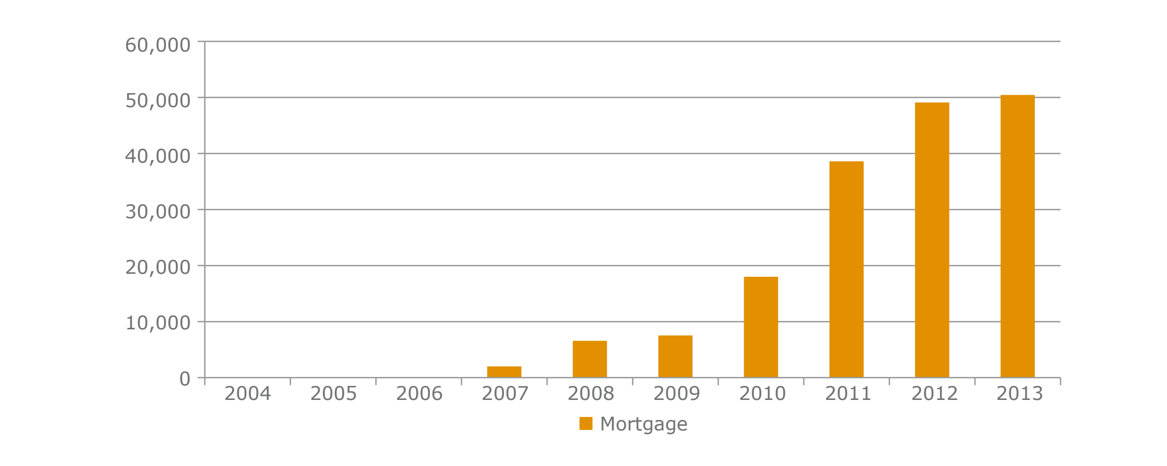
According to our Canada Economist, Emanuella Enenajor, in a report named "Housing crash fears are overdone", a quick glance at the housing sector in Canada would make most investors nervous. Whether it is the 140% increase in prices since 2000 or the elevated 7% direct share of housing in GDP, the sector appears overextended and eerily reminiscent of the US pre-crisis market. But a closer look suggests that while valuations are lofty, there is little reason to fear a painful correction. The Canadian Economics team sees homebuilding edging down in 2014, with the pace of house price gains set to gradually slow to the rate of inflation. A continued low-rate environment and only modest rate hikes come 2016 are important assumptions in that view. They also emphasise that:

1. **The bubble check list does not check out:** speculation does not appear to be an important element in the Canadian housing boom. Housing bubbles are often characterized by the presence of fickle speculators who enter and exit with great speed to benefit from rapidly rising prices. But when examining residential sales activity normalized by the population (our measure of transaction frequency), Canada's housing turnover appears flat since the recovery. That suggests limited evidence of a speculative ramp-up in sales

or flipping as was seen in the US housing bubble. Also, mortgage credit growth has slowed to 5% yoy today from its cyclical 13% peak rate in 2008. The slower momentum in mortgage debt growth points to a steady cooling in housing demand.

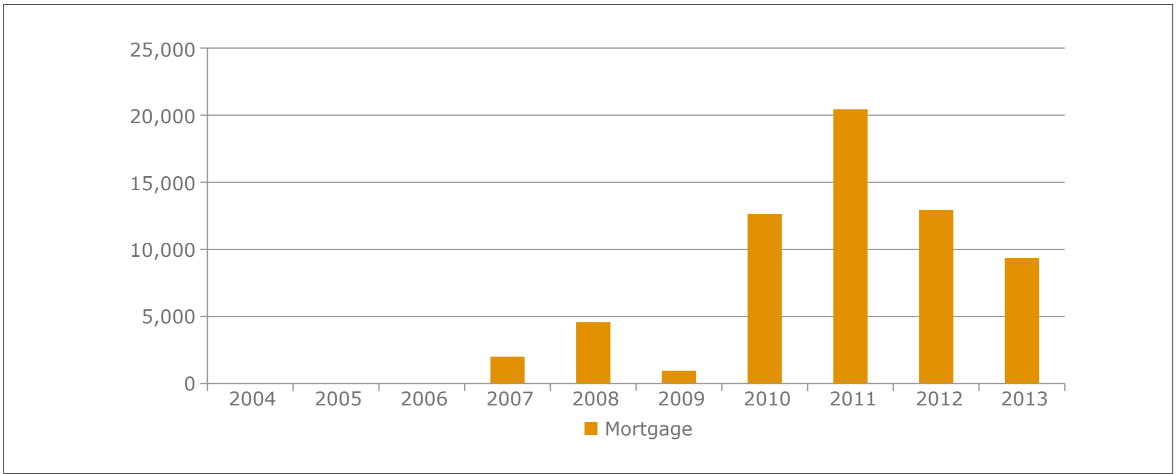
2. **Canada is not the US:** if Canada's housing market on the surface looks similar to the US prior to the housing bust, the two are not the same. As cited by the Bank of Canada, subprime lending accounts for less than 10% of the total Canadian mortgage market, while in the US, the figure was closer to 20% prior to the crisis. The share of total mortgages that are delinquent for three or more months is a miniscule 0.3% in Canada, much lower than the US pre-crisis figure of 2% or roughly 6% in 2013. This less-risky environment is driven by conservative practices by both borrowers and lenders. 80% of mortgages in Canada are originated by firms that are supervised by a single federal regulator, the OSFI. Furthermore, since 2008, the Federal government has tightened lending standards by introducing a 5% minimum down payment requirement and progressively shortening the maximum amortization period for mortgages, among other moves. On the borrower side, Canadian households that take on a mortgage are incentivized to pay off their debts as soon as possible, as unlike the US, interest is not deductible for income tax purposes. Also unlike the US, most Canadian provinces offer mortgage loans that are full recourse. That encourages prudence on the part of borrowers who may see their other assets seized and liquidated if they cannot repay a mortgage that exceeds the value of their home.
3. **Base case scenario:** our macroeconomists' base case scenario is a 0.6% decline in homebuilding activity and a slowdown in house price appreciation to roughly 2% in 2014. Historically low rates and positive economic growth could forestall an outright decline in the price of residential properties in 2014 and 2015. Looking further out to 2016, a modest policy rate hike cycle could cause a further softening in the residential market. As the Bank of Canada nudges up its policy rate, house prices could gradually decline by 5%–10% over the span of a couple of years as higher borrowing costs discourage demand. Increasingly prudent lending standards, the absence of speculation driving up prices, and reasonable supply metrics suggests that the Canadian housing market is built on stone, not sand. While the residential market will likely lose some of its earlier momentum over the next several years, they do not expect a downturn that triggers financial or banking sector woes, or that requires a policy easing from the Bank of Canada.

> FIGURE 3: COVERED BONDS OUTSTANDING, 2004-2013, EUR M



Source: EMF/ECBC

> FIGURE 4: COVERED BONDS ISSUANCE, 2004-2013, EUR M



Source: EMF/ECBC

Issuers: Royal Bank of Canada (RBC), Bank of Montreal (BMO), Bank of Nova Scotia (BNS), Canadian Imperial Bank of Commerce (CIBC), Caisse Centrale Desjardins (CCDJ), National Bank of Canada (NBC), Toronto-Dominion Bank (TD).

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/12/Canadian_Covered_Bonds

3.6 CHILE

By Antonio Procopio, Emiliano Muratore and Patricia Perez, Banco Santander Chile

I. FRAMEWORK

The legal framework for Chilean covered bonds (Bonos Hipotecarios, also BHs) is determined by:

> The General Banking Law (Ley General de Bancos, LGB): Article 69, n°2, BH issuances; and Articles 125, 126 and 134, special treatment of banking entities under bankruptcy.

> The Chilean Central Bank: Financial Regulation Compendium (*Compendio de Normas Financieras*, CNF), Chapter II.A.2, Chilean Central Bank complementary rules.

> Superintendency of Banks (*Superintendencia de Bancos e Instituciones Financieras*, SBIF): *Recopilación Actualizada de Normas* (RAN), Chapter 9-2, Complementary rules of the Chilean banking regulatory agency.

In 2010, Law 20.448 – also called MKIII, the third reform to the Capital Markets Law — introduced a series of changes in terms of liquidity, financial innovation and integration of the capital markets. Among them was the amendment of Article 69, n°2 of the LGB which enabled banks to issue bonds with no special guarantees, called BHs. These securities are specifically aimed to raise funds for the origination of mortgage loans (*mutuos hipotecarios*) used to finance the acquisition, construction, repair or extension of residential properties. Only residential mortgages for these purposes are accepted as collateral, excluding commercial, public or other types of loans. An additional restriction imposed to define an eligible mortgage is that only new mortgages are accepted. Hence, a maximum time limit of 18 months was set for the origination of eligible loans since the date of the BH's issuance. Thus, BH bonds also have an anticipated rescue clause for a proportional prepayment of the bond in case of insufficient origination. The issuer has the flexibility of an additional one month period to incorporate new mortgage loans of the same nature and quality to comply with the cover asset limit and balance principle at the end of this 18 months allocation period and at the end of each month along the life of the bond.

Under an eventual credit event/default of an issuer, Articles 125, 126 and 134 of the LGB give BHs the same treatment and current legal status as that of outstanding *Letras Hipotecarias* (LH), a type of mortgage bond frequently used by Chilean banks in the past to finance their mortgage business. These articles regulate the procedures in such case and the mechanisms for the tender process and subsequent transference of eligible loans/assets and liabilities from the defaulted issuer to a new entity.

In September 2012, the final regulation was published in a joint statement by the Chilean Central Bank and the SBIF, describing BHs as a new source of long term funding for banking entities, thus allowing better conditions for clients as well as a new investment alternative for institutional investors. At the same time it explicitly incorporated a prudential regulation associated with financial stability objectives. In particular it stated the obligation of periodic reporting of both bonds and loans, the definition of certain credit indicator limits, specific policies to grant loans and other transparency objectives for the benefit of both clients and investors.

Chapter II.A.2 of the CNF regulates issues related with eligible loans, as well as investments in fixed income securities as substitute collateral since the date of issuance during the period of loan origination, specifying limits for compliance during the whole life of the bond.

The SBIF's RAN mainly regulates the issuance of BHs, the relationship between bonds and loans, and the establishment of a special Register for further control which includes detailed up-to-date information to comply with transparency and monthly reporting objectives.

II. STRUCTURE OF THE ISSUER

Under current legislation only banking entities are allowed to issue Bonos Hipotecarios. Cover assets are held within the balance sheet with the proper internal controls to monitor the cover pool and its relationship with its related bond ratios and limits over time.

Banco Santander Chile issued the first ever local covered bond (Bono Hipotecario). The first covered bond program was for a total amount of UF 3 Million (aprox. USD 134 million), the first issuance out of the program was in August 1st, 2013 for a total amount of UF 1.5 MM (aprox. USD 68 million) and then the second one was in November 20th, 2013. Both issuances generated a great appetite from local investors and the result was a spread of 15 bps lower than the senior unsecured debt outstanding. Currently, Banco Santander Chile is in the process of registering the second covered bond program for a total amount of UF 5 Million (aprox. USD 220 million).

III. COVER ASSETS

Regulation states that issuers have 18 months since the bond's date of issuance to allocate the resources to the origination of mortgages. After that period, at the end of each month during the life of the BH, the outstanding balance of mortgages, excluding amounts in arrears, should not be lower than 90% of the outstanding balance of the respective bonds. Any difference between the outstanding amounts of the mortgages and the bonds must be covered by high credit quality fixed income instruments.

FIGURE 1: FIXED INCOME SUBSTITUTE COLLATERAL: MINIMUM 80% IN SOVEREIGN BONDS (CATEGORIES: I. AND II.)

I.	Sovereing bonds	Fixed income instruments issued by Chilean central bank.
II.	Sovereing bonds	Fixed income instruments issued by Chilean treasury.
III.	Corporate bonds	Local high rated corporate bonds. Sub limit of up to 10% of the total of funds by each *Bono Hipotecario* issuance.
IV.	Bonos Hipotecarios	*Bonos Hipotecarios* issued by other banking entities.
V.	Term deposits	Term deposits originated by high rated banks established in Chile, excluding those of the issuer of the covered bonds.
VI.	LCH	Housing LH: *Letras De Crédito Hipotecario* issued for housing purposes by other banking entities.
VII.	Unsecured bank bonds	Unsecured bank bonds rated AA+ or higher, excluding those of own issuance.

Source: Chilean Central Bank, Banco Santander Chile

IV. VALUATION AND LTV CRITERIA

Eligible loans are only accepted as collateral for the corresponding issued bond once the accredited third-party property appraiser has finished the valuation process and, after it has been registered at the corresponding CBR (*Conservador de Bienes Raices*) – the local entities that certify legal dominion of properties.

The minimum loan-to-value (LTV) defined by law is 80%. Conditions for valuation are also subject to performing or non-performing status of loans. The maximum accepted number of arrears of any single loan in the pool is 10. Above that, the loan must be replaced with a new one of the same nature. As explained before for the cover-to-bond outstanding balance ratio all amounts in arrears are excluded.

LTV alone is not enough for eligibility of mortgage loans. In addition a maximum debt-to-income ratio of 25% is demanded.

V. ASSET - LIABILITY MANAGEMENT

Current legislation does not prescribe over-collateralization for the issuance of BHs.

Under a balance principle the nominal amount of cover assets must always be at least equal to the outstanding amount of related *Bonos Hipotecarios* and loans in arrears or prepaid should be replaced always under the restriction that only new mortgages are potentially eligible as collateral for BHs.

Banks are free to structure the covered bonds according to their own needs and criteria. Banco Santander's first program bond was a 15 year amortizing structure reflecting the expected amortization schedule of the underlying loan portfolio adjusted by the empirical loan prepayment rate. The second bond program will be a 18 years amortizing structure reflecting the expected amortization schedule and the empirical prepayment rate of the new loan portfolio.

VI. TRANSPARENCY

Current regulation includes a prudential approach associated with financial stability objectives: mandatory monthly reports of assets and liabilities in the Register and compliance of required ratios; a specific Credit Policy for mortgage eligibility which must be approved by the Board of Directors and published on the issuer's webpage; and client's LTV and debt-to-income ratios reported in a monthly basis.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Article 69, n°2 of the LGB mandates banks to maintain a special mortgage register (*Registro de Mutuos Hipotecarios*) for the identification and control of the relation between mortgages and their respective BH issuances.

SBIF's RAN 9.2, n°5, sets conditions for inscription of mortgages on the Register and the required information including: identification of bond issuance and loans; dates of inscriptions; original and substitute loans; identification of fixed income assets held as substitute collateral; and elimination from the register by number of arrears or property value deterioration.

Central Bank's CNF Chapter II.A.2, n°18, within its explicit transparency and information objectives, details monthly reporting data including: up-to-date average debt-to-income ratios of clients with eligible loans for each series of BH issuances; average value of properties linked to BHs at the date the credit was granted; LTV of the pool updated by loan replacements; loan characteristics (maturity, interest rates, fixed, floating or mixed type, currency denomination, inflation link mechanism and loan prepayment conditions); outstanding balances of loan portfolios and associated BH issuances and, finally, the total amount of fixed income assets and its general characteristics.

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

There are 2 main issues related with bankruptcy in the BH legislation:

1) Since only new loans are accepted as collateral this avoids the possibility of structuring BHs with a selection of the best quality assets which could be against the interests of other creditors such as depositors in case of bankruptcy.

2) In the case of bankruptcy a special procedure in the way of a separated auction or tender process is triggered for those assets and liabilities clearly identified and associated with BHs in the Register. Eligible bidders are other public or private financial institutions, and the final buyer must take care of BH payments. This process, the same as for Letras de Crédito Hipotecarias (LH) is thoroughly covered in the LGB.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Chile is not a member of the European Union. Therefore, and although Chilean BHs will be issued under the existence of a specific country legislation – which is a requirement for these matters – no special treatment or benefit is expected in terms of preferred risk-weighting for regulatory capital purposes.

X. ADDITIONAL INFORMATION

In a clear intent to provide these Bonds with more liquidity the Chilean Central Bank announced on 28 March 2013 a special Repo program ("Repo BH") which will accept exclusively BHs as collateral. The Repo BH will be offered for up to 14 days at a floating rate equivalent to the current monetary policy rate (MPR) of each day plus 25 basis points. Eligible BHs will be subject to the credit rating of the BH issuer banking entity which must be in AAA, AA or A.

3.7 CYPRUS

By Ioannis Georgiou, Bank of Cyprus

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 entered the covered bond universe in December 2010.

The primary legislation governing the issuance of covered bonds (Kalimmena Axiografa) is the Covered Bond Law of 2010, (130 (I)/2010), which came into force on December 23, 2010 (the "Law").

On the same day, the CBC issued a Directive (526/2010) under the provisions of the Law, which constitutes the regulatory framework for the issue of covered bonds (the "Directive").

The Law and the Directive (the "Cypriot Legal Framework") are further supplemented by other laws (e.g. the Bankruptcy Law, the Banking Business Law, the Companies Law etc.) as referenced by the Law.

The Cypriot Legal Framework has been finalized in consultation with and following the positive opinion of the ECB, dated 14 October 2010 and 23 March 2011 related links are: http://www.ecb.int/ecb/legal/pdf/en_con_2011_27_f_sign.pdf and http://www.ecb.int/ecb/legal/pdf/en_con_2010_73__f_sign.pdf)

II. STRUCTURE OF THE ISSUER

Under the Cypriot Legal Framework, Credit Institutions which have been approved by the Competent Authority (i.e. the CBC or the CSSDA), are only allowed to issue covered bonds using the direct issuance route.

Credit Institutions are defined, under the Law, to be:

> Banks (as defined in the Banking Laws);

> Cooperative Credit Institutions (as defined in the Cooperative Societies Law); and

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

In accordance with Parts II and III of the Law, only Approved Institutions are eligible to issue covered bonds. Approved Institutions, are those Cypriot Credit Institutions which have been registered in the Register of Approved Institutions, (publicly available at the following link: http://www.centralbank.gov.cy/media/xls/ENG_2_Register_of_Approved_Inst.xls) following a relevant application to the Competent Authority.

Approval of such application is granted within 1 month from submission, and only after the Credit Institution has successfully demonstrated its ability to carry out the legal obligations of an Approved Institution, and that it fulfills the criteria and conditions determined by the Competent Authority.

Indicative minimum requirements set out in the Directive, for the registration of a Credit Institution in the Register of Approved Institutions, are:

> Core Tier 1 capital of at least EUR 50 million and capital adequacy ratio as required by the CBC under Pillar I and Pillar II of Regulation 575/2013 (Capital Requirements Regulation);

> Establishment of an automated system for the support of the covered bonds business;

> Established risk management procedures for the recognition, management, monitoring and control of risks that may arise during the conduct of the covered bonds business;

> Procedures, policies and systems in place for the support of the covered bonds business; and

> Compliance with the provisions of the Law and the Directive, to be represented by a written confirmation by the Board of Directors of the Credit Institution.

With respect to individual covered bond issuance, Approved Institutions must subsequently apply to the Competent Authority for registration of such new issue in the Covered Bonds Register (publicly available at the following link: http://www.centralbank.gov.cy/nqcontent.cfm?a_id=11439&tt=article&lang=en). Approval of such application is granted within 10 days from submission, and it is only following such approval that a newly issued bond becomes a covered bond.

III. COVER ASSETS

Primary cover assets are:

> Residential property backed loans (i.e. any kind of credit facility, secured on immovable property, provided that the property is used or intended to be used for residential purposes);

> Commercial property backed loans;

> Public claims;

> Maritime loans; and

> Any other type that may be determined by the Competent Authority.

The criteria, terms and conditions in relation to cover assets are determined by the regulator in Art.13, 14 and 15 of the Directive. The main criteria indicatively include:

> Residential and commercial loans should be secured by a mortgage (or an equivalent security over a property if the property is not located in Cyprus) created in accordance with the Laws of Cyprus or the law of other Member States[1];

> The mortgage or the equivalent charge on immovable property, securing the credit facility, is created for an amount, at least, equal to the value of the loan;

> The immovable property securing the credit facility must be situated on the territory of the Republic or on the territory of other Member States;

> A residential or commercial loan secured by buildings under construction may be included in the cover pool, provided that the total value in each cover pool of the loans secured by buildings under construction does not exceed 10% of the cover pool value;

> Rescheduled loans may be included in the cover pool, only after the lapse of six months from the payment date of the first rescheduled loan instalment;

> Hedging contracts may also be included in the cover pool, only to the extent that they are used exclusively for the purpose of hedging any type of risk that may adversely affect the value of the cover assets.

a) It is noted, that in accordance with Art. 33(b) of the Directive, the counterparty in a hedging contract must *"have a credit rating assigned to the first credit quality step as determined in Annex VI of the Directive 2006/48/EC or a guarantee by a connected entity of the counterparty whose credit rating is assigned to the first credit quality step"*. The latest version of Annex VI is now incorporated in Article 129 of the Capital Requirements Regulation (CRR).

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.).

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

Limitations and guidelines on the above are specified in the Directive (e.g. total value of Complementary Assets included in the cover pool and counted in the measurement of the Basic Collateralisation, not to exceed 15% of the total value of covered bonds, etc.).

IV. VALUATION AND LTV CRITERIA

For **residential loans**, the LTV is not allowed to exceed 75%, provided that if the LTV is above 75% but below 100%, such loans may be included in the cover pool on the condition that:

> They do not exceed 25% of the value of the covered bonds secured by the cover pool; and

> Such inclusion would not cause the weighted LTV of the cover pool to exceed 80%.

For **commercial loans**, the LTV is not allowed to exceed 60%, provided that if the LTV is above 60% but below 80%, such loans may be included in the cover pool on the condition that:

> They do not exceed 25% of the value of the covered bonds secured by the cover pool, and

> Such inclusion would not cause the weighted LTV of the cover pool to exceed 65%.

For **maritime loans**, the LTV is not allowed to exceed 60%, provided that if the LTV is above 60% but below 70%, such loans may be included in the cover pool on the condition that:

> They do not exceed 25% of the value of the covered bonds secured by the cover pool, and

> Such inclusion would not cause the weighted LTV of the cover pool to exceed 65%.

In accordance with Art.13(10) and Art.15(10) of the Directive, the valuation of residential and commercial properties and the valuation of ships (Art.15(10) of the Directive) should be carried out by an independent valuer; i.e. a person who possesses the necessary qualifications, ability and experience to produce a valuation and is independent from the credit decision process.

For the monitoring and review of the value of the residential and commercial properties, the provisions of paragraph 8 (b) of Part 2 of Appendix VIII of the Directive of the Central Bank to banks for the Calculation of the Capital Requirements and Large Exposures shall apply. The provisions of the Directive dictate the following:

> The revaluations of the properties may be carried out by applying statistical methodologies.

a) For commercial properties, according to the aforementioned Directive, the value of the property is reviewed regularly and at least once a year;

b) For residential properties, according to the aforementioned Directive, the value of the property is reviewed regularly and at least once every three years; and

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

> When information indicates that the value of the property may have declined materially relative to general market prices, the property valuation must be reviewed by an independent valuer.

> Also when the balance of the financing exceeds €3million or 5% of the own funds of the credit institution, the valuation of the property will be reviewed by an independent valuer at least every 3 years.

Additionally, and pursuant to Art.46(b) of the Directive, the Covered Bond Monitor ("CBM"), appointed in accordance with Art.49 of the Law, has a duty to examine the valuation process in relation to the valuation of the cover assets.

V. ASSETS - LIABILITY MANAGEMENT

The Directive provides for the following statutory tests:

> **Nominal Value Test**

The adjusted[2] nominal value[3] of the Basic Cover (i.e. the Basic Collateralisation as defined under Art.24 of the Directive) must be at least equal to the total value of covered bonds issued under the programme.

> **Net Present Value Test**

The adjusted net present value of the Basic Cover must be at least equal to 105% of the total net present value of covered bonds issued under the programme. All cover pool assets, including loans, Complementary Assets and hedging instruments must be included in the calculation of net present value of the Basic Cover.

The above 105% condition must also be met in the following scenarios:

(a) Parallel interest rate shift of +200 and -200 basis points;

(b) Interest rate shifts determined by a 99% 6-month confidence interval using daily changes for the last 365 days;

(c) Exchange rate changes:

- Euro and member-state currencies: 10%;
- Currencies of the United States, Canada, Japan, Switzerland, Australia: 15%; and
- Other currencies: 25%.

(d) Exchange rate shifts determined by a 99% 6-month confidence interval using daily changes for the last 365 days.

> **Weighted Average Life Test**

The weighted average life of cover assets counted in the measurement of Basic Cover and Supervisory Overcollateralisation (as defined under Art.25 of the Directive), must be longer than the weighted average life of the covered bonds.

> **Interest Cover Test**

Interest inflows from cover pool assets in the Basic Cover and Supervisory Overcollateralisation for the next 180 days must be reconciled with interest due on the covered bonds for the next 180 days and the highest net interest shortfall must be covered by the Complementary Assets contained in the Basic Cover and Supervisory Overcollateralisation.

> **Prematurity Test**

In relation to the repayment of the principal amount of the covered bonds, liquidity must be maintained, in the form of Complementary Assets or outside the cover pool in the form of liquid assets, as follows:

a) For the period between 180 days to 30 days before the maturity date of the covered bonds, at least 50% of the principal amount due for repayment;

b) For the period between 30 days before the maturity date and the maturity date of the covered bonds, 100% of the principal amount due for repayment.

Liquidity maintained for the purpose of meeting the prematurity test is not subject to the 15% limit of Complementary Assets in the cover pool (set in Art.20 of the Directive).

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

Additionally to the above statutory tests, and with a view to protect the depositors and all other unsecured creditors in case of insolvency proceedings, and to potentially provide for a reserve of assets that may be used in the future to sustain further stresses, the Directive provides that an Approved Institution is not permitted to issue covered bonds, if such an issue would result in:

> the total value of the primary assets which are required to be included in the institution's cover pools for each cover bond category, to exceed 90% of total value of the institution's eligible primary assets for that cover bond category, or

> the total value of the cover assets included in all cover pools and counted in the cover pool adequacy, to exceed 25% of the total value of the institution's assets.

VI. TRANSPARENCY

Transparency, in the Cypriot Legal Framework, is ensured through a series of reporting and registers that need to be maintained, updated and monitored by the covered bond Issuers as well as by the Competent Authority.

In accordance with Art.23 of the Law, covered bond Issuers are required to maintain a cover pool register for each covered bond Issue or Programme outstanding. Specific conditions for maintaining such Cover Pool Register (e.g. form, content, entry recording etc.) are outlined in Art.34-38 of the Directive. The Cover Pool Register is to be updated whenever an asset is included or excluded from the cover pool (and at least on a monthly basis) and shared with the Competent Authority and the CBM.

Specifically, Art.39-42 of the Directive set further transparency obligations to the covered bond issuers, requiring them to disclose, on a quarterly basis and in a publicly accessible area (e.g. their websites), specific statistical information relating to their outstanding covered bonds, in the form determined therein. The above information is also submitted to the Competent Authority and the CBM on a quarterly basis, in the form of Appendix 5 of the Directive.

With respect to the covered bond issuers and the covered bonds issued and outstanding in Cyprus, transparency is ensured through the maintenance of a Register of Approved Institutions (Art.5 of the Law) as a well as a Covered Bonds Register (Art.12 Law) by the Competent Authority. Both registers are kept in an electronic form and are publicly accessible in the website of the Competent Authority.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The Cypriot Legal Framework is structured in a manner which ensures very vigilant regulatory supervision of covered bond issuers. In accordance with Art.49 of the Law, each institution applying for registration in the Register of Approved Institutions, is required to appoint a qualified entity (e.g. an audit firm not associated with the covered bond issuer) as a Covered Bond Monitor (the "CBM"), such appointment being subject to the approval of the Competent Authority. The CBM must possess the necessary knowledge, experience and ability for the effective discharge of its functions and have the necessary qualifications outlined in Art.44 of the Directive. To the extent that, for any reason, the covered bond issuer has not managed to appoint a CBM, the Competent Authority is entitled to appoint one.

The duties of the CBM include a broad range of responsibilities, ranging from verifying to the Competent Authority, ahead of the application for the registration of bonds in the Covered Bonds Register, that the institution fulfils the conditions for registration as an approved institution, to submitting information and regular reports to the Competent Authority.

The main responsibilities of the CBM under the Cypriot Legal Framework include:

> Overseeing the compliance of the Issuer with its obligations under the Cypriot covered bond Legislation;

> Prior to an application for the registration of any covered bonds in the Covered Bonds Register, verifying that the Issuer fulfils the conditions for registration as an approved institution and complies with the provisions of the Law in relation to every previous issue of covered bonds that are outstanding

> Where hedging contracts are included in a cover pool, verifying that these contracts fulfil the criteria set out in Art.26 of the Cypriot covered bond Legislation;

> Monitoring the cover pool assets included in a cover pool, including:

(a) Verifying the accuracy and completeness of the information provided for the cover pool Assets included in the Cover Pool Register;

(b) Examining the valuation process in relation to the valuation of the cover pool assets;

(c) Monitoring compliance, on an on-going basis, with the Statutory Tests; and

(d) Examining the entries in and removals from the Cover Pool Register and confirming the correct recording of the necessary information in the Cover Pool Register

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

Following the registration of the covered bonds in the Covered Bonds Register, and in accordance with Art.16 of the Law, the cover pool is segregated from the covered bond issuer's insolvency estate, securing the claims of the Cover Pool Creditors[4] and constituting a form of charge over the cover pool assets.

In accordance with the provisions of Art.28 of the Law and Art.21 of the Directive, covered bond issuers are required to maintain a Special Transaction Account, recording all inflows from the cover assets and the outflows from the account together with the details of such outflow. The balance of such Special Transaction Account is to be used solely for the servicing of the covered bonds as well as for the creation or acquisition of cover assets to be included in the cover pool, to ensure fulfillment of the cover pool adequacy criteria.

Furthermore, pursuant to Art.21(3) of the Directive, the covered bond issuer must have procedures in place which ensure, at any time, the ability to trace and calculate the cash inflows from the cover assets that have not been used. The operation of the Special Transaction Account is subject to the supervision of the CBM, in order to ensure that the covered bond issuer complies with the provisions of the Cypriot Legal Framework at all times.

In case of dissolution of the covered bond issuer, and until all legal claims of the Cover Pool Creditors are fully satisfied, the cover pool assets are not available to satisfy the claims of any other creditors of the Issuer in accordance with Art.40(5) of the Law.

By virtue of Art.40(7), 41 and 42 of the Law, the Covered Bond Business Administrator (the "CBBA") is empowered to dispose of the Cover Pool Assets, and use the proceeds of such disposal in order to satisfy the claims of the Cover Pool Creditors in priority over the claims of all other creditors.

To the extent that a covered bond issuer is subject to dissolution proceedings, in accordance with Art.40(5) and Art.40(6) of the Law, until the claims of the Cover Pool Creditors are satisfied in full, the cover pool assets will not be available to satisfy the claims of other creditors. Any surplus from the disposal of the cover pool, and only once the claims of the Cover Pool Creditors have been satisfied in full, shall be returned to the credit institution (Art. 44(1) of the Law).

Cover Pool Creditors enjoy a dual recourse, safeguarded under the Law. In accordance with Art.43(5) of the Law, to the extent that the claims of the Cover Pool Creditors are not fully satisfied from the disposal of the cover pool, then these creditors are, with respect to the unsatisfied part of their claims, unsecured creditors of the covered bond issuer.

In addition, where a covered bond Issuer is subject to dissolution proceedings, a Covered Bond Business Administrator (the "CBBA") is appointed by the Competent Authority (as per Art.59(1) of the Law), who takes all

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

necessary measures to assume the control and the management of the cover pool and carries out the covered bond business. Any Cover assets not counted for the purposes of fulfilling the Statutory Tests shall be removed from the cover pool and the Cover Pool Register only by the CBBA.

The treatment of the cover pool following the commencement of dissolution proceedings is summarized below:

> Upon the initiation of dissolution proceedings, the CBBA assumes control of the cover pool (*according to the provisions of Art.40 of the Law*) and also of any liquid assets maintained outside the Register for the purposes of meeting the Prematurity Test, and is responsible to review the adequacy of the cover pool in accordance with Art.19 and Art.23 of the Directive;

> Cover pool adequacy assessment is being performed by the CBBA as per Art.18(6) of the Law, using solely those cover assets which are counted for the purposes of such assessment;

> To the extent that the above assessment has been successfully met, any assets which are not required to meet such assessment, including relevant requirements under a contractual OC, are being released and become available to satisfy the claims of all other creditors, members and investors of the credit institution;

> To the extent that the above assessment has not been successfully met, the CBBA (*according to the provisions of Art.29(2) of the Directive*) is entitled to use any assets included in the cover pool register that do not meet the criteria, terms and conditions for counting a cover asset in the cover pool adequacy. (*To the extent that such assessment is not met, the CBBA has the right to accelerate or transfer the CB business to another approved institution, in accordance with Art.62 (1) of the Law*).

With respect to an automatic acceleration of the covered bonds, this is something that is not provided for by the Law, where a covered bond Issuer is subject to dissolution proceedings.

In accordance with Art. 40(1) of the Law, all outstanding covered bonds will remain in force (subject to the terms and conditions under which they were issued), and the obligations of the covered bond Issuer under the covered bonds continue to be enforceable.

IX. RISK WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 CRR. Cypriot covered bonds meet the criteria of UCITS 52(4).[5] This results in a 10% risk weighting assigned by the CBC. Covered bonds issued under the Cypriot Legal Framework form acceptable collateral for refinancing purposes with the ECB, following the typical ECB eligibility assessment and their inclusion on the ECB Eligible Assets Database (EADB).

X. ADDITIONAL INFORMATION

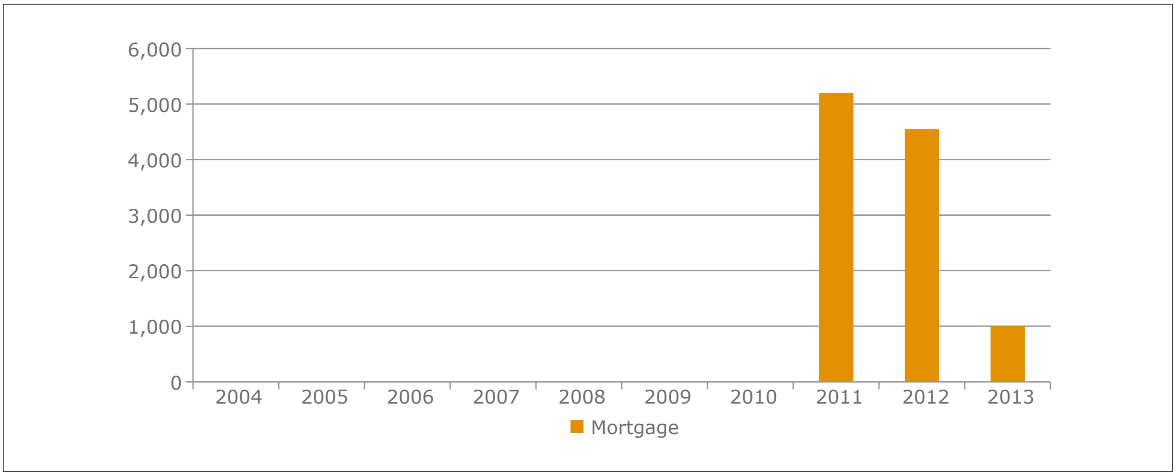
Covered bond issuers are, in accordance with Art.20 of the Law, required to maintain, throughout the life of the covered bonds, a set-off reserve in connection with cover assets that are subject to set-off.

The Directive provides for the maintenance of such a set-off reserve, in the form of additional assets which are included in the cover pool (Art.22, 24 and 25 of the Directive).

The set-off reserve is quantified by the Issuer and such calculation is subject to the monitoring of the CBM. The set-off reserve is segregated from the Issuer's other assets, forming part of the cover pool where Cover Pool Creditors have a priority claim over amounts in such reserve

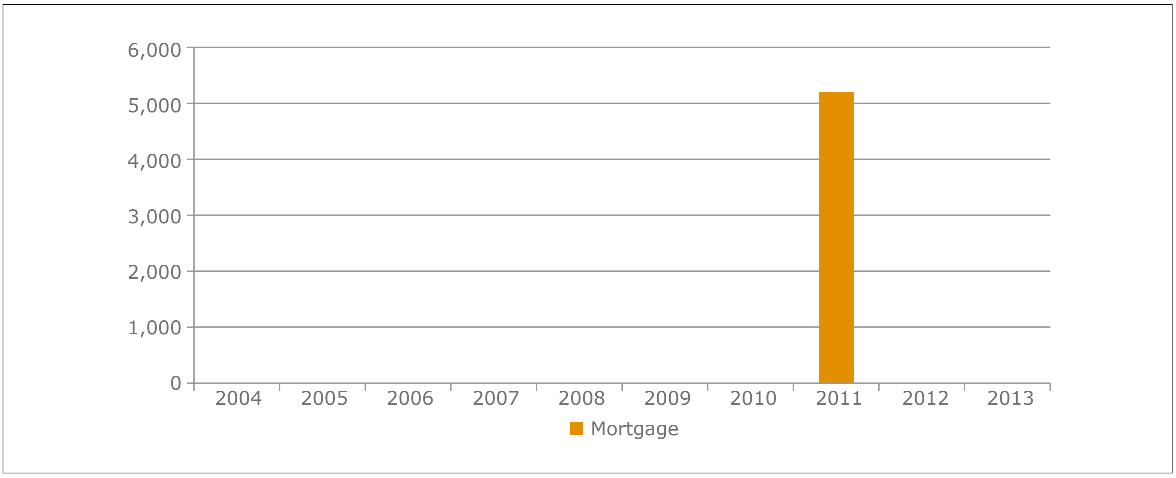
5 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2004-2013, EUR m



Source: EMF/ECBC

Issuers: Bank of Cyprus Public Co Ltd.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/93/Cyprus_CBs

3.8 CZECH REPUBLIC

By Libor Ondřich, UniCredit Bank Czech Republic and Slovakia

I. FRAMEWORK

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 loans (hereinafter also referred to as "ML") and the other terms and conditions of mortgage financing are regulated in detail in the Bond Act (hereinafter also referred to as "BA"), which entered into force on April 1, 2004. The latest amendment has been effective since August 1, 2012, which, besides other things, enables issuance of the MCBs under a law different from the Czech law and clarifies the calculation of the minimum LTV required by the law.

Specific provisions treating cover assets and applicable at the opening of the insolvency proceedings or declaration of bankruptcy of the issuing bank are part of the Insolvency Act No. 182/2006 Coll.

II. STRUCTURE OF THE ISSUER

MCBs may only be issued by a bank holding a Czech banking license (i.e., a banking license issued under the Banking Act no. 21/1992) and having its registered office in the Czech Republic (an "Issuing Bank"). An Issuing Bank can generally pursue all business activities that are permitted for credit institutions and need not be a specialized bank. The MCBs constitute direct and unconditional obligations of the Issuing Bank, and the Issuing Bank is fully liable for any payment obligations thereunder. All obligations arising from the MCBs are obligations of the Issuing Bank as a whole to be paid from all the assets of the Issuing Bank, subject to specific provisions applicable to the Issuing Bank's insolvency (dual recourse).

III. COVER ASSETS

Pursuant to the BA, the MCBs are such covered notes where the nominal value of and revenue from which are fully covered with (i) receivables from MLs or parts of these receivables (the so-called "regular coverage") and (ii) by substitute collateral. The text "Mortgage Covered Bond" has to be a part of the name of this covered bond. No other securities and/or covered bonds are allowed to use this name.

ML is such loan that is secured with a mortgage to a real estate (residential mortgages, commercial mortgages, land, buildings under construction). The amount of receivables from ML must not exceed double the collateral value of the mortgaged real estate. 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 loan is considered to be the mortgage loan on the day of origin of legal effects of the mortgage right registration.

The mortgage right securing the ML 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 loan which:

> Is extended by a building society or a loan extended for a cooperative housing construction supported by the State. The precondition for this is that the building society or the creditor of the cooperative housing construction loan 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 a lower ranking. The receivable from the ML secured with a mortgage right not in the first position may not be used to cover the MCBs without such consent.

> Will be repaid so that the mortgage right related to the ML will move from the second position to the first position of registration in the Real Estate Register.

Substitutive Coverage

Substitute collateral is restricted to 10% of the nominal amount of MCBs outstanding. The following substitute 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 CNB;

> 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.

IV. VALUATION AND LTV CRITERIA

Only the issuer's receivables arising from mortgage loans or parts thereof may be used for the proper coverage of the total obligations arising from all the mortgage bonds in circulation issued by one issuer. Such receivables or parts thereof may not, during the period when they are used for such coverage, exceed 70% of the aggregate mortgage lending value of the mortgaged property securing such receivables (70% portfolio LTV limit).

If any mortgage rights in priority sequence are attached at the same time to any real estate that serves to secure the construction savings credit or the cooperative housing construction loan, only the receivable from the mortgage loan or its part in the maximum amount of the difference between 70% of the mortgage lending value of the real estate under mortgage and the sum of the receivables from the loan extended by the building society and the cooperative housing construction credit may be used for the purposes of coverage of the MCBs.

The issuer of the MCBs determines the *mortgage lending value* of the real estate under mortgage, and namely as the *prudent market value*, 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 *prudent market value* 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 prudent market value 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 lending value* shall not exceed the *prudent market value* of the real estates.

The conditions allowing the use of the receivable from the ML to cover the MCBs have to be complied with throughout the period for which the receivable from the ML is included in the MCB coverage.

V. ASSET – LIABILITY MANAGEMENT

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 ML (regular coverage) or possibly in a substitutive manner (substitutive coverage). No other test is required by the law. Derivatives are not eligible cover assets.

VI. TRANSPARENCY

An initiative sponsored and coordinated by the Czech Banking Association aiming for the improvement of the covered bond legislation was launched in December 2012. The initiative prepares proposals for legislative changes, which should help to further promote soundness of the Czech covered bond market. The Bond Act and Insolvency Act are within the scope of this initiative. The changes are expected to become effective in 2015.

VII. COVER POOL MONITORING AND BANKING SUPERVISION

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 (Czech National Bank). 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 MLs used to cover the MCBs) and with the substitute collateral, 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 MLs for coverage and elimination of the MLs from the coverage shall be made by the departments independent of the departments responsible both for the extension of MLs and for issuance of the MCBs and namely up to the managing Board member.

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

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 ML) serving to cover the MCBs of the bankrupt issuer constitute the mortgage estate (cover pool). A special administrator may be appointed to administer the mortgage estate and to satisfy the claims resulting from the MCBs in circulation. The yield from the encashment of the mortgage estate shall be first used to satisfy the costs of administration and encashment of the mortgage estate 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. Otherwise there is no specific provision regarding the treatment of cash flows generally, including those received prior to opening of the insolvency proceedings or declaration of bankruptcy and those received afterwards. The current automatic acceleration of covered bonds is intended to be removed in the planned update of the legal framework for Czech covered bonds.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR)[1].

1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

The risk-weighting of MCBs is regulated by the Czech National Bank decree no. 123/2007 Coll. transposing EU's Capital Requirements Directive into the Czech law. Risk-weight of 10% (under the standardized approach) is assigned provided that the MCB complies with the requirements of the Annex 4 of the aforementioned decree.

Czech investment legislation allows investment funds to invest up to 25% of the fund's assets in MCBs complying with the requirements of Article 52(4) UCITS Directive (Art. 28(2)(c) of the Czech Collective Investment Act).

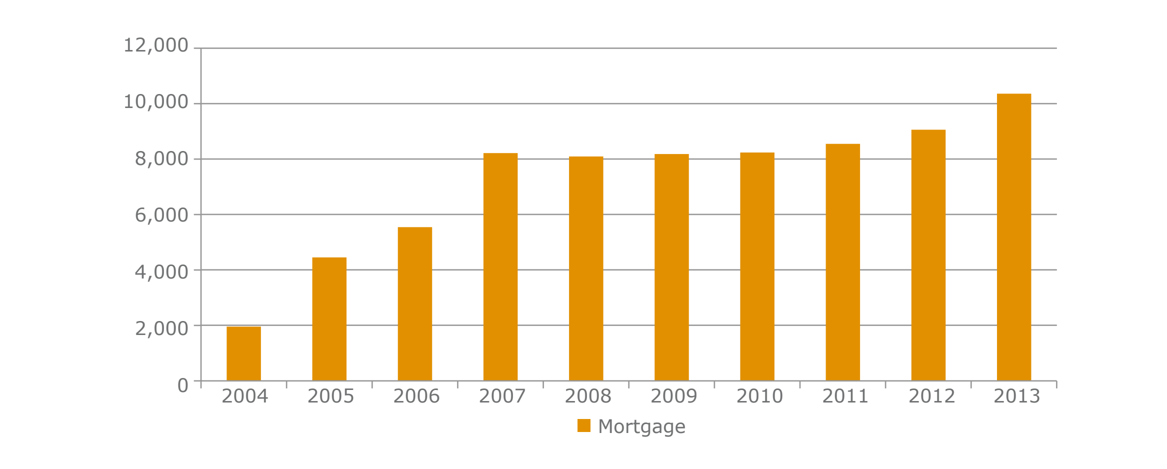
X. ADDITIONAL INFORMATION

State Incentives

The debtor from the ML may reduce his income tax base with the interests he has paid to the issuer from the ML used to finance his housing needs.

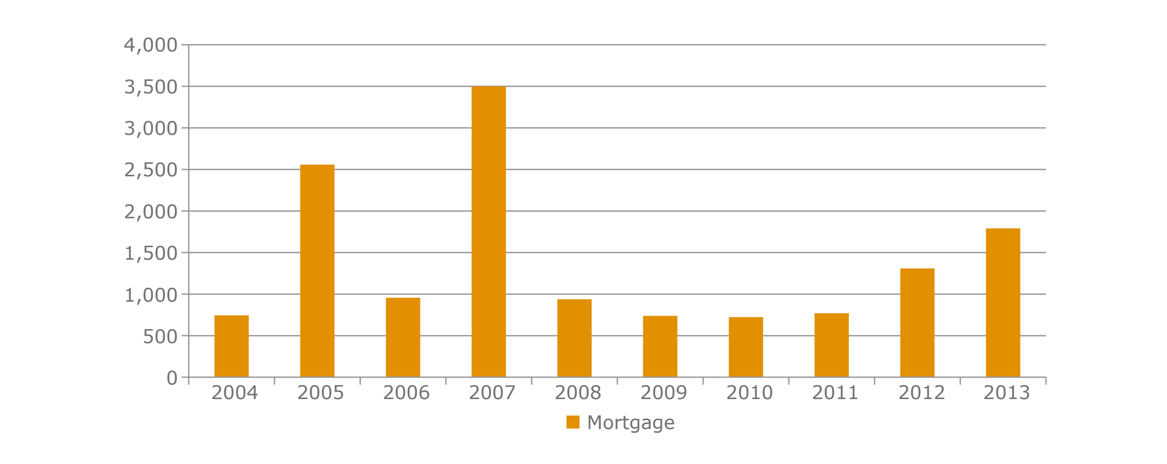
The interest revenues from MCBs are exempt from the income tax, provided that such MCBs were issued before the 1st of January, 2008 and are covered by receivables from MLs for housing investments.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2004-2013, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2004-2013, EUR M



Source: EMF/ECBC

Issuers: There are eight issuers in the Czech Republic - Česká spořitelna, Československá obchodní banka, Hypoteční banka, Komerční banka, Raiffeisenbank, Sberbank CZ, Wüstenrot hypoteční banka, UniCredit Bank Czech Republic and Slovakia.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/112/Czech_Republic_Covered_Bonds

3.9 DENMARK

By Mette Saaby Pedersen, Association of Danish Mortgage Banks and Svend Bondorf, Nykredit

I. FRAMEWORK

The Danish Act on covered bonds (SDOs) came into force on 1 July 2007. It was passed to implement the new set of rules on covered bonds from the EU (Capital Requirements Directive - CRD I). At the same time, it met the political objective of giving both mortgage banks and commercial banks the opportunity to issue SDOs.

Danish mortgage banks and commercial banks are regulated in detail by the Danish Financial Business Act (*Lov om finansiel virksomhed*). Danish mortgage banks are also governed by the Danish Mortgage-Credit Loans and Mortgage-Credit Bonds etc. Act (the "Mortgage Act") (*Lov om realkreditlån og realkreditobligationer mv.*). The Capital Requirements Regulation (CRR) is directly applicable to the commercial banks and the mortgage banks. 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 covered bonds. Since this date, also commercial banks can obtain a license to issue covered bonds.

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

> Særligt Dækkede Obligationer (SDOs) issued by either commercial or mortgage banks. SDOs are both UCITS (Article 52(4)) and CRR compliant (Article 129).

> Særligt Dækkede Realkreditobligationer (SDROs) issued exclusively by mortgage banks, fulfilling the former as well as the new legal requirements. SDROs are both UCITS (Article 52(4)) and CRR compliant (Article 129).

> Realkreditobligationer (ROs) issued exclusively by mortgage banks. ROs are UCITS compliant (Article 52(4)).

In addition, all ROs issued before 1 January 2008 have maintained their covered bond status in accordance with the grandfathering option under the CRR. The grandfathered bonds are both UCITS (Article 52(4)) and CRR (Article 129) compliant.

The covered bond legislation in Denmark allows for joint funding, i.e. two or more institutions joining forces to issue covered bonds in order to achieve larger issues. The first issue of joint funding between non-affiliated institutions took place in 2012.

Danish mortgage banks operate subject to a specialist banking principle in accordance with Danish legislation, which confines the activities of issuers to the granting of mortgage loans funded by the issuance of covered 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 (Consolidating Act no 886-8 August 2011).

The specialist banking principle implies that mortgage banks are confined to granting loans that meet the requirements for cover assets imposed by legislation. Similarly, the funding sources are limited to ROs, SDOs and SDROs. This is due to the fact that Danish mortgage banks are not allowed to accept deposits, etc. as a source of funding, cf section 8 of the Financial Business Act.

The issuer (mortgage bank or commercial bank) holds the cover assets on its balance sheet as well as all rights under the cover assets. Bonds and cover assets are assigned to individual capital centres in mortgage banks and to registers in commercial banks. The individual bonds, however, are not linked to individual mortgage loans.

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.

III. COVER ASSETS

Assets eligible as the basis for mortgage covered bond issuance:

SDO	SDRO	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. Land and loan registration has been digital since 2009 with faster and more efficient handling of customers' loans as a result.

The mortgage loans are originated in a mortgage bank or a credit institution in the same group, or transferred to a mortgage bank according to a structure in which the mortgage bank has knowledge of and is responsible for correct valuation of the mortgaged property and verification of the debtor's creditworthiness and ability to pay.

The difference between funding and lending may be hedged through derivatives, which are included in the cover pool assets.

In a capital centre in a mortgage bank the cover pool is dynamic as a result of the current addition and disposal of loans in connection with the granting and repayment of loans. In most capital centres assets may exclusively be transferred to or from the cover pool upon new lending and (p)repayment. On (p)repayment, the corresponding amount of issued bonds will be transferred from the capital centre. Each mortgage loan (cover asset) refers to specific ISIN codes and both cover assets and ISIN codes are assigned to specific capital centres. It is therefore not possible for the issuer to (i) change the cover pool unless in connection with new lending and (p) repayment nor (ii) transfer cover assets between different cover pools. Such cover pools are thus less dynamic than cover pools where existing mortgages can be transferred into and out of the cover pools. Cover assets must be identifiable, and the FSA supervises cover asset identification.

IV. VALUATION AND LTV CRITERIA

The financial legislation contain provisions on property valuation. Valuations are based on the open market value of a property.

LTV limits - an overview

Loan Type / Property category	SDO	SDRO	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 collateral to the capital centre/register. Otherwise, the issues may lose their status as SDOs or SDROs.

Mortgaged property is valued (on-site inspection) as part of the processing of loan applications. 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 legislation. 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.

V. ASSET - LIABILITY MANAGEMENT

The financial legislation 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 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 banks 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% 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%/ 5% of capital adequacy requirement + 2%/10% of the additional excess cover Loss limit for **commercial banks** dependent of stress test: 10%/100% of excess cover
Currency risk	Exchange rate indicator 2 (few currencies) + Loss limit of 0.1% of capital base	Simple stress test Loss limit for **mortgage banks**: 10% of capital adequacy requirement + 10% of the additional excess cover for EUR and 1% of capital adequacy requirement + 1% of additional excess cover of other currencies Loss limit for **commercial banks**: 10% 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% of capital adequacy requirement + 1% of the additional excess cover No maturity or structural limits Loss limit for **commercial banks**: 5% of excess cover No maturity or structural limits
Liquidity risk	Limitations on temporary liquidity deficits 25% (years 1-3) 50% (years 4-10) 100% (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%. 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 mortgage lending and funding. Thus, the mortgage banks have nearly eliminated interest rate risk, foreign exchange risk and prepayment risk.

Since mortgage bond issuance is the only eligible funding source for Danish mortgage banks, issuance takes place on a daily basis. The mortgage bank commonly achieves this through tap issuance. Each loan is closely matched to the future cash flow of one or several specific ISIN codes currently open for issuance. On any given banking day the mortgage bank calculates the bond amounts to be tapped in the relevant ISINs corresponding to the loans disbursed that day. These bond amounts are then issued and sold to investors. These simple principles ensure that the balance principle is maintained day by day and minimizes the subsequent need for active asset-liability management.

A typical mortgage ISIN is open for tap issuance for several years after opening. Issuance trades are executed alongside with other trades in a unified, highly liquid and tightly priced market. Thus, there is no strict distinction between primary and secondary markets in the Danish system.

The Danish commercial banks, too, are subject to the strict ALM rules. In practice the commercial banks operate under a general asset and liability management and do not offer pass-through products.

To address refinancing risk the legislation was amended in 2014. The new regulation applies to bullet bonds and floating-rate bonds where the loan term is longer than the maturity of the bond used to fund it. The rules were implemented on 1 April 2014 for bonds with an original maturity up to 12 months and will come into effect for longer bonds, too, on 1 January 2015. The new regulation introduces a soft bullet mechanism controlled by two triggers: a refinancing failure trigger and an interest rate trigger, either of which may extend the bond maturity by 1 year. The interest rate trigger, which applies solely to bond maturities of 2 years or less, comes into effect in case of a 5% point bond yield increase over the last year before ordinary maturity. The new legislation has provided clarity for the position of borrowers, investors and mortgage banks in an extreme crisis where a mortgage bank is unable to complete the refinancing by sale of bonds at market terms, or interest rates suddenly rise very sharply.

According to the legislation , the capital base must represent at least 8% of risk-weighted assets. 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.

VI. TRANSPARENCY

A high level of transparency is an important characteristic of the Danish covered bond market. The Danish covered bond issuers publish information via many different platforms, such as prospectuses, investor reports, trading venues and issuers' investor relations web sites.

Information is thus easily accessible. Previously the information has been somewhat fragmented, requiring investors to seek and collect information from different sources and in different formats.

To complement the ECBC Label Initiative, the Danish market participants have gathered available information and consolidated it in an intuitive and user-friendly structure in the national transparency template. The Danish issuers report data uniformly cell by cell in excel format as specified in the transparency template. The uniform reporting makes it easy for investors to compare data across issuers' cover pools and to extract data for further analysis.

The establisment of the national transparency template provides investors a single point of entry for the extensive information available on covered bond issues – be it SDO, SDRO or RO with means to compare key information across an array of issuers. The template is a valuable tool that supports covered bond investors' investment decisions by comprehensive overview of covered bond issues and marking comparison of key information easier.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

General banking supervision is carried out by the Danish FSA. The FSA supervises compliance with the legislative framework for carrying on mortgage banking activities and thereby the issuance of covered bonds.

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. The FSA performs random checks of mortgage banks' valuations by way of on-site inspections and by checks of the internal valuation reports and which other property has been used as reference to the basis for the valuation. In the Danish mortgage model where loans are originated, serviced and redeemed directly in the cover pool, there is no need for monitoring other than as provided by the FSA.

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.

Issuers are also required to prepare comprehensive reports on asset-liability management for the FSA on a quarterly basis. The FSA must be informed of any balance principle breaches without delay. If the capital requirement is not observed, the FSA must be informed without delay.

The FSA has the authority to issue an order with which the issuer must comply. In case of severe or multiple breaches of Danish law or of such orders, the FSA may revoke the operating licence and dismiss the management of the issuer, cf sections 373-374 of the Financial Business Act.

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

Capital centres of mortgage banks (regardless of whether the issuer has issued ROs, SDROs or SDOs)

The rules for resolving a mortgage bank are detailed and well considered.

The main considerations are to ensure (i) that bond investors receive timely payments and (ii) that the rights of borrowers are not prejudiced materially.

Balance sheets of Danish mortgage banks are structured with a number of separate capital centres (cover pools) out of which covered bonds are issued. A capital centre consists of a group of series in which covered bonds backed by an equivalent amount of mortgage loans (match funding) are issued and a joint series reserve fund (equity). In addition, supplementary capital (senior secured debt/junior covered bonds) may be issued out of the capital centre for overcollateralisation purposes.

If a mortgage bank is declared bankrupt, a trustee in bankruptcy is appointed. The Danish FSA may declare a mortgage bank bankrupt.

The trustee looks after the interests of the estate in bankruptcy, i.e. the interests of the creditors and particularly the covered bond investors in relation to the individual capital centres. Today, the creditors of a mortgage bank are almost exclusively covered bond investors. The trustee must seek the most efficient administration of the estate, having regard to the fact that the position of covered bond investors and borrowers must remain essentially as if the capital centre had still been a going concern. If a mortgage bank is declared bankrupt, no acceleration therefore takes place in respect of covered bond investors or borrowers. This is the key principle. It is only possible because the mortgage system is structured around capital centres that offer very high statutory collateral for bonds based on ring-fenced, bankruptcy-remote capital centres and match-funded lending.

Resolution is not fast, but orderly, with a minimum of changes for both bond investors and borrowers. No public funds are used for such resolution, as borrowers' ongoing payments are passed through to bondholders. Holders of hybrid core capital and subordinate loan capital cannot use the bankruptcy of a mortgage bank as grounds for a claim of default. Similar rules apply to counterparties to financial instruments used to hedge risk in a capital centre.

A mortgage bank is not considered insolvent if it fails to meet its payment obligations to holders of subordinated debt (subordinate loan capital and hybrid core capital).

The practical duty of a trustee is to simulate a going concern. Borrowers' rights in respect of prepayment are unchanged. The trustee must, as far as possible, continue to make payments to bond investors and to look after the interests of existing borrowers. The trustee may not issue new loans or otherwise expand business, as the mortgage lender's licence to carry on mortgage banking has been withdrawn.

The trustee may issue bonds to refinance bonds which have matured (adjustable-rate mortgages). But such issuance may only take place if the trustee deems that there are "sufficient funds" to satisfy the claims of creditors. The bonds may also be extended by 12 months at a time, if there is an insufficient number of buyers for the bonds.

The trustee may also raise other loans for the purpose of paying bond investors. Such loans cannot be secured against existing mortgages, as these already serve as security for the issued covered bonds.

The trustee may transfer a total capital centre to another mortgage lender as an independent asset. A full transfer must be authorised by the Danish Minister for Economic and Business Affairs. Bondholders do not have a right of early redemption as a result of such transfer. Transfer in cases other than bankruptcy/suspension of payments requires the consent of creditors in accordance with the general rules of Danish legislation on the change of debtors as well as prior public authority approval.

If a mortgage lender is declared bankrupt, the assets, after deduction of estate administration costs, will be segregated to satisfy bond holders, etc., in accordance with their legal position as secured creditors. Covered bond holders have a primary secured claim against all assets in the cover pool. Counterparties to financial instruments used to hedge risk in a capital centre rank pari passu with covered bond holders in the relevant capital centre.

Proceeds from loans raised for the purpose of overcollateralisation (senior secured bonds/junior covered bonds) will serve to satisfy the claims of covered bond holders in case of bankruptcy. Any excess funds will be repaid to the lender.

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 or overcollateral in general (also referred to as junior covered bonds or senior secured 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 or senior secured bonds may also be proved as ordinary claims against the assets available for distribution.

The register is – contrary to the capital centres of mortgage banks – not subject to any specific statutory minimum requirement as to capital adequacy. The 8% capital adequacy requirement must only be fulfilled at the level of the commercial bank.

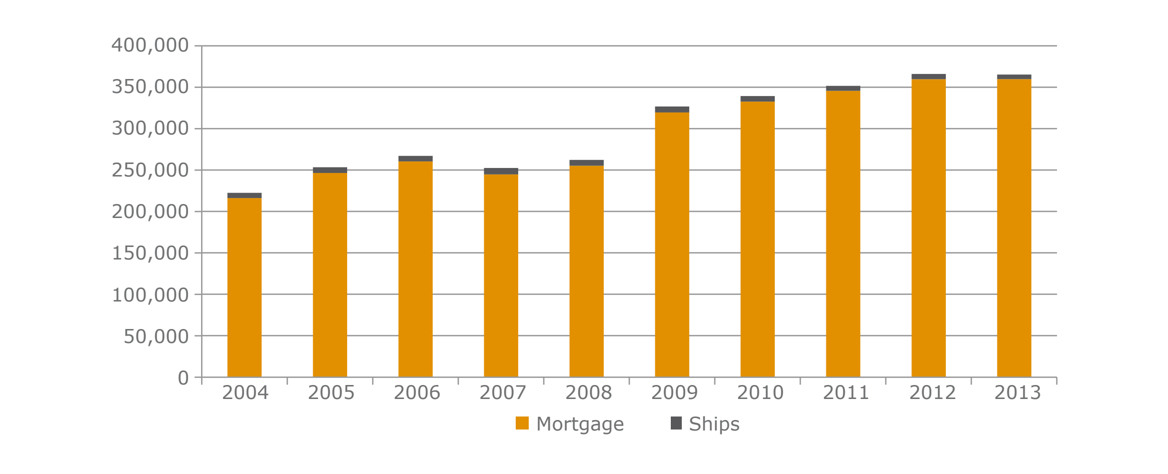
IX. RISK WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

SDOs, SDROs and ROs fulfill the criteria of Article 52(4) UCITS. SDOs and SDROs also fulfill the requirements of Article 129 CRR.[2] ROs issued before 1 January 2008 maintain the low risk weighting of 10% throughout the maturity of the bonds in accordance with the grandfathering option under the CRR. 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.).

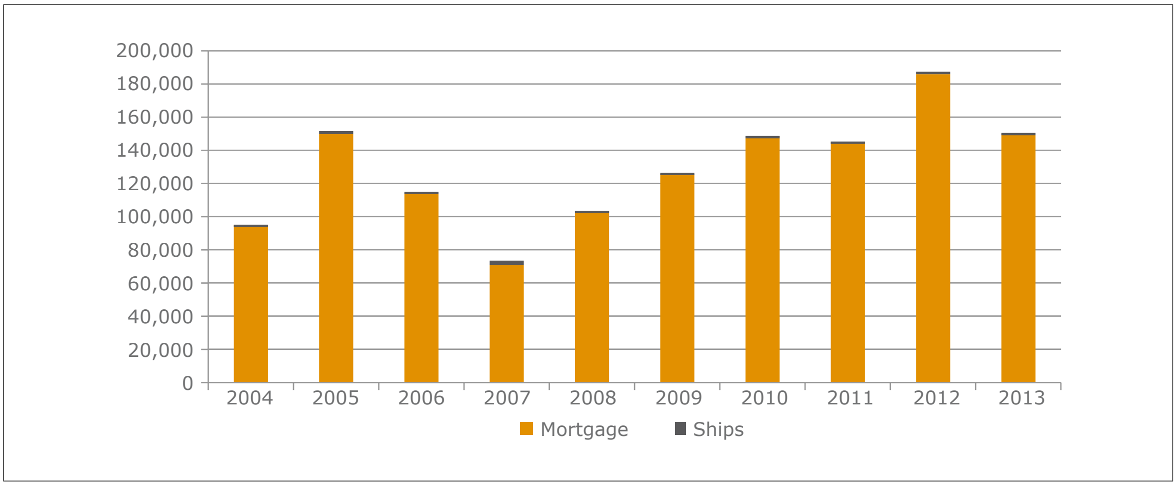
2 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2004-2013, 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), Realkredit Danmark A/S. At the end of 2013 the mortgage banks' outstanding volume of covered bonds was EUR 339 bn. Since the current 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 21 bn. Danish Ship Finance is the only Danish issuer of covered bonds backed by ship loans.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/87/S%C3%A6rligt_D%C3%A6kkede_Obligationer_-_SDO, http://ecbc.eu/framework/88/S%C3%A6rligt_D%C3%A6kkede_Realkreditobligationer_-_SDRO and http://ecbc.eu/framework/89/Realkreditobligationer_-_RO

Covered Bond Label: BRFKredit a/s Capital Center E; Danish Ship Finance General Capital Center; Danske Bank A/S Cover Pool D – Denmark; Danske Bank A/S Cover Pool I – International; Danske Bank A/S Cover Pool C – Commercial; DLR Kredit A/S Capital Centre B; Nordea Kredit Capital Center 1 / Nordea Kredit Capital Center 2; Nykredit Capital Centre E; Nykredit Capital Centre H; Realkredit Danmark A/S Capital Centre S; Realkredit Danmark A/S Capital Centre T

3.10 FINLAND

By Timo Ruotsalainen, Aktia Bank plc and Bernd Volk, Deutsche Bank

I. FRAMEWORK

There are currently five issuers of Finnish covered bonds. The five Finnish covered bond issuers have eight covered bond programmes. Three covered bond programmes are legacy programmes, i.e. are no longer used for public issuance.

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 the 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. No counterparty restrictions apply and derivative counterparties are typically internal.

II. STRUCTURE OF THE ISSUER

The issuer of Finnish covered bonds can be a universal bank or a specialist mortgage bank. Generally, entities that can issue covered bonds are credit institutions authorised to engage in mortgage credit bank operations. The issuer of Finnish covered bonds can still be a specialised bank, but deposit banks or credit entities are entitled to apply for a licence to issue covered bonds. The existing specialised banks tend to stay in business in the way they have been operating since being established. Unless it is a mortgage credit bank, the issuer must obtain a license to engage in mortgage credit bank operations (i.e., issue covered bonds).

The Finnish covered bond law stipulates certain requirements to receive a covered bond issuance license. The covered bond issuer should provide a business plan, show financial stability, expertise in mortgage credit operations, risk management and practices concerning valuation of collateral. Interestingly, the requirements to receive a Finnish covered bond license seem very similar to the requirements to receive a German Pfandbrief license.

The issuer holds the cover assets on the balance sheet. A subsequent transfer of the cover assets to another legal entity is not taking place. A direct legal link between single cover asset and the covered bonds issued does not exist. All obligations from Finnish Covered Bonds are direct and unconditional obligations of the issuing bank as a whole. In the case of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved only for the claims of the holders of Finnish Covered Bonds.

Under the previous legal framework, only bonds covered by mortgages were issued by Finnish mortgage banks. A separate cover pool was to be established if these banks were to start the issuance of public-sector backed Finnish Covered Bonds. Under the new law, mixed pools comprising mortgage loans as well as eligible public sector assets are allowed.

III. COVER ASSETS

Finnish covered bonds have a cover pool register that includes all cover pool assets, covered bonds and derivatives. Eligible assets for Finnish covered bonds are residential mortgage loans (including shares in Finnish housing companies), commercial mortgage loans, public sector loans and substitution assets. At least 90% of the cover pool loans must consist of residential mortgage loans, public-sector loans or substitution assets. Cover pool assets can be within European Economic Area countries.

Enforcement of non-Finnish cover pool assets would usually be determined by the laws of the jurisdiction in which the assets. Due to European law, inside the EU, enforcement is safeguarded anyway. However, Finnish issuers have so far only Finnish assets in the covered bond pools.

Derivatives may also be registered in the cover pool. 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 Article 129(1) CRR are also eligible.

A new feature in the law is that a specialised mortgage credit bank can grant an intermediate credit to a deposit bank or a credit entity. This intermediate credit must be covered with eligible cover assets as stated above. These assets must also be recorded into the cover register.

Up to 20% of the mortgage cover pool is allowed to consist of substitute cover assets; bonds and other debt obligations issued by the State, a municipality or another public-sector organisation or another credit institution than one belonging to the same consolidation group as the issuer; a guarantee as for own debt granted by a public-sector organisation or credit institution referred above; a credit insurance given by an insurance company other than one belonging to the same group, referred to in the Act on Supervision of Finance and Insurance Groups; cash assets of the issuer deposited in the Bank of Finland or a deposit bank with the restriction that if the issuer is a deposit bank the cash deposit may not be in a deposit bank belonging to the same consolidation group as the issuer.

ABS or MBS tranches are not eligible for the cover pool.

Derivatives are eligible for the cover pools only if they are used for hedging purposes.

The nature of the cover pool is dynamic. Currency risk is perfectly matched as the law requires cover assets to be in the same currency as the covered bonds.

IV. VALUATION AND LTV CRITERIA

The property valuation within the legal framework for covered bonds in Finland is based on market values, valuations are based on “current value”, market value determined in accordance with FFSA regulations. Based on the updated regulation, the issuer needs to monitor the valuation of the property also based on statistical methods (indexed value) quarterly and set limits for the acceptable changes of the values. Should the value exceed or drop below the limits the property valuation needs to be updated accordingly.

There are different LTV levels for residential and commercial mortgage loans: 70% of the value of the residential property and 60% of the value of the commercial property accepted. This LTV is a relative limit, i.e. when a loan exceeds the 60%/70% limit, the part of the loan up to 60%/70% LTV remains eligible to the cover pool. A loan placed as collateral for a covered bond may not exceed the current value of the property standing as collateral.

V. ASSET - LIABILITY MANAGEMENT

There are legal standards for Asset-Liability Matching in the Finnish Covered Bond System. For instance, the aggregate interest received on the cover assets in any 12-month period must exceed the interest paid on the outstanding covered bonds. This regulation takes derivatives for hedging purposes into account.

The total amount of collateral of covered bonds shall continuously exceed the remaining combined capital of the covered bonds.

The net present value of the total amount of collateral of covered bonds shall continuously exceed by at least 2% the total net present value of the payment liabilities resulting from the covered bonds. The net present value test helps mitigate interest-rate, currency and liquidity risk.

As mentioned above, interest receivable on cover assets must be sufficient to cover interest payable on covered bonds on a twelve month rolling basis. Moreover, the test needs to be stressed by +/- 1%. 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. In addition to the 2% net present value legal minimum, further OC may be committed by contract. Non-performing loans (defined as 90 days past due) are excluded from cover tests. Assets that are ineligible for Finnish covered bonds (.e.g. non-performing loans) are excluded from the cover tests, but can be retained in the cover pool and lead to additional OC.

VI. TRANSPARENCY

The annual and interim reports of the issuer indicates, in addition to that provided in the act on Credit Institutions, the basis of the valuation of the collateral and the amount of residential mortgage loans and possible intermediary loans and public sector loans issuer has granted, as well as the amount of covered bonds issued.

The leading Finnish issuers have adopted the ECBC Label initiative for Covered Bonds and created Finnish National Transparency Template: https://www.coveredbondlabel.com/issuers/national-information-detail/9/.

On top of the regulatory requirements all issuers provide additional information about the cover pools, ratings and other relevant topics on their websites. Please find the website information at section X, Additional information.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The issuer carries out the monitoring of the cover pool. The issuer reports to the FSA on a monthly basis. With regard to UCITS 52(4), this supervision of a specialised bank as issuer of the covered bond is compliant to the "special supervision". The FSA is responsible for overall supervision, covered bond licensing, issuing regulations and compliance with the law.

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.

With regard to UCITS 52(4), this supervision of a specialised bank as issuer of the covered bond is compliant to the "special supervision".

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

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. The Finnish covered bond law specifically excludes set-off against cover pool assets. The law also specifically excludes claw-back risk.

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. The cover pool administrator can only accelerate the covered bonds if the cover tests can no longer be fulfilled. This would trigger the sale of the cover pool assets.

Following issuer default, the regulator is not a manager or servicer of last resort. However, a cover pool supervisor is appointed to supervise the interests of covered bondholders, with powers to direct the issuer's general administrator.

The cover pool supervisor will supervise cover pool cash flows and payments to covered bondholders. The general administrator also has powers to act in the interests of the covered bondholders under the direction of the cover pool supervisor. This includes the ability to assign the liability for a covered bond as well as the related cover pool assets to another licensed covered bond issuer (with the permission of the FSA).

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. Substitute assets are deposits, bonds or guarantees of public sector entities or credit institutions and certain credit insurance. 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.

Some Finnish covered bonds mitigate liquidity risk via contractual 12 month maturity extensions ("Soft Bullet"). The extension provides additional time for principal amounts to be refinanced. Combined with the interest coverage test, maturity extensions improve the chance that principal and interest payments can be met without refinancing the covered bonds for the first twelve months after issuer default.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

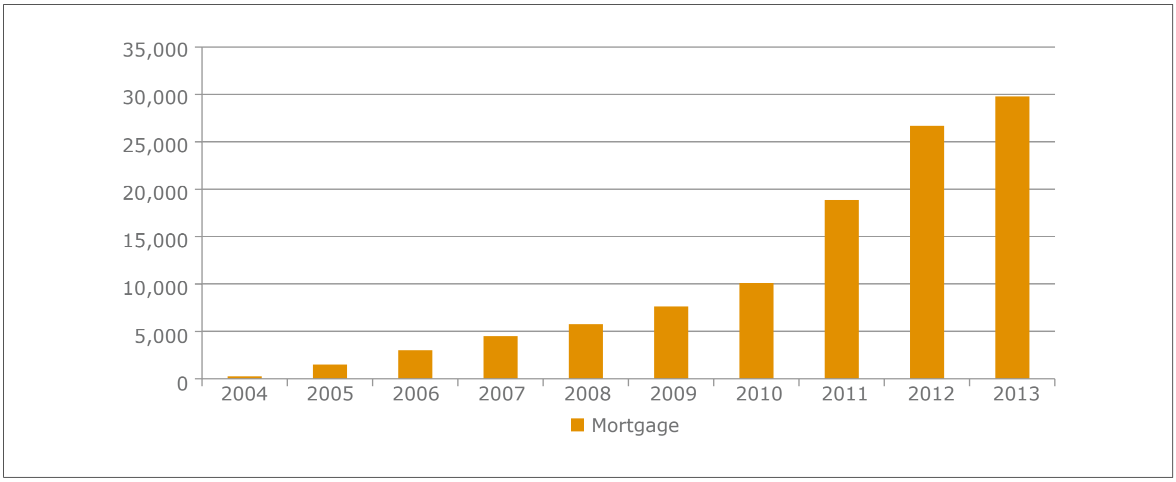
Finnish Covered Bonds comply with the requirements of Art. 52(4) UCITS Directive. The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR)[1]. Therefore, these bonds 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 Eurozone.

1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position

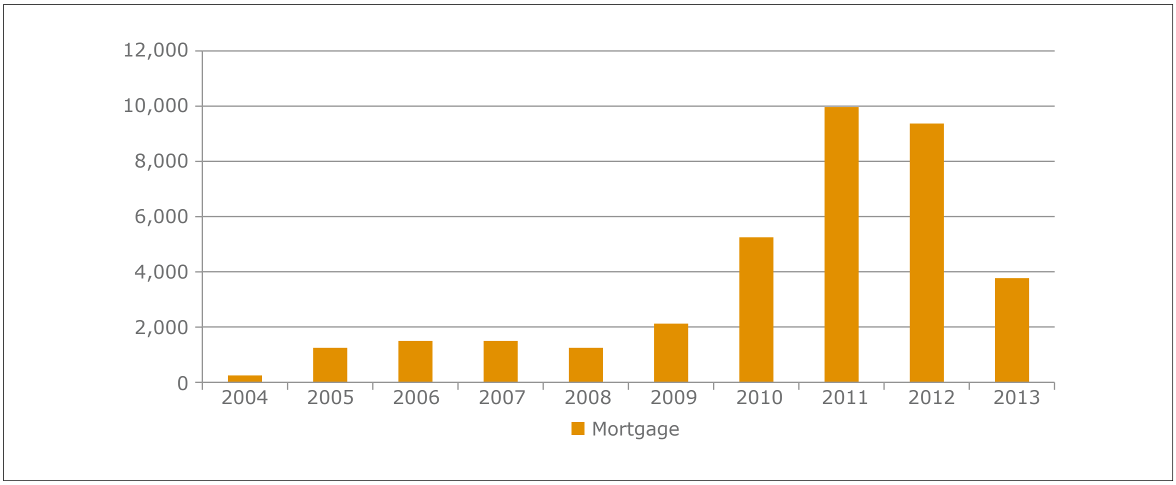
As far as the domestic issuers are aware, there are no further specific investment regulations regarding Finnish Covered Bonds.

> Figure 1: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2004-2013, EUR m



Source: EMF/ECBC

Issuers: CAktia Bank, Aktia Real Estate Mortgage Bank, Danske Bank, Nordea Bank Finland, OP Mortgage Bank, Alandsbanken.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/19/Finland

Covered Bond Label : Danske Bank Plc Pool 1; Nordea Bank Finland cover pool; OP Mortgage Bank, Pool B

3.11 FRANCE

Three main covered bond issuing structures exist in France today:

> *Sociétés de crédit foncier*;

> *Sociétés de financement de l'habitat*; and

> *Caisse de Refinancement de l'Habitat*.

Previously registered French structured covered bond issuers that had not apply for their conversion into société de financement de l'habitat can also continue their activities.

Regulation of *société de crédit foncier* ("SCF") and *sociétés de financement de l'habitat* ("SFH") was substantially strengthened in 2014 by Decree n° 2014-526 dated 23 May 2014 and *Arrêté* dated 26 May 2014.

A – SOCIETE DE CREDIT FONCIER (SCF)

By Francis Gleyze, Caisse Centrale du Crédit Immobilier de France

I. FRAMEWORK

While several countries allow ordinary credit institutions to issue covered bonds subject to the segregation of the cover pool in their balance sheet, France requires the set-up of an ad hoc company - the *SCF* - 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* (OFs) and the management of the assets backing those issues (the "cover pool").

The *SCF* is governed by Articles L.513-2 et seq. and R.515-2 et seq. of the French Monetary and Financial Code (the "Code"). This stringent legal framework is specially designed to protect the holders of the *OFs* it issues.

SCF is also governed by French general banking regulations.

II. STRUCTURE OF THE SOCIETE DE CREDIT FONCIER

The *SCF* is a credit institution licensed by the *Autorité de Contrôle Prudentiel et de Résolution (ACPR)*, the French Banking Authority, with a single purpose: to grant or acquire eligible cover assets, as defined by Law, and to finance them by issuing *OFs*, which benefit from a special legal privilege (the "Privilege"). It may also issue or contract other debts benefiting or not from the Privilege.

The *SCF* operates under the close control of the ACPR, which requires it to comply with strict management rules in order to ensure control over risks.

Furthermore, and in addition to the nomination of two external auditors as all French credit institutions, the *SCF* is also required to appoint an independent controller (the "Specific Controller") whose mission, beyond the single monitoring of the cover pool, is more globally to ensure that the *SCF* complies with the regulations and especially with the coverage ratio requirement and the assets/liabilities matching.

III. COVER ASSETS

Only eligible assets, restrictively defined by law, are authorized on the balance sheet of the *SCF*. 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 is not a member of the group to which belongs the SCF. The amount of these loans cannot exceed 35% of the assets of the *SCF*;

> public exposures that are totally guaranteed by:

a) Central administrations, central banks, public local entities and their grouping, belonging to a Member State of the European Union (EU) or a country of the European Economic Area (EEA), or under rating conditions - central administrations and central banks belonging to a non-EU/EEA country;

b) European Union, International Monetary Fund, Bank for international Settlements and mul¬tilateral developments banks registered by the French Ministry of Finance;

c) Other public sector entities and multilateral development banks as described in Article L.513-4 of the Code;

> senior securities issued by French securitisation vehicles or equivalent entities subject to the law of an EU/EEA country, 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 Banque de France.

Such senior securities cannot exceed 10% of the nominal amount of the outstanding issue. However, until 31 December 2017, the 10% limit shall not apply, provided that:

> the loans carried by the securitisation vehicles were originated by a member of the same consolidated group of which the issuer of the covered bonds is also a member or by an entity affiliated to the same central body to which the issuer of the covered bonds is also affiliated (that common group membership or affiliation to be determined at the time the senior securities are made as 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.313-42 et seq. of the Code. The mortgage notes may not represent more than 10% of the assets of the *SCF*;

> liquid and secured assets (the "substitution assets") up to 15% of the amount of the outstanding covered bonds issued by the *SCF*. Substitution assets are: 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 an EU/EEA country 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 value. Senior securities of securitisation vehicles are subject to similar rules.

IV. VALUATION AND LTV CRITERIA

Loans in the cover pool can be financed by OFs and other privileged debt up to the amount of:

> the remaining principal balance of the loan; or

> the value of the real estate financed or given as collateral multiplied by the financing coefficient, whichever is lower.

This financing coefficient is equal to:

> 60% of the value of the financed real estate for guaranteed loans, or of the assets given as collateral for residential mortgages;

> 80% of the value of the real estate in the case of loans that were granted to individuals either to finance the construction or purchase of a home, or to finance both the acquisition of the undeveloped land and the cost of building the home;

> 100% of the value of the real estate financed, in the case of loans guarantied by the *Fonds de garantie à l'accession sociale* (Guaranty Fund for Social Home Accession).

The real estates financed by the loans are valued according to the French mortgage market accepted practice. The real estates values are based on the index provided by INSEE (*Institut National de la Statistique et des Études Économiques*) or on the index provided by Notaries (PERVAL). The real estates are revaluated on an annual basis.

Real estate valuations must be based on their long-term characteristics. Under banking regulation N° 97-02, real estate values are considered as part of the risks of *sociétés de crédit foncier*. The valuations are made by independent experts in compliance with banking regulation.

Among his duties, the Specific Controller controls the eligibility, composition and valuation of the assets.

V. ASSET - LIABILITIY MANAGEMENT

The *SCF* must comply with asset/liabilities rules as required by banking regulations and, in particular, it is required to match its assets and liabilities in terms of interest rates and maturities.

Market risks

SCF must manage and hedge market risks on its 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.

Coverage ratio - overcollateralization

At all times, the total value of the assets of the *SCF* must be, at least, after weighting, equal to 105% of the liabilities benifiting from the Privilege.

From a regulatory standpoint, the coverage ratio is calculated on the basis of the *SCF* accounting data by applying different weights to classes of assets:

> loans secured by a first-ranking mortgage or by an equivalent guarantee are weighted 100% up to their part eligible for privileged debt financing;

> loans guaranteed by a credit institution or an insurance company are weighted 100% if the guarantor qualifies, at least, for the step 2 credit quality assessment, weighted 80% if it qualifies for the step 3 credit quality assessment, and weighted 0% in any other case;

> public exposures and replacement assets are weighted 100%; and

> senior securities of securitisation vehicles are weighted 100%, 80%, 50% or 0% subject to different criteria including, essentially, their rating.

The coverage ratio is reported and published at regular intervals, in accordance with the applicable laws and regulations.

Maturity mismatch

Under the new *Arrêté* dated 26 May 2014, the remaining weighted average life of the assets of the *SCF* should not exceed that of the covered bonds by more than 18 months. Cover pool assets taken into account are only those that are strictly necessary to satisfy the minimum legal overcollateralization requirement of 105%. The ACPR has given a delay until 31 December 2015 for the existing *SCF* to comply with this maturity requirement. In addition, new issuers and structures in run off might be exempted of this requirement.

Liquidity risk

SCF is required to ensure that its 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 *SCF*'s assets, as well as to flows related to its derivative instruments. 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.

SCF is authorized to subscribe to its own *OFs* up to 10% of total privileged liabilities provided that these OFs are only used as collateral with the central bank or cancels them within 8 days.

Exposure on the group to which belongs the SCF

New Decree N° 2014-526 and *Arrêté* dated 26 May 2014 limits the ability of the *SCF* to hold assets in the form of exposures on entities of the group to which it belongs. In this aim, when these assets exceed 25% of the non-privileged assets of the *SCF*, the difference between the exposure on these entities and the sum of 25% of the non-privileged assets together with the assets received in guarantee, pledged or full property, is deducted from the numerator of the coverage ratio.

General risks

As credit institution on general, the *SCF* is subject to the banking regulation N° 97-02 on internal control. Accordingly, it 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.

VI. TRANSPARENCY

As credit institution and listed company, the *SCF* must issue periodic financial information and, in accordance with French regulation N°97-02, a report on risk management.

Moreover, the *SCF* is 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 the *SCF* website;

> An annual report describing:

> > the nature and the quality of their assets, 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

- > 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 quarterly report, on 31 March, 30 June, 30 September and 31 December of each year relating to:

- > the amount of its coverage ratio and the compliance with the limits they are requested to respect i.e. the 35% limit of guaranteed loans, the 10% limit of mortgage promissory notes etc.;
- > the data of the calculation of the coverage of its liquidity needs;
- > the gap of the average duration between those of its eligible assets and its privileged liabilities;
- > the valuation of the coverage of the privileged debts until their maturity by the available eligible assets and the estimation of the future new production of these eligible assets on the basis of prudent assumptions.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The Specific Controller is appointed by the *SCF* with the agreement of the ACPR. To ensure his independence, the Specific Controller may not be an employee of either of the *SCF*'s independent auditors, of the company that controls the *SCF*, or of any company directly or indirectly controlled by a company that controls the *SCF*.

The mission of the Specific Controller involves the following verifications:

- > that all assets granted or acquired by the *SCF* 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 105%;
- > that the *SCF* 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
- > that, on general, the *SCF* complies with the law and regulations.

The Specific Controller certifies that the *SCF* complies with the coverage ratio rules on the basis of a quarterly issuance program, and for any issue of privileged debt of an amount equal or above EUR 500 m. These coverage ratio affidavits are required to be stipulated in issuance contracts where the debt benefits from the Privilege.

The Specific Controller reports to the ACPR. He attends shareholders' meetings, and may attend Board meetings.

Pursuant to Article L.513-23, the Specific Controller is liable towards both the *SCF* and third parties for the prejudicial consequences of any breach or negligence he may have committed in the course of his duties.

The *SCF* operates under the constant supervision of the ACPR.

Its management, its Specific Controller and its Independent Auditors should be agreed by the ACPR.

All the above-mentioned reports should be sent to the ACPR together with the annual report of the Specific Controller and the report of the annual reports of the Independent Auditors.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS

Pursuant to Article L.513-11 of the Code, holders of *OFs* and other privileged debts have preferred creditor status and the right to be paid prior to all other creditors who have no rights to the assets of the SCF until the claims of preferred creditors have been satisfied in full.

This 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 *SCF* 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 *SCF* does not accelerate the reimbursement of *OFs* 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 *SCF* may avail itself of any right over that company's property and rights;

> The common provisions of French bankruptcy law affecting certain transactions, which entered into force during the months prior the insolvency proceedings (the *période suspecte*), are not applicable to *sociétés de crédit foncier*.

As an exception to the general French bankruptcy law, bankruptcy proceedings or liquidation of a company holding share capital in a *SCF* cannot be extended to the *SCF*. As a result, *SCF* is totally bankruptcy remote and enjoy full protection from the risks of default by their parent company or the group to which it belongs.

IX. RISK- WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR).

OFs comply with the requirements of Article 52(4) of the UCITS Directive and Article 129(1) CRR.[1]

OFs have a 10% risk-weighting according to the Standardised Approach in the CRR.

X. ADDITIONAL INFORMATION

Covered bonds liquidity

The French *sociétés de crédit foncier* which issue jumbo *OFs* have together signed with more than 20 banks a specific standardised market-making agreement, which has become a national agreement.

1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position

B - CAISSE DE REFINANCEMENT DE L'HABITAT (CRH)

By Henry Raymond, Caisse de Refinancement de l'Habitat

I. FRAMEWORK

CRH was created in 1985 by French Government with State explicit guarantee as a central agency in order to refinance French banks in the specific legal framework of art 13 of law 85-685 of July 1985.

Up to the creation of the SFEF (*Société de financement de l'économie française*) in October 2008, no other agency of that type was created in France. Since 1 January 2010, CRH has been appointed to control debt' service and collateral administration of the 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 specialised credit institution of which the sole function is to fund French banks housing loans to individuals granted by French banking system.

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 11 July 1985 as complemented by Article 36 of Act 2006-872 of 13 July 2006.

CRH received approval to issue bonds under Article 13 of Act 1985-695 by letter of 17 September 1985 from the Minister for the Economy, Finance and Budget.

CRH's operations are governed by the provisions of Articles 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. STRUCTURE OF THE ISSUER

Caisse de Refinancement de l'Habitat, a French corporation (*société anonyme*), is a credit institution licensed to operate as a financial company (*société financière*) by virtue of the decision taken on 16 September 1985 by the French Credit Institutions Committee (*Comité des Établissements de Crédit*).

CRH is therefore governed by the provisions of Articles L. 210-1 to L. 228-4 of the French Commercial Code and Articles L. 511-1 et seq. of the French Monetary and Financial Code.

Its equity belongs to French banks:

> Crédit Agricole SA – Crédit Lyonnais	37.5 %
> Crédit Mutuel – CIC	32.7 %
> Société Générale	13.6 %
> BNP Paribas	9.7 %
> BPCE	6.0 %
> Others	0.5 %

Every borrower is committed to become a shareholder of CRH with a part in CRH's equity related to the part of its borrowings in CRH's global loans amount. Furthermore, every borrower is committed to supply back up lines to CRH if CRH calls them.

These shareholders-borrowers are among the best European names. Their global market share is roughly 90% of the French Mortgage Market

III. COVER ASSETS

CRH's loans to banks (represented by promissory notes) are covered by the pledge of eligible loans kept in balance sheets of borrowing banks.

Eligible loans are only home loans to individuals defined by law: first-ranking mortgages or guaranteed loans.

The cover pool which include exclusively residential loans are compliant with the Capital Requirements Regulation (CRR) and secured by first rank mortgages (77% area of the pool) or, under certain conditions by guarantees (de facto 23% of the pool).

Guaranteed loans are loans with the guarantee of a credit institution or an insurance company (the total amount of these loans cannot exceed 35% of the covering portfolio).

CRH's internal rules only allow French residential loans with maturity under 25 years and size under EUR 1 million.

The total value of the cover pool must equal at least 125% of the total amount of CRH loans (equal to the total amount of CRH bonds) – 150% if floating rate loans.

The geographical area for eligible loans is the European Economic Area (EEA) in the law but CRH's by-laws restrict that area to France and overseas territories only. Public sector assets are not eligible.

No replacement assets are allowed. RMBS and other loans are not eligible.

IV. VALUATION AND LTV CRITERIA

The rules for real estate valuations are the same as those of *sociétés de credit foncier*.

All buildings financed by eligible loans are the subject of a prudent evaluation that excludes all speculative aspects. It is carried out by the borrowing bank.

This valuation must be performed by an independent expert, i.e. a person who is not part of the lending decision-making process.

The valuation is performed taking into account the building's long-term characteristics, normal and local market conditions, the current use made of the asset and all other uses that might be made.

The valuation of the buildings is re-examined as part of the risk measurement system required of borrowing credit institutions by CRBF Regulation no. 97-02. This examination is performed annually using statistical methods.

Loan to value must not exceed 80% (de facto 90% because of the over-sizing of the covering portfolio by 25%).

V. ASSET - LIABILITY MANAGEMENT

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.

VI. TRANSPARENCY

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.

For being compliant with the ECBC Label, CRH releases on a quarterly basis data information on its cover pool required by the National Transparency Template.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

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.

As a credit institution, CRH operates under the general supervision of the French banking authority *l'Autorité de contrôle prudentiel et de résolution* and soon under direct ECB's supervision. Furthermore, its operations are under a specific supervision of *l'Autorité de contrôle prudentiel et de résolution* because of the provisions of Article L.313-49 of Monetary and Financial Code.

CRH is also subject to audit by its shareholder banks.

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

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.

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.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

CRH's debt has been rated AAA and Aaa by Fitch and Moody's since 1999.

CRH's bonds are compliant with the criteria of Article 129(1) CRR and Article 52(4) of the UCITS Directive.[1] They are 10% risk-weighted in standard approach.

They are included in securities accepted for the European Central Bank (ECB) open market operations.

X. ADDITIONAL INFORMATION

CRH belongs to covered bonds world but is very different from other issuers:

> CRH is a former agency created by French government,

> CRH is regulated by specific legal framework dedicated to it,

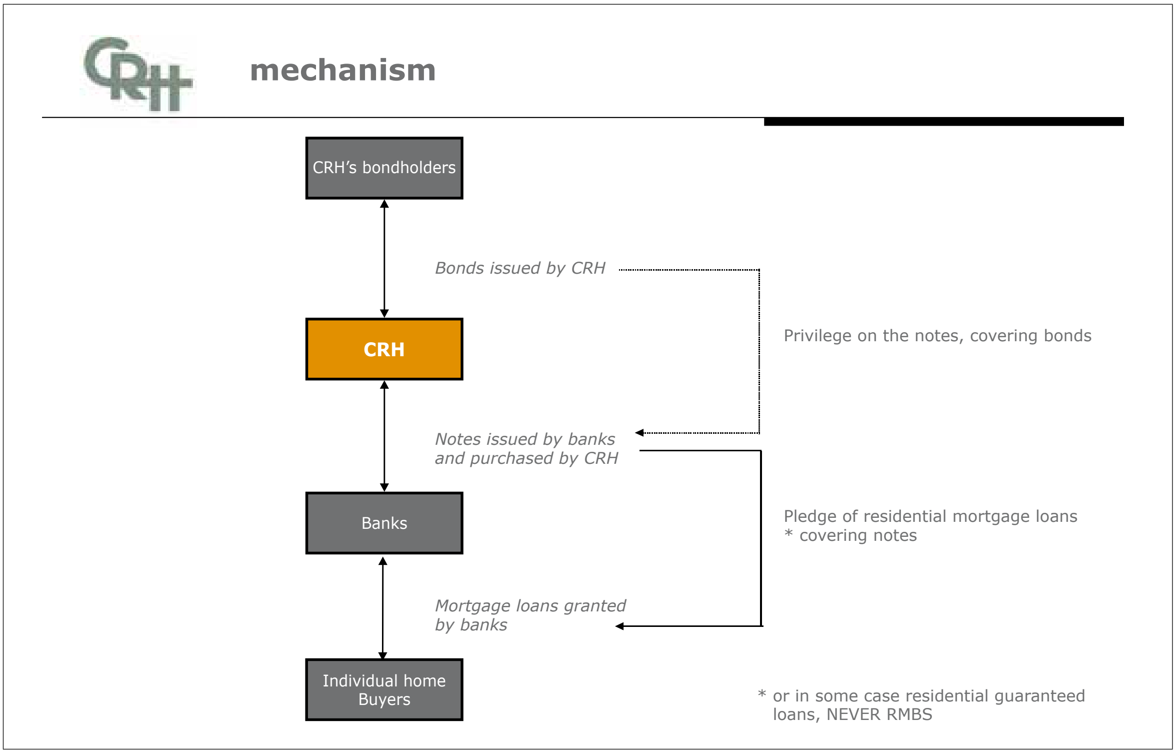
> CRH is not borrowing for itself but for the account of French Banking system,

> CRH is a credit institution of full exercise able to refuse to fund a shareholder,

> CRH benefits from cross commitments of French's banks to supply cash advances and capital contributions.

1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

Figure 1: Mechanism



C – OBLIGATIONS DE FINANCEMENT DE L'HABITAT

By Cristina Costa, Société Générale, Boudewijn Dierick, BNP Paribas,
Diane Jammaron, BNP Paribas and Jennifer Levy, Natixis

The *Société de Financement de l'Habitat* (SFH) and the *Société de Crédit Foncier* (SCF) are subject to the same law and regulations (specific controller, coverage ratio, liquidity ratio, etc.) implemented in the French Monetary and Financial Code (the Code). The segregation of assets is based on the European Collateral Directive which has been transposed into the French Monetary and Financial Code. The SCF/SFH framework was amended on May 2014[1] to increase legal minimum collateralization to 105% (from 102%) and provide further details on exposure to the sponsor bank, maximum asset liability mismatch and liquidity buffer rules.

Under the SFH legislation, the holders of the *Obligations de Financement de l'Habitat* (OH) benefit from a legal privilege granted over the SFH programme's assets (according to article L. 513-11 of the Code). If the issuer becomes insolvent, the OHs and other privileged debts are paid in priority and in accordance with their payment schedule, over any of the programme's other debts or non-privileged creditors in relation to the SFH's assets.

I. FRAMEWORK

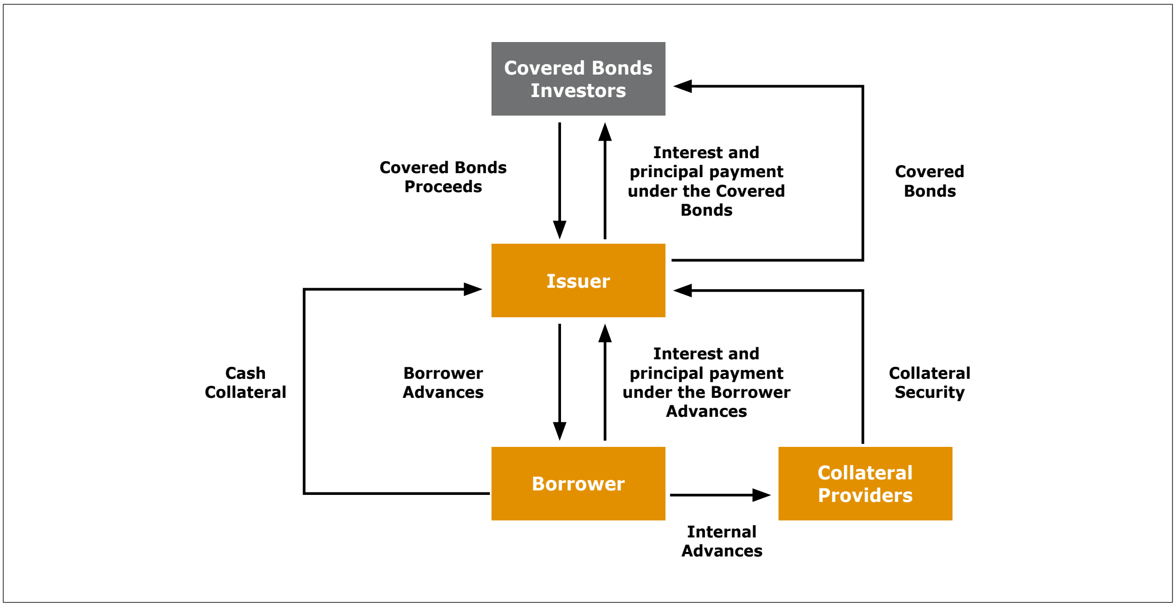
The SFH structure makes use of the implementation of the EU Collateral Directive 2002/47/EC, as amended, under French law (implemented into the Code under articles L. 211-36 and seq.), which allows for a segregation through a specific pledge of the assets without an actual transfer (true sale) of assets to the issuer. Pursuant to article L.211-38 of the Code, the pledge shall be enforceable even when the relevant collateral provider is subject to an insolvency proceeding.

The sponsor bank pledges or assigns collateral to a dedicated subsidiary, which is a regulated French specialised credit institution with limited purpose licensed as a SFH (e.g. issuing covered bonds for the purpose of providing financing to the sponsor bank). The covered bond proceeds are used to fund advances to the respective sponsor bank(s). The covered bonds are secured by the legal privilege over the assets of the issuer (advances to the sponsor bank(s)), which are in turn secured by a pledge over cover assets (i.e. residential home loans), 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 without any formalities to the covered bond issuer.

All the French OH issuers choose the dual structure.

1 http://www.legifrance.gouv.fr/affichTexte.do;jsessionid=?cidTexte=JORFTEXT000028970057&dateTexte=&oldAction=dernierJO&categorieLien=id, JORF n°0121 du 25 mai 2014.
http://www.legifrance.gouv.fr/affichTexte.do;jsessionid=?cidTexte=JORFTEXT000028990539&dateTexte=&oldAction=dernierJO&categorieLien=id, 8551, JORF n°0123 du 28 mai 2014.

FIGURE 1: STRUCTURE OF OBLIGATION DE FINANCEMENT DE L'HABITAT (DUAL STRUCTURE)



Sources: Moody's, Natixis

II. STRUCTURE OF THE ISSUER

The sole purpose of SFH 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 a SFH programme (EMTN), the SFH issues *Obligations de Financement de l'Habitat* (OHs) which are unsubordinated senior secured obligations and rank *pari passu* among themselves benefiting from the legal privilege.

These specialised credit institutions are usually an affiliate of the sponsor bank. There are currently eight SFH issuers: BNP Paribas Home Loan SFH (99.9% owned by BNP Paribas), BPCE SFH (99.9% owned by BPCE S.A.), Crédit Mutuel Arkea Home Loans SFH (affiliate of the Crédit Mutuel Arkéa group), Crédit Mutuel-CIC Home Loan SFH (a subsidiary of Banque Fédérative du Crédit Mutuel), Crédit Agricole Home Loan SFH (99.9% owned by Crédit Agricole S.A.), HSBC SFH (France) (a subsidiary of HSBC France), La Banque Postale HL SFH (a subsidiary of La Banque Postale) and Société Générale SFH (a subsidiary of Société Génerale).

III. COVER ASSETS

Pursuant to the SFH Law, the eligible assets of a SFH comprise, inter-alia:

> Home loans (*prêts à l'habitat*) which include (i) loans 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 ne sûreté immobilière conférant une garantie au moins équivalente*[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 highest level of credit assessment;

2 Art. L513-29, II, 2° of the Code.

- 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 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 and (ii) such units or notes benefit from the highest level of credit assessment (*meilleur échelon de qualité de credit*) promissory notes (*billets à ordre*); and
- Substitution assets (*valeurs de remplacement*), under certain liquidity and maturity conditions and provided that their aggregate value is up to a maximum amount of 15% of the outstanding covered bonds. The substitution assets of the SFH may now include within the 15% limit debt securities (*titres de créances*) issued or guaranteed by public sector entities referred to in paragraph I, 1 to 5, of Article L. 513-4 of the French Monetary and Financial Code (*Code monétaire et financier*);
- Within the limit of the liquidity buffer, in addition to substitution assets, debt securities (*titres de créances*) issued or guaranteed by a central administration of a Member state of the European Union and cash invested on accounts opened within the books of a central bank of a Member State of the European Union which comply with the criteria listed in 1(a) of Article 416 of the Capital Requirements Regulation n°575/2013 dated 26 June 2013.

Under the SFH Law, cover pool assets comprised of units or notes issued by securitisation vehicles (*organismes de titrisation*) are only eligible to support covered bond issuance if they are rated Aa3/AA- or above (100% eligible) or A3/A- or above (50% eligible). ABS/MBS count as collateral within the pool depending on the originator, the rating of the securitisation, and the time at which the securities were acquired by the issuer.

Weightings of ABS/MBS for *Sociétés de Crédit Foncier* and *Sociétés de Financement de l'Habitat*:

If the underlying assets of the ABS/MBS were originated by the group and they were acquired by the issuer after 31 December 2011, the securities count as collateral with the following ratings:

> 100% as long as they are rated Aaa/AAA;

> 80% if the rating is between Aa3/AA- and Aa1/AA+;

> 0% if the rating is below Aa3/AA-.

If the underlying assets of the ABS/MBS were originated by the group and they were acquired by the issuer before 31 December 2011 or after 31 December 2014, the securities count as collateral with the following ratings:

> 100% as long as they are rated Aaa/AAA;

> 50% if the rating is between Aa3/AA- and Aa1/AA+;

> 0% if the rating is below Aa3/AA-.

If the underlying assets of the ABS/MBS were transferred by an institute that is not a member of the same group as the covered bond issuer and they were acquired by the issuer after 31 December 2011 but before 31 December 2017, the securities count as collateral with the following ratings:

> 100% as long as they are rated Aaa/AAA;

> 50% if the rating is between Aa3/AA- and Aa1/AA+;

> 0% if the rating is below Aa3/AA-.

If the underlying assets of the ABS/MBS were transferred by an institute that is not a member of the same group as the covered bond issuer and they were acquired by the issuer before 31 December 2011 but after 31 December 2014, the securities count as collateral with the following ratings:

> 100% as long as they are rated Aaa/AAA;

> 0% if the rating is below Aaa/AAA.

N.B. These weightings are also applicable to Sociétés de Crédit Foncier.

The SFH regulation applies a haircut to in-house guarantors: i.e. if the guarantor is a group institution, only 80% of the loan may be included. In addition, a rating criterion/trigger has been introduced. If the credit rating is in the BBB region (i.e. below A-), the rate of inclusion drops to 80% for external guarantors and 60% for internal guarantors. If the rating of the guarantor is non-investment grade, the guarantee will no longer be recognized and the guaranteed loans may not be included in the cover pool. For more information please refer to the following box.

Weighting of guaranteed home loans for *Sociétés de Financement de l'Habitat*:

When the home loan guarantor is not part of the same consolidation scope as the SFH or the SCF, the weighting is as follows:

> 100% when the home loan guarantor has at least the second highest level awarded by a rating agency (≥A3/A-/A- by Moody's/S&P/Fitch);

> 80% when the home loan guarantor has at least the third highest level of quality awarded by a rating agency (≥Baa3/BBB-/BBB- by Moody's/S&P/Fitch);

> 0% in all other cases.

When the home loan guarantor is part of the same consolidation scope as the SFH, the guaranteed home loans are weighted as follows:

> 80% when the home loan guarantor has at least the second highest level of quality awarded by a rating agency (≥A3/A-/A- by Moody's/S&P/Fitch);

> 60% when the home loan guarantor has at least the third highest level of quality awarded by a rating agency (≥Baa3/BBB-/BBB- by Moody's/S&P/Fitch);

> 0% in all other cases.

IV. VALUATION AND LTV CRITERIA

The properties are valued according to the French mortgage market accepted practice. The property values are indexed to the French INSEE (*Institut National de la Statistique et des Etudes Economiques*) or PERVAL (Notaries) house price index on a quarterly basis. In most programmes, price decreases are fully reflected in the revaluation, while in the case of price increases, a 20% haircut is applied even though this is not required by law. This valuation is assessed in an annual report by the SFH and certified by the specific controller[3].

In order to ensure overcollateralization (far above the 5% minimum required by law), the SFH programmes also 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 at least 8%. However, that being said all SFH programmes currently exceed the minimum amount due to adjustments to the most recent 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%. 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 105% on the adjusted cover pool balance at all times. When intra-group loans in the cover pool exceed 25% of the issuer's non-privileged liabilities (i.e. typically the issuer's share capital or any subordinated bonds), a portion of such loans will be excluded from the cover pool for the purpose of calculating the over-collateralisation test.

3 Pursuant to the ACPR regulation CRBF 99-10.

This limits the risk that covered bond issuers rely on assets directly exposed to the credit quality of their parent or any of their affiliates. For the calculation of this ratio, the SFH must take into account its risk exposure on its sponsor bank up to a limit of 25% of the non-privileged assets.

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. It is no longer possible to cover the existing six-month liquidity gap with intragroup liquidity line.

Liquidity: The SFH framework provides further liquidity means 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.

Maturity mismatch test: from 2014 onwards, the remaining weighted average life (WAL) of assets should not exceed that of the covered bonds by more than 18 months. Cover pool assets included in this test are only those that are strictly necessary to satisfy the minimum legal OC requirement of 105%. This new test supplements the pre-existing general maturity matching principle (*principe de congruence des maturités*). New issuers and structures in run off might be exempted of this requirement and the ACPR has given a compliance delay for the issuers to comply with this maturity mismatch test until 31 December 2015.

The SFHs must also submit once a year to the regulator a **maturity mismatch** forecast cover plan, that has to be verified by the specific controller.

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, set–off risk, market risk, etc, as follows:

> Interest rate and currency risks need to be neutralised (the hedging strategy[4]); subject to certain rating triggers, swaps with suitable counterparties have to be entered to ensure that exposure to market risk is properly hedged;

> 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;

> 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 bank account holder and swap counterparties.

VI. TRANSPARENCY

All French SFH issuers publish information on their cover pools and outstanding covered bonds on their website. French issuers publish two types of reports i) French Covered Bond Label Reports (national transparency template) and report on the quality of their assets published on a quarterly basis) and ii) Cover pool investor reports (published on a monthly basis). Due to the new regulation, the SFH must disclose (but not publish), on a quarterly basis: i) the overcollateralization ratio, ii) the components of the calculation of the liquidity buffer, iii) the gap between the average life of the assets and liabilities and iv) the forecast cover plan regarding the matching between the assets and the liabilities.

4 Article L. 513-15 of the Code.

VII. COVER POOL MONITORING & BANKING SUPERVISION

The issuing bank is responsible for the monthly pool monitoring, with the asset coverage test calculation being checked by an independent Asset Monitor (and by the specific controller – some SFH do not have both). Under the terms of the asset monitor agreement, the asset monitor tests the calculation of the asset coverage test annually. In case of non-compliance with the asset coverage test or in case the senior unsecured rating of the sponsor bank drops below a predefined trigger rating level, the test has to be performed on a monthly basis. In addition, rating agencies are involved in the programme and re-affirm the ratings of the program upon a pre-defined issuance volume. They also monitor the amount of overcollateralisation required to maintain the triple-A ratings.

Under SFH Law, each issuer has to appoint a Specific Controller (*Contrôleur Spécifique*), and a Substitute Specific Controller (*Contrôleur Spécifique Suppléant*), who are selected from an official list of external auditors and are appointed subject to the prior approval of the ACPR. 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 (iii) notify the Issuer and the ACPR if he considers such balance to be unsatisfactory. The Specific Controller remains liable, both as regards the Issuer and third parties, for any loss suffered by them, which results from any misconduct or negligence arising in the performance of its duties. The Specific Controller verifies key financial aspects of the activities of the Issuer, in particular the extent of the collateral for the covered bonds. He is independent from both the issuer and the sponsor bank. Furthermore, for every issuance with an amount exceeding EUR 500 m, the specific controller must attest the compliance of the cover ratio on the basis of the quarterly programme of debt issued benefiting from the privilege.

VIII. SEGREGATION OF COVER ASSETS & BANKRUPTCY REMOTENESS

Under the SFH legislation, the holders of the OH benefit from the legal privilege over the SFH programme's eligible assets. If the issuer becomes insolvent, the OHs and other privileged debts are paid in accordance with their payment schedule, and have priority over any of the 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 the SFH law provides for a regime which derogates in many ways from the French insolvency provisions (the same applies for the SCF programmes):

> **Legal Privilege / No acceleration of covered bonds as a result of insolvency of SFH:** in the event of an insolvency proceeding of the SFH (safeguard procedure, judicial reorganization or liquidation), all claims benefiting from the Privilège[5] (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 the hardening period:** the provisions allowing an administrator to render certain transactions entered into during the hardening period (*période suspecte*) null and void are not applicable for the transfer of assets 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.

5 Principal and interest of the Covered Bonds benefit from the so called "Privilège" (priority right of payment). As a consequence, and notwithstanding any legal provisions to the contrary, all amounts payable to the issuer in respect of the cover pool and forward financial instruments are allocated in priority to the payments of any sums due in respect of the covered bonds.

Figure 2: Comparison of French covered bonds

	Obligation de Financement de l'Habitat
Legal Framework	French Monetary and Financial Code, Articles L.513-28 to L.513-33, CRBFregulation no. 99-10 of 9 July 1999 Decree no. 2011-205 of 23 February 2011 and the Banking and Financial Regulation Act no. 2010-1249 of 22 October 2010; amendment in Decree no. 2014-526 of 23 May 2014 and Arrêté of 26 May 2014
Issuer	duly licensed specialized credit institution - Société de Financement de l'Habitat (SFH)
Eligible cover pools	> First rank mortgagees and guaranteed home loans (commercial real estate loans are not eligible) > State-guaranteed real estate loans > EEA & outside min A-rated max. 20% > Securitization of the above (subject to specific rules and criteria)
Collateralisation	105%*
Legal Privilege	Yes
LTV ratio	> First-rank residential mortgage loans and guaranteed home loans: max. 80% LTV > State-guaranteed real-estate loans: max. 100% LTV
Substitution assets	Max. 15% of
Liquidity	Requirement to cover all cash flows for a period of 180 days, taking on principal and interests on its assets, and cash flows pertaining to existing six-month liquidity gap with intragroup liquidity line.
Investor protection	Overcollateralisation, 180-day liquidity needs coverage and ability mismatch test (remaining WAL of assets snould not exceed WAL
Issue's structure/Transfer of assets	True sale of cover assets or loans secured by financial guarantees (articles L.211-38 and seq French Monetary & Financial Code - trans-position of "Collateral" Directives)
Supervision	Autorité de Contrôle Prudentiel et de Résolution (ACPR) - one specific Financiers)
UCITS Compliant	Yes
Risk-weighting according to EU Credit institutions	10%**

* when intra group loans in the cover pool exceed 25% of the issuer's non-privileged liabilities, a portfion of such loans will be excluded from the cover pool for the purpose of calculating the overcollateralisation test

** According to Art 129(1)(e) of CRR, guaranteed home loans are eligible for preferential treatment subject to the portion of each of the loans having a maximum LTV of 80%, the eligible guarantor has a rating of maximum Credit Quality Step 2 (equivalent to minimum AA-), and where a loan-to-income ratio respects at most 33% when the loan has been granted.

Obligations Foncières	Caisse de Refinancement de l'Habitat
French Monetary and Financial Code, Articles Articles L.513-2 to L.513-27, 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; amendment in Decree no. 2014-526 of 23 May 2014 and arrete of 26 May 2014	French Monetary and Financial Code Articles L.313-42 to 313-49 and Art L.515-14-1, article 13 Law n°85-695 of 11 July 1985
duly licensed specialized credit institution - Société de Crédit Foncier (SCF)	duly licensed specialized credit institution – Caisse de Refinancement de l'Habitat
> First-rank residential mortgage loans > First-rank commercial mortgage loans > State-guaranteed real-estate loans > Third party guaranteed real estate loans (max. 35% of total assets) > Public sector loans, bonds and leasing > Securitization of the above (subject to specific rules and criteria)	> First rank residential mortgage loans > State guaranteed mortgage loans > Third party guaranteed real estate loans (max. 35% of total assets) > No securitisation tranches, no RMBS > No loans with duration over 25 years > No loans with unit amount over €1m
105%*	125%
Yes	Yes
> First-rank residential mortgage loans and guaranteed home loans: max. 80% LTV > First-rank commercial mortgage loans: max. 60% LTV > State-guaranteed real-estate loans: max. 100% LTV	> Residential mortgage loans: max 80% LTV, max 90 % LTV if overcollateralisation of 25% > State guaranteed mortgage loans: max 100% LTV
total Privileged debts	Non eligible
into account all cash flows resulting of future payments term instruments. It is no longer possible to cover the	
to repo own issuances, controlled ALM, maturity of covered bonds by more than 18 months)	Overcollateralisation, full recourse to the participating banks in case of collateral shortfall
True sale nearly exclusively (but loans secured financial guarantee for "public exposures" legally possible)	ad hoc promissory notes exclusively secured by eligible cover pools
controler - twoauditors - AMF (Autorité des Marchés	Autorité de Contrôle Prudentiel et de Résolution (ACPR) - two auditors - AMF (Autorité des Marchés Financiers)
Yes	Yes
10%	10%

IX. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

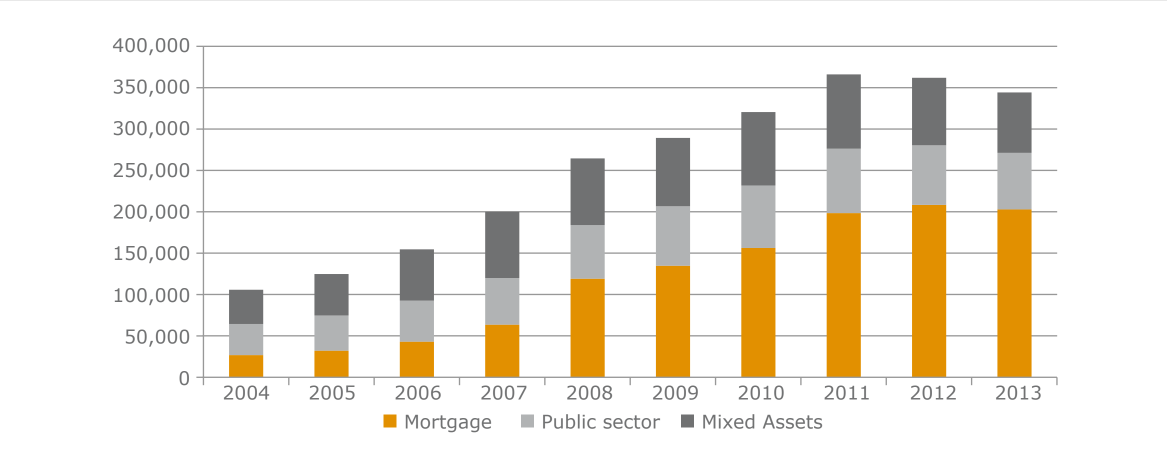
The SFH meet the requirements of Article 52(4) of the UCITS directive.

Article 129 of CRR defines which assets are eligible as collateral for covered bonds to ensure a lower risk-weighting.[6] French guaranteed home loans (*prêts cautionnés*) are eligible for preferential treatment subject to a number of conditions: (i) the eligible guaranteed home loan provider qualifies for credit quality step 2 or above (i.e. rated minimum A3/A-/A- by Moody's, S&P and Fitch); ii) the portion of each of the loans that is used to meet the requirement for collateralization of the covered bonds does not represent more than 80% of the value of the corresponding residential property located in France (i.e. guaranteed home loans comply with the 80% LTV limit), and (iii) where a loan-to-income ratio is limited to 33% when the loan has been granted.

In France and abroad, French OH currently have a 10% risk-weighting under the CRD IV Standard Approach. The ECB has updated its eligible asset database (https://mfi-assets.ecb.int/queryEa) with a field 'CRD_COMPL'.

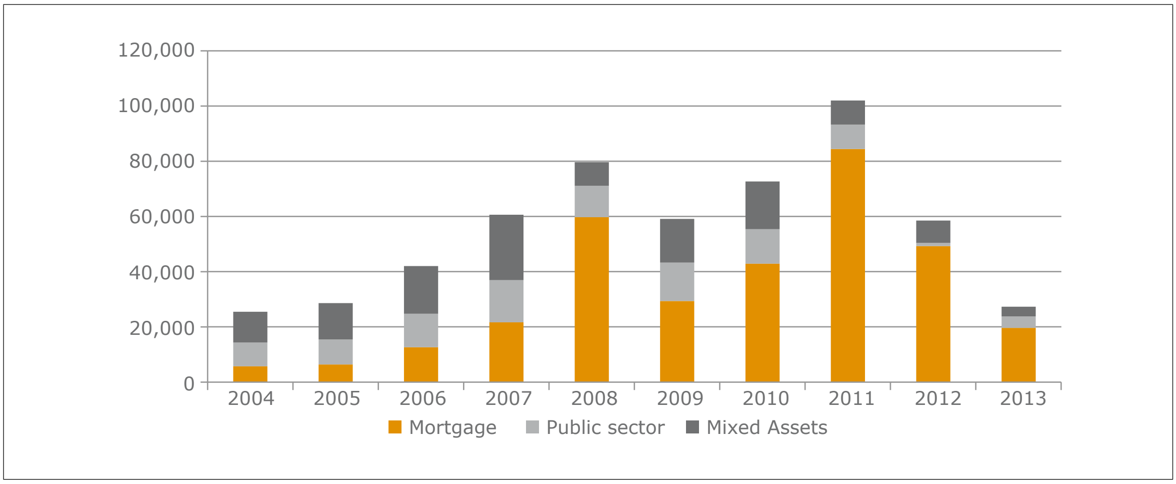
6 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> FIGURE 3: COVERED BONDS OUTSTANDING, 2004-2013, EUR M



Source: EMF/ECBC

> FIGURE 4: COVERED BONDS ISSUANCE, 2004-2013, EUR M



Source: EMF/ECBC

Issuers: AXA Bank Europe (SCF); BNP Paribas Public Sector (SCF); BNP Paribas Home Loan (SFH); BPCE (SFH); Banques Populaires Covered Bonds (BP CB); Caisse d'Epargne (CNCE CB); Caisse Française de Financement Local (CAFFIL); CIF Euromortgage; Compagnie de Financement Foncier (CFF); Crédit Foncier et Communal d'Alsace et de Lorraine (CFCAL); Crédit Agricole Public Sector (SCF); Crédit Agricole Home Loan (SFH); Crédit Mutuel - CIC Home Loan (SFH); Crédit Mutuel Arkéa (SCF); Crédit Mutuel Arkéa (SFH); Caisse de Refinancement de l'Habitat (CRH); GE Money Bank (SCF); HSBC (SFH); La Banque Postale Home Loan (SFH); Société Générale (SCF); Société Générale (SFH).

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/21/Caisse_de_Refinancement_de_l%27Habitat_-_CRH, http://ecbc.eu/framework/71/General_Law_Based_CBs, http://ecbc.eu/framework/73/Obligations_Fonci%C3%A8res_-_OF, http://ecbc.eu/framework/90/Obligations_%C3%A0_l%27Habitat_-_OH

COVERED BOND · LABEL · : AXA Bank Europe SCF; BNP Paribas Home Loan SFH; BNP Paribas Public Sector SCF; BPCE Home Loan SFH; CRH; Caisse Française de Financement Local; Compagnie de Financement Foncier; Credit Agricole Home Loan SFH; Credit Agricole Public Sector SCF; Crédit Mutuel - CIC Home Loan SFH; Crédit Mutuel Arkéa Home Loans SFH; Crédit Mutuel Arkéa Public Sector SCF; HSBC SFH (France); La Banque Postale Home Loan SFH; SG Credit Public Sector SCF; SG Credit Home Loan SFH

3.12 GERMANY

By Wolfgang Kälberer and Otmar Stöcker, Association of German Pfandbrief Banks

I. FRAMEWORK

In Germany, the legal basis for covered bond issuance is the German Pfandbrief Act (PfandBG – Pfandbriefgesetz) dated 22 May 2005. It supersedes the general bankruptcy regulation (§§ 30-36a of the Pfandbrief Act).

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. Further amendments came into force on 25 November 2010, on 1 January 2011 and 1 January 2014 in order to strengthen the position of the special cover pool administrator. The last amendment of the PfandBG introduced further transparency requirements in favour of Pfandbrief investors, to be applied from spring 2014 on.

In spring 2014, draft legislation on transposing the BRRD into German law was published; this bill contains further amendments of the Pfandbrief Act. The mayor issue is to provide the BaFin with the competence to order higher minimum OC than the legal 2% (cover add-on).

II. STRUCTURE OF THE ISSUER

Since 2005, the issuer of Pfandbriefe is no longer required to be a specialised bank. Instead, Pfandbrief issuers are allowed to exercise all activities of a credit institution, although a special licence for Pfandbrief issuance is required. The minimum requirements to obtain and keep the special licence are as follows:

- Core capital of at least EUR 25 million
- General banking licence which allows the issuer to carry out lending activities
- Suitable risk management procedures and instruments
- Business plan showing regular and sustainable issues as well as necessary organisational structure

Since the German outsourcing guidelines of the BaFin do not allow for the outsourcing of important and decision-making sections of the credit institution, the issuer is required to have its own employees. In addition, the PfandBG requires Pfandbrief banks to manage their own risk and take their own credit decisions on their own.

The issuer holds the cover assets on his balance sheet. A subsequent transfer of the cover assets to another legal entity does not take place. Given that a direct legal link between single cover assets and Pfandbriefe does not exist, all obligations relating to Pfandbriefe are obligations of the issuing bank as a whole, to be paid from all the cover assets of the issuer, recorded in the cover register. In the case of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved for the claims of the Pfandbrief holders. Even then, Pfandbrief holders still have a claim against the general insolvency estate.

III. COVER ASSETS

Cover assets are produced by mortgage lending, public sector lending, ship and aircraft financing activities. ABS/MBS are not eligible. A specific class of covered bonds corresponds to each of these cover asset classes: Hypothekenpfandbriefe, Öffentliche Pfandbriefe, Schiffspfandbriefe and Flugzeugpfandbriefe. The respective Pfandbrief must be fully secured by its specific cover asset class (§ 4 PfandBG). Detailed transparency requirements are regulated in § 28 PfandBG, enhanced by the amendments 2009, 2010 and 2013.

Up to 10% of the nominal volume of Pfandbriefe outstanding may consist of money claims against the European Central Bank, central banks in the European Union or against suitable credit institutions, which fulfil the requirements of credit quality step 1 according to Table 1 of the Annex VI of Directive 2006/48/EC.

The geographical scope of eligible mortgage assets is restricted to EU/EEA countries, to Switzerland, USA, Canada and Japan. Public sector loans to these countries are eligible for the cover of Öffentliche Pfandbriefe (§ 20 PfandBG). The total volume of loans granted in non-EU countries where it is not certain that the preferential right of the Pfandbrief creditors extends to the cover assets, may not exceed 10% of the total volume of the cover loans (§§ 13 I 2, 20 I 2 PfandBG) and 20% for ship and aircraft mortgages (§§ 22 V 2, 26b IV PfandBG).

Derivatives are eligible for cover pools under certain conditions. They must not exceed 12% of the cover assets when calculated on a net present value basis (§ 19 I 4. PfandBG).

IV. VALUATION AND LTV CRITERIA

Property valuation is regulated in § 16 PfandBG. This provision refers to the mortgage lending value (Beleihungswert) which is, in contrast to the market value, based on sustainable aspects of the property. Details about the valuation process and the qualifications of valuers are regulated in a specific statutory order on the mortgage lending value (Beleihungswertermittlungsverordnung, BelWertV), § 16 IV PfandBG.

Monitoring requirements result from the Capital Requirements Directive (once a year for commercial real estate and once every three years for residential real estate). In addition, § 27 BelWertV requires a review of the underlying assumptions when the market has declined substantially; a review of property values is also necessary when the loan has defaulted.

The BelWertV requires personal and organisational independence of the valuer (internal or external valuer)

For both commercial and residential property, the LTV limit is 60% of the mortgage lending value of the property. This LTV is a relative limit, i.e. when the loan exceeds the 60% limit, the part of the loan up to 60% LTV remains eligible for the cover pool.

V. ASSET - LIABILITY MANAGEMENT

§ 4 PfandBG stipulates that the total volume of Pfandbriefe outstanding must be covered at all times by assets of at least the same amount. Thus, the nominal value of the cover assets must permanently be higher than the respective total value of the Pfandbriefe.

In addition, the Pfandbrief Act requires that Pfandbriefe are covered on a net present value basis even in the event of severe interest rate changes or currency fluctuations. The issuer has to provide an overcollateralisation of at least 2% after stress tests which have to be carried out weekly. Both the maturity of outstanding Pfandbriefe and the fixed-interest periods of the cover pool are disclosed on a quarterly basis. Details about the calculation are regulated in a special statutory order Net Present Value (Barwertverordnung).

Furthermore, each day Pfandbriefbanks have to calculate the maximum liquidity gap 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 over-collateralisation have to be published (§ 28 I PfandBG). The stress tests apply not only to interest rate risks but also to foreign exchange risks.

Cash flow mismatch between cover assets and covered bonds is furthermore reduced by the prepayment rules applicable to fixed interest rate mortgage loans. Prepayments of mortgages during fixed rate periods are only permitted in cases of "legitimate interest" of the borrower or after a period of ten years. If the mortgage is prepaid, the borrower has to compensate the damage of the lender caused by the prepayment (§ 490 II German Civil Code).

VI. TRANSPARENCY

According to § 28 of the Pfandbrief Act (Pfandbriefgesetz, PfandBG), all Pfandbrief Banks are obliged to publish detailed information about their Pfandbrief outstanding and the pertaining cover pools on a quarterly basis. These include

> The total volume of Pfandbrief outstanding as well as the related cover pools in terms of nominal, net present and stressed net present value;

> The share of derivative financial instruments in the cover assets;

> Information on interest rate and currency risk;

> The share of further cover assets, separated between claims against public authorities or claims against credit institutions and separated according to the state in which the debtor is located;

> The maturity structure of the Pfandbrief and cover assets;

> Information on the size of the cover assets;

> Information on the mortgages by property type/type of use, region and state;

> Information on the average LTV and average seasoning;

> 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.

The legal transparency requirements are frequently amended in order to increase confidence and security of investors. In 2009, for example, the Pfandbrief Banks pressed for a more detailed disclosure of maturities in order to ensure that investors are better informed about the short and medium-term maturities. The 2010 amendment of the Pfandbrief Act introduced a period of one month after the end of each quarter, in which the quarterly report must be published, except for the fourth quarter, where this period is extended to two months. The 2013 amendment of the PfandBG introduced inter alia further transparency requirements, which have to be applied since spring 2014.

Beside these legal requirements, the vdp member banks started the vdp Transparency Initiative in 2010. Within the scope of this initiative, transparency reports of vdp member institutions are published

> In a uniform format;

> That can be processed electronically;

> Using a uniform understanding of the legal requirements; and

> On one central website (the vdp's).[1]

Each report is available as a reading version in pdf format and, suitable for further direct processing, in xls (Excel) and csv formats as well. Automatic links to investor data bases are possible. The website offers sorting possibilities for the reports both by reporting date and bank name. All reports are published in English and German language versions. There is a data history available that goes back to 31 December 2008. Hence, the vdp Transparency Initiative provides investors with excellent resources to analyse Pfandbrief cover pools pursuant to their specific needs.

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

While transparency of cover pools is important for investors, information on covered bonds has to go far beyond cover assets. Another crucial element is transparency regarding the legal structure of covered bonds, which includes information on the legal nature of the cover pool, the segregation of cover assets, the insolvency remoteness of covered bonds, the timely payment in the case of the issuer's insolvency and on the question who actually issues the covered bond. Transparency of these aspects is of utmost importance for investors as covered bonds are designed to survive the issuer's insolvency. The best cover assets will be of no value for the investor if they disappear in the issuer's insolvency estate. The Pfandbrief Act contains detailed regulations of all these aspects, thus ensuring investors a high degree of product transparency.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

BaFin carries out the general banking supervision on German Pfandbrief banks.

In addition, BaFin carries out a special supervision on Pfandbrief banks through a dedicated division. The "Pfandbriefkompetenzcenter" is responsible for all fundamental issues regarding the PfandBG and carries out cover pool audits using own staff or external auditors.

Cover audits

The cover pools are subject to a special audit conducted usually every two years by the super¬visory authority (§ 3 PfandBG). Cover pool audits are performed either by the appropriate specialist section at BaFin itself or by suitable auditors, who are mandated via contract by public tender.

A cover audit is conducted in respect of individual cover pool assets, the observance of match¬ing cover requirements in terms of the nominal and net present value calculation, the proper keeping of the cover registers, and the systems and processes in place with regard to the cover pools.

Audits of individual cover assets seek to ensure that the respective assets were included in cover in accordance with the relevant rules and regulations or that their continued inclusion is in line with requirements. These audits are made on the basis of suitable samples, which BaFin defines with the help of extensive information about the composition of the cover pools. Moreover, the audit may concentrate on particular areas if BaFin wishes to focus on specific countries, currencies or types of property use. More than 100 individual cases are audited, depending on the size and composition of the cover pool. Where the loan files are not stored at a central location, and given that the documentation for one individual property finance trans¬action can fill several dozen ring binders, this calls for intensive logistical preparations in order to limit the – in practice – customary length of the audit to two to three months.

A system audit entails examining all the Pfandbrief bank's main processes and systems that are directly or indirectly linked to the cover assets and the issued Pfandbriefe. In particular, process documentation, system descriptions and the proper implementation of the relevant methods are scrutinized.

Furthermore, 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 or new Pfandbriefe been issued. 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.

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

A cover register (Deckungsregister) permits the identification of the cover assets, § 5 PfandBG. The register records the cover assets being used to cover the Pfandbriefe as well as claims under derivatives (§ 5 I 1 PfandBG).

The legal effect of registration is that in the case of insolvency of the issuer, the assets which form part of the cover pool can be identified: All values contained in the register would not be part of the insolvency estate. § 30 I 1 PfandBG now calls them "insolvency-free assets".

While the bank carries out the daily administration of the cover register, it is the cover pool monitor who supervises the required cover und registration in the cover register, § 8 I, II PfandBG. Copies of the cover register shall be transmitted to the supervisory authority on a regular basis.

Asset segregation

The cover pool is a part of the general estate of the bank as long as the issuer is solvent. If insolvency proceedings are launched, by operation of law, the assets recorded in the cover registers are excluded from the insolvency estate (§ 30 I 1 PfandBG). Those assets will not be affected by the launching of the insolvency proceedings (§ 30 I 2 2. HS PfandBG).

After the launching of the insolvency proceedings, a special cover pool administrator (Sachwalter) carries out the administration of the cover assets (§ 30 II 1 PfandBG). Through the appointment of the cover pool administrator by the court, on proposal of the BaFin (or by BaFin in case of urgency), 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 illiquidity of the cover pool, the BaFin may apply for a special insolvency procedure relating to the cover pool and covered bonds (§ 30 VI 2 PfandBG). Insolvency of the cover pool is the only reason, which might trigger acceleration of Pfandbriefe.

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 over-collateralisation (OC). However, the insolvency administrator may only demand that the over-collateralisation 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 was focused 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 would get automatically 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 2010 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". The amendments 2013 clarified a few issues regarding the bridge bank solution.

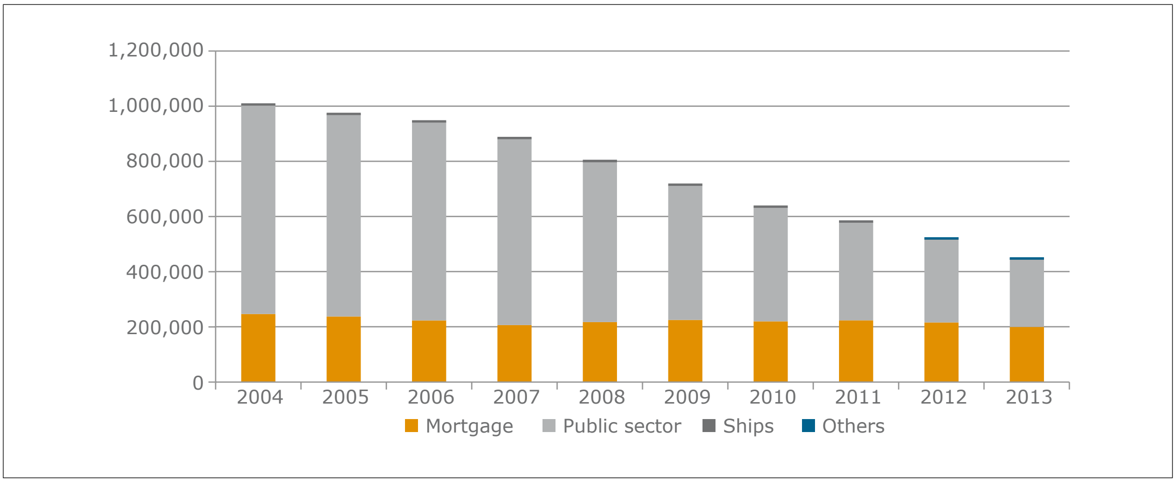
IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk-weighting of covered bonds (German Pfandbriefe and foreign covered bonds) is regulated by Art. 129 Capital Requirements Regulation (CRR). Thus, German Pfandbriefe as well as foreign covered bonds complying with the CRR and carrying an external rating of at least AA- will enjoy a 10% risk weight. Cover pool derivatives will not be receiving a preferential treatment under the new framework any more.

Finally, German investment legislation allows investment funds to invest up to 25% of the fund's assets in Pfandbriefe and furthermore in covered bonds issued by credit institutions complying with the requirements of Art. 52 par. 4 UCITS Directive (Article 60 par. 2 German Investment Act).[2]

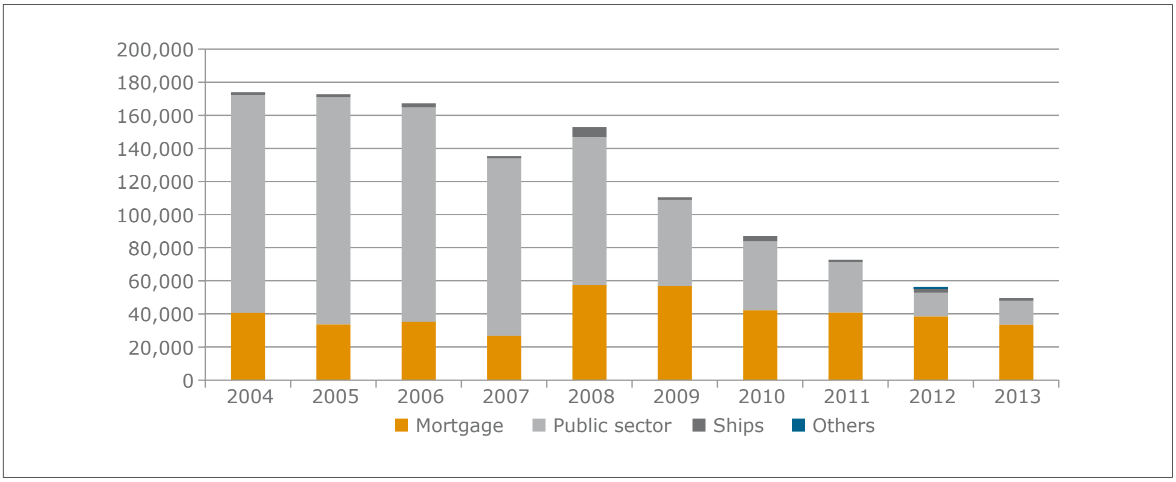
2 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2004-2013, EUR m



Source: EMF/ECBC

Issuers: There are currently about 70 Pfandbrief banks in Germany, including banks from all three pillars of the German banking industry (private banks, public banks and co-operative banks). They include 18 former mortgage banks, 10 Landesbanks and circa 30 savings banks. Also, an increasing number of private universal banks became Pfandbrief banks within the last years.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/23/Pfandbriefe

Covered Bond Label : NORD/LB; UniCreditBank AG HVB Mortgage; UniCreditBank AG HVB Public

3.13 GREECE

By Alexander Metallinos, Karatzas & Partners Law Firm

I. FRAMEWORK

In Greece, the primary legal basis for covered bond issuance is article 152 of Law 4261/2014 "On Access to the Activity of Credit Institutions, Prudential Supervision of Credit Institutions and Investment Firms (transposition of Directive 2013/36/EU), Repeal of Law 3601/2007 and Other Provisions", (the "Primary Legislation"). This provision is identical with the provision of article 91 of the now repealed Law 3601/2007, which had entered into force on 1 August 2007 and therefore the repeal of Law 3601/2007 had no effect on the regulation of covered bonds. The Primary Legislation supersedes general provisions of law contained in the Civil Code, the Code of Civil Procedure and the Bankruptcy Code. By way of implementation of the Primary Legislation and, pursuant to an authorization provided by the latter, the Governor of the Bank of Greece has issued Act nr. 2598/2.11.2007, which was replaced by the Bank of Greece Act nr. 2620/28.8.2009 (the "Secondary Legislation"). Finally, the legislative framework in Greece is supplemented by Law 3156/2003 "On Bond Loans, Securitization of Claims and of Claims from Real Estate" (the "Bond Loan and Securitization Law"), to the extent that the Primary Legislation cross-refers to it.

II. STRUCTURE OF THE ISSUER

The Greek legislative framework permits the issuance of covered bonds in two ways, either directly by a credit institution, or indirectly by a subsidiary of a credit institution. In the direct issuance structure the covered bonds are issued by a credit institution and the segregation of the cover pool is achieved through a statutory pledge over the cover pool assets.

Paragraph 13 of the the Primary Legislation allows for a variation to the direct issuance. Under this structure the covered bonds are issued by the credit institution and are guaranteed by a special purpose entity (SPE), which acquires the cover pool. This structure has not yet been used by any issuer.

In the indirect issuance structure the covered bonds are issued by a special purpose entity being a subsidiary of a credit institution, which purchases the cover assets from the credit institution by virtue of the provisions of the Bond Loan and Securitization Law, and are guaranteed by the credit institution.

The reason for introducing the indirect issuance structure was that historically most Greek banks had issued a significant amount of notes under medium term note (MTN) programmes containing negative pledge covenants, which did not allow the creation of security over the cover pool, as is necessary for the direct issuance of covered bonds. However all Greek banks having MTN programmes have now amended the terms of such programmes to carve out the security provided to holders of covered bonds from the scope of the negative pledge covenants, and therefore the need for the indirect issuance of covered bonds has been removed. In fact, the only indirect issuance of covered bonds has now been fully redeemed and it is to be expected that the regulator will likely not approve any future indirect issue of covered bonds.

III. COVER ASSETS

The type of assets that may form part of the cover pool is regulated by the Secondary Legislation by reference to assets referred to in a section of Act nr. 2588/20.8.2007 regarding the calculation of capital requirements in relation to credit risk according to the standardized approach. Following the entry into force of Regulation 575/2013 (Capital Requirements Regulation), this reference should be read as a reference to article 129 of the Regulation. 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). In addition, openings to credit institutions and investment services undertakings may be included in the cover pool up to an aggregate limit of 15% of the nominal value of the outstanding covered bonds. Derivatives may also be included in the cover pool to the extent that they are used exclusively for the purpose of hedging the interest rate, FX or liquidity risk. To the extent that the counterparties to such derivatives are credit institutions and investment services undertakings (as opposed to state entities or central counterparties in organized markets), the net present value of derivatives included in the pool is included in the above 15% limit. Finally, the cover assets may be substituted by certain tradable assets but only up to the amount by which the aggregate nominal value of the cover assets including accrued interest exceeds the nominal value of the outstanding covered bonds including accrued interest.

IV. VALUATION AND LTV CRITERIA

Loans secured by residential mortgages are required to have a loan to value (LTV) ratio of 80%, whereas loans secured by mortgages over commercial properties and ships are required to have an LTV ratio of 60%. Loans with a higher LTV ratio may be included in the cover pool, but they are taken into account for the calculation of the statutory tests described below only up to the amount indicated by the LTV ratio. Thus, by way of example, a loan of 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.

V. ASSET-LIABILITY MAMANGEMENT

The Secondary Legislation provides for tests that are required to be met for the full duration of the covered bonds.

More particularly, the Secondary Legislation provides for the following statutory tests:

(a) The nominal value of the covered bonds including accrued interest may not exceed at any point in time 95% of the nominal value of the cover assets including accrued interest.

(b) The net present value of obligations to holders of covered bonds and other creditors secured by the cover pool may not exceed the net present value of the cover assets including the derivatives used for hedging. This test must be met even under the hypothesis of a parallel movement of the yield curves by 200 basis points.

(c) The amount of interest payable to holders of covered bonds for the next 12 months must not exceed the amount of interest expected to be received from the cover assets over the same period. For the assessment of the fulfilment of this test derivatives entered into for hedging purposes are taken into account.

Tests (b) and (c) are performed on a quarterly basis. In case any of the tests is not met, the credit institution is obliged to immediately take the necessary measures to remedy the situation.

The results of the tests (a) to (c) above and the procedures used to monitor the compliance with such tests are audited on a yearly basis by an auditor independent of the statutory auditors of the credit institution.

The breach of the above mentioned legislation leads to regulatory sanctions. The parties can also agree that the breach of the statutory tests constitutes an event of default.

Moreover, since the Bank of Greece approves each issuance of covered bonds, it would not approve any issuance in case the statutory tests (including the liquidity test) are not met. Therefore a breach of the statutory (but not of any contractual) liquidity test would in practice lead to a Programme freeze. Also the failure to comply with the requirement to restore the statutory tests may lead to sanctions by the Bank of Greece. Apart from the sanctions provided by the Primary and the Secondary Legislation, the contracting parties may agree to additional sanctions, in particular, to alternative administration or an event of default.

VI. TRANSPARENCY

Currently, the issuer's reporting obligations (as described in detail under paragraph on reporting duties of section VII) and the disclosure of the cover pool as conducted via the summary registered with the competent land registry for the establishment statutory pledge (for more details on this issue we cross refer to paragraph on the cover pool monitor of section VII) are the basic transparency tools provided under applicable covered bonds legislation. So far in Greece no market or regulatory initiatives have been undertaken on the creation of a national transparency template, in line with the guidelines of the ECBC Label Initiative.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Cover pool monitor

The compliance with statutory tests, mentioned above, is audited by independent auditors. Such audit reports, as well as the quarterly compliance reports by the issuer shall be submitted with the Bank of Greece as regulator.

Prerequisites for the issuance of covered bonds

According to the Primary Legislation, covered bonds may be issued by credit institutions having Greece as home member state. However, in case of issuance of covered bonds by a credit institution having as home state another member state of the European Economic Area (EEA), and provided that they are characterized as covered bonds in accordance with the law of such member state, the provisions of the Primary Legislation on the creation of a statutory pledge will apply in relation to claims governed by Greek law, as well as the tax exemptions which apply to Greek bonds. Therefore, foreign banks established within the EEA having a significant loan portfolio in Greece may use the loans of such portfolio as part of the cover pool.

The Secondary Legislation sets additional prerequisites for the issuance of covered bonds. Specifically the credit institutions issuing covered bonds:

- must have certain minimum risk management and internal control requirements including suitable policies and procedures for the issuance of covered bonds, organizational requirements, IT infrastructure and a policy for the reduction and management of risks deriving from the issuance of covered bonds, such as interest rate risk, counterparty risk, operational risk, FX risk and liquidity risk; and
- must have aggregate regulatory capital of at least 500 million Euros and a capital adequacy ratio of at least 9%.

Reporting duties of the issuer to the supervisor concerning covered bonds and cover pool

Credit institutions that issue (directly or indirectly) covered bonds shall provide in their financial statements and on their websites information on such covered bonds including on the nominal value and net present value of the bonds and the cover pool and the net present value of derivatives used for hedging.

More particularly, pursuant the Secondary Legislation there are the following disclosure requirements to the Bank of Greece until the end of March of each year in relation to data as of end of December of the year preceding:

- The certified by auditor results arisen following the audit conducted pursuant to the provisions of the Secondary Legislation and following the follow-up of processes and restrictions as set by the Secondary legislation. Any detailed presentation of data, methods and parameters used should also be mentioned.
- Detailed data of the cover pool assets that would confirm the restrictions set under the Secondary Legislation along with the information related to the real estate's revaluation of the mortgages and other loans.
- The following data and information:
  a) weighted average interest-rate per category of assets and weighted average interest-rate of all cover pool assets;
  b) the real estate values of the mortgages and of the other loans;
  c) validation of the selected policy of risk hedging with detailed analysis of the degree of effectiveness of this;
  d) table of corresponding maturities of the covered bonds and corresponding assets of the cover pool and the derivatives;
  e) Finally all the credit institutions have to communicate to the Bank of Greece, within 30 days from the expiry of each quarter, with data of 1st, 2nd and 3rd quarter end, concise information with regards to the results from the tests provided under the Secondary Legislation.

Covered bond supervision in crisis

As described in detail under section VIII of this article, the Primary Legislation provides that in case of insolvency of the issuer, the Bank of Greece may appoint an administrator, regardless of the powers they may assign to a special liquidator pursuant to the generally applicable banking special liquidation provisions, if the trustee does not do so.

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

Segregation of cover assets

In case of a direct issuance the cover assets are segregated from the remaining estate of the credit institution through a pledge constituted by operation of law (statutory pledge). In case of assets governed by a foreign law (which will typically include *inter alia* claims from derivative contracts) a security interest must be created in accordance with such foreign law. The statutory pledge and the foreign law security interest secure claims of the holders of covered bonds and may also secure (in accordance with the terms of the covered bonds) other claims connected with the issuance of the covered bonds, such as derivative contracts used for hedging purposes. The statutory pledge and any foreign law security interest is held by a trustee for the account of the secured parties.

The claims constituting cover assets are identified by being listed in a document signed by the issuer and the trustee. A summary of such document is registered in the land registry of the seat of the issuer. Such summary document includes within its content a description of the assets that constitute the cover pool. Claims may be substituted and additional ones may be added to the cover pool through the same procedure.

The Primary Legislation creates an absolute priority of holders of covered bonds and other secured parties over the cover pool. The statutory pledge supersedes the general privileges in favour of certain preferred claims (such as claims of employees, the Greek state and social security organizations) provided for by the Code of Civil Procedure. Furthermore, upon registration of the summary of the document listing the claims included in the cover pool, the issuance of the covered bonds, the establishment of the statutory pledge and the foreign law security interest and the entering into of all contracts connected with the issuance of the covered bonds are not affected by the commencement of any insolvency proceedings against the issuer.

In case of an indirect issuance or a direct issuance guaranteed by an SPE the cover pool assets are segregated from the estate of the credit institution by virtue of their sale to the special purpose entity. For such transfer, the provisions of the Bond Loan and Securitization Law apply, which provide equivalent protection from third party creditors and insolvency to the one the Primary Legislation provides in case of direct issuance.

It is worth noting that according to the Primary Legislation both in case of direct and of indirect issuance the cover assets may not be attached. This has the indirect result that the Greek law claims constituting cover assets are no longer subject to set-off, because according to article 451 of the Greek Civil Code claims which are not subject to attachment are not subject to set-off. This is important because under generally applicable law borrowers the loans to whom become cover assets would have had a right to set-off, which would reduce the value of the cover pool, for all counterclaims (including notably deposits) predating the creation of the pledge or the transfer of the claims, as the case may be.

No specific provisions exist in relation to voluntary overcollateralisation. As a result the segregation applies to all assets of the cover pool, even if their value exceeds the minimum required by law. The remaining creditors of the credit institution will only have access to any remaining assets of the cover pool after the holders of the covered bonds and other creditors secured by the cover pool have been satisfied in full.

Bankruptcy remoteness of and impact of insolvency proceedings on covered bonds

According to the Secondary Legislation covered bonds do not automatically accelerate upon insolvency of the credit institution having issued (in a direct issuance structure) or guaranteed (in an indirect one) the covered bonds.

Pursuant to the Primary Legislation, as amended, the bond loan programme may provide that either from the outset or following the occurrence of certain events, as, indicatively, initiation of insolvency proceedings against the issuer, the trustee will be entitled to assign or undertake the collection and management, in general, of the cover assets by application *mutatis mutandis* of the Bond Loan and Securitization Law.

Additionally, the Primary Legislation provides that in case of insolvency of the issuer, the Bank of Greece may appoint an administrator, regardless of the powers they may assign to a supervisor or liquidator pursuant to articles 137 and 145 of the Primary Legislation, if the trustee does not do so. The proceeds coming both from the collections of the claims that are included in the legal pledge and from the realization of the rest of the assets which are subject to the legal pledge are applied towards the repayment/redemption of the bonds and of the other claims, which are secured by the legal pledge, pursuant to the terms of the bond loan.

The provisions of the Bond Loan and Securitization Law are respectively applied in the sale, transfer, collection and administration, in general, of the assets comprising the cover.

In case of an indirect issuance the obligations of the credit institution under the Guarantee are automatically accelerated in case of bankruptcy by virtue of the generally applicable provisions of bankruptcy law, but this does not lead to automatic prepayment of the covered bonds. To the contrary, the terms of the covered bonds may provide that the proceeds of the Guarantee will be placed in a special account to be used for the servicing of the covered bonds.

Access to liquidity in case of insolvency

The Primary legislation provides that the trustee can be entitled, pursuant to the terms of the programme and the legal relationship connecting the trustee with the bondholders, to sell and transfer the cover assets, and to use the net proceeds of such sale in order to redeem the bonds which are secured by the legal pledge, by way of derogation from articles 1239 and 1254 of the Civil Code.

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

Exercise of the claims of covered 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.

The programme of the covered bonds may provide that more than one series or issues of bonds may be secured through a single statutory pledge.

The programme may also provide on any other issue related to the priority in satisfaction of the Covered Bondholders and the way they are organized in a group and they are represented, by derogation from the Bond Loan and Securitization Law. Furthermore, the parties may agree to apply a foreign law on these matters.

Protection of depositors

In order to not jeopardize the interests of depositors in case of insolvency of a credit institution due to the segregation (discussed below) of high quality assets in favour for the holders of covered bonds, the Secondary Legislation provides that, in case the cover assets exceed significantly the amount of 20% of the available assets of the credit institution on an unconsolidated basis, the Bank of Greece may impose additional capital adequacy requirements. For the purposes of this calculation available assets are considered to be all assets of the credit institution excluding (i) assets subject to securitization, (ii) assets subject to reverse repo agreements and (iii) assets encumbered in favour of third parties. In exercising its discretion to impose additional capital adequacy requirements the Bank of Greece will take into account qualitative considerations such as (i) any deterioration of the average quality of the remaining available assets after the issuance of covered bonds, (ii) the increase of the liquidity of the credit institution combined and any positive effects it may have on its credit rating and prospects and (iii) the results of additional stress tests. As of November 2014 the authority to impose additional capital requirements shall be conferred to the European Central Bank subject to and in accordance with the provisions of Regulation 1024/2013.

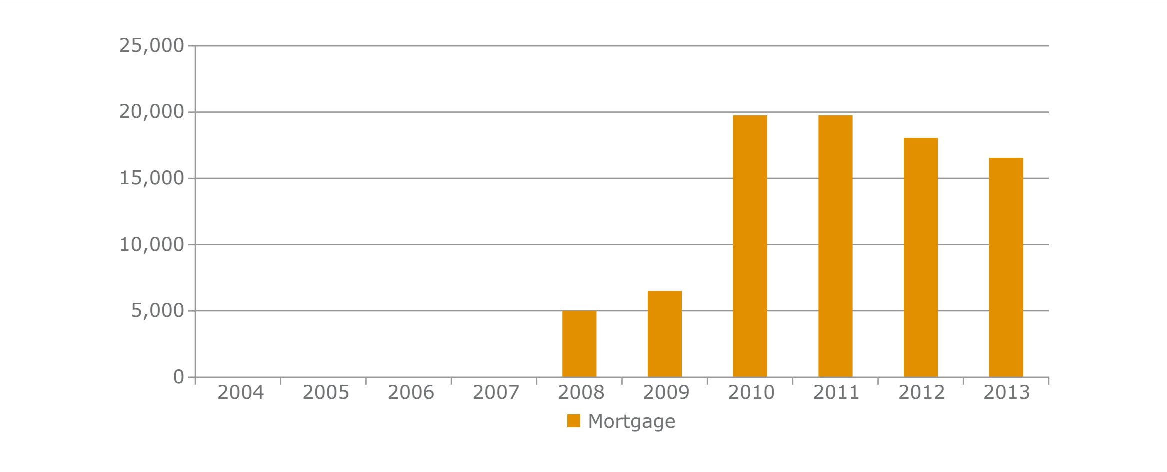
IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk-weighting of covered bonds (both Greek and foreign) is regulated by article 129 of Regulation 575/2013. According to this, bonds falling within the provisions of art. 52 par. 4 of the UCITS Directive are eligible for preferential treatment, provided that the cover pool consists of the assets enumerated in paragraph 1 of Article 129 of Regulation 575/2013 and the provisions of paragraph 7 of the same article regarding the information provided to holders of covered bonds are met. By way of exception, bonds issued before the 31st December 2007 and falling within the provisions of art. 52 par. 4 of the UCITS Directive are considered as covered bonds, even if the cover assets do not comply with the provisions of Regulation 575/2013[1].

Directly issued Greek covered bonds comply with both the UCITS Directive and Regulation 575/2013 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 art. 52 par. 4 of the UCITS Directive, because they are not issued by a credit institution.

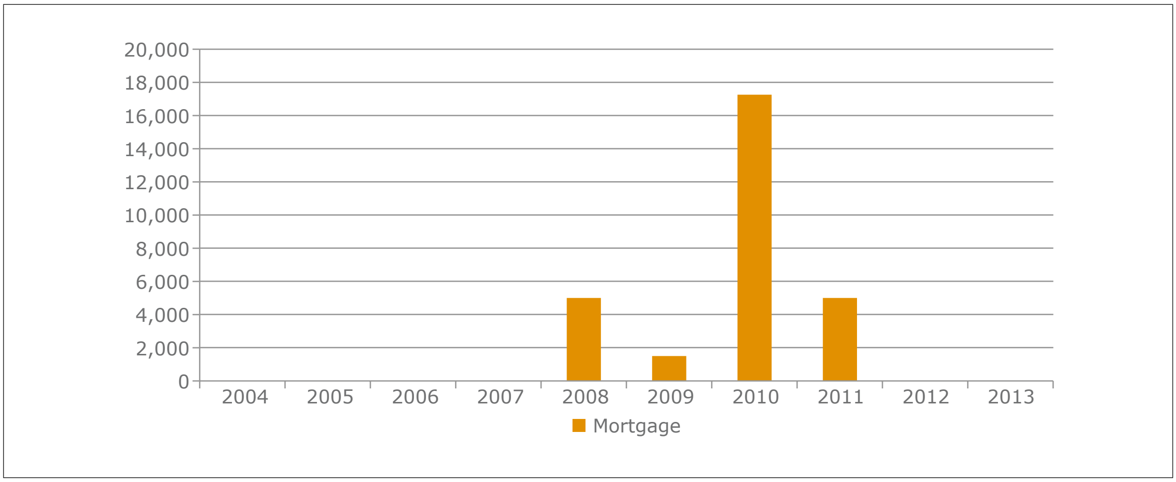
1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2004-2013, EUR m



Source: EMF/ECBC

Issuers: Alpha Bank, National Bank of Greece, Eurobank Ergasias, Pireus Bank.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/66/Greece

3.14 HUNGARY

By András Gábor Botos, Association of Hungarian Mortgage Banks

I. LEGAL FRAMEWORK

Act No. XXX of 1997 on Mortgage Banks and Mortgage Bonds (Mortgage Bank Act) contains the specific rules applicable to mortgage banks and mortgage bonds. Act No. CXII of 1996 on Credit Institutions and Financial Enterprises is applicable generally to the establishment, operation, supervision and liquidation of mortgage banks, unless otherwise provided by the Mortgage Bank Act.

II. STRUCTURE OF THE ISSUER

Mortgage banks are specialized credit institutions in Hungary whose business activity is restricted, in principle, to mortgage lending and auxiliary financial services: mortgage banks grant financial loans secured by mortgages – including independent mortgage liens – on real estate property located on the territory of the Republic of Hungary and other EEA countries. Funds will be raised by way of issuing mortgage bonds. In the Hungarian banking sector only mortgage banks are entitled to issue mortgage bonds ("*jelzáloglevél*"). Cover assets will be held on the balance sheet of the mortgage bank. All the mortgage bonds of a single mortgage bank are covered by the same coverage pool which is only open to changes with the prior permission of the coverage supervisor, acting in the interest of mortgage bond holders.

III. COVER ASSETS

The Mortgage Bank Act provides that mortgage banks shall always possess cover surpassing the principal of outstanding mortgage bonds and the interest thereon both on a nominal basis and based on present value calculation. Decree No. 40/2005. (XII. 9.) of the Minister of Finance contains the detailed provisions on the present value calculation of cover assets and the methodology of stress tests to be published on a regular basis. Furthermore, mortgage banks shall prepare a manual of keeping the register of cover assets ("*fedezet-nyilvántartás*"), which also needs the approval of the Hungarian National Bank in its capacity as financial supervisory authority (HNB) and the coverage supervisor.

Loans secured by a residential real estate can be taken in cover up to 70% of the mortgage lending value of the property. In case of loans secured by commercial real estate the limit is 60%.

Mortgage bonds are covered by loans secured by mortgages ("*jelzálogjog*"), independent mortgage liens ("*önálló zálogjog*") or by joint and several surety assumed by the Hungarian State ("*állami készfizető kezes-ségvállalás*"). Supplementary coverage may exclusively consist of liquid assets listed in the Mortgage Bank Act and may not exceed 20% of the coverage. Pursuant to the Mortgage Bank Act, cover assets must be entered into the register of cover. The availability and quality of cover assets is permanently monitored by the coverage supervisor, reports on availability and quality of cover assets are disclosed on a daily basis.

According to Section 14 (5) of the Mortgage Bank Act, in the case when 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 HNB.

V. ASSET - LIABILITY MANAGEMENT

As indicated above, the Mortgage Bank Act provides that mortgage banks shall always possess cover surpassing the principal of outstanding mortgage bonds and the interest thereon. Mortgage banks shall comply with the above requirements as follows:

> The aggregate amount of the outstanding principal claims considered as coverage, reduced by the amount of any value adjustments, shall exceed 100% of the amount of the nominal value of the outstanding Mortgage Bonds; and

> The aggregate amount of interest accrued on the outstanding principal claims considered as coverage, reduced by the amount of any value adjustments, shall exceed 100% of the amount of interest accrued on the nominal value of the outstanding mortgage bonds (Section 14 (2) of the Mortgage Bank Act).

Under Section 14 (4) of the Mortgage Bank Act the amount of coverage for mortgage bonds shall always be calculated and published at their present value as well.

Cash flow mismatch between cover assets and cover bonds is furthermore reduced by special prepayment restrictions on the borrowers' side.

VI. TRANSPARENCY

Mortgage banks shall publish the amount of the nominal value and the accrued interest of the outstanding mortgage bonds as well as the value of the coverage assets in a national daily newspaper and in the Exchange Journal as of the last day of each quarter, before the last day of the next month. Such figures need to be certified by the coverage supervisor and disclosed to the HNB as well.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The coverage supervisor (cover pool monitor) shall be appointed by the mortgage bank and approved by HNB. 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

HNB. Within the scope of his coverage supervision activities, the coverage supervisor may not be instructed by the mortgage bank.

The HNB 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 HNB 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, HNB shall draw up an analysis schedule and conduct on site audits of mortgage banks according to the analysis schedule it compiles.

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

Pursuant to the Mortgage Bank Act a cover pool administrator will be delegated to the insolvent mortgage bank to safeguard the interests of bondholders and derivative partners. The cover pool administrator cannot be identical with the insolvency administrator of the mortgage bank. The cover pool administrator should provide for the timely satisfaction of principal and interest claims of bondholders and derivative partners in case of a possible insolvency situation. The cover pool administrator will only safeguard the interests of bondholders and derivative partners and will also have an access to the part of assets not qualifying as coverage and those not recorded in the cover register. The transfer of the portfolio or parts of it to another mortgage bank may grant for liquidity, however, the transfer of the portfolio or parts of it requires the prior written consent of the HNB.

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 HNB or the only competent Metropolitan Court Budapest on issuer default, after proving all relevant circumstances, it is only the HNB 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 HNB prior to any insolvency situation.

For example, the HNB is entitled to delegate a supervisory commissioner to the mortgage bank. This extraordinary measurement may be taken by the HNB prior to the commencement of any insolvency procedure – in accordance with Section 157 (1) of the Credit Institution Act. In this case both the rights of the owners of the mortgage bank and the rights of the management of the mortgage bank will be restricted in order to guarantee the satisfaction of the claims of the mortgage bank's creditors, e. g. bondholders' and derivative partners' claims.

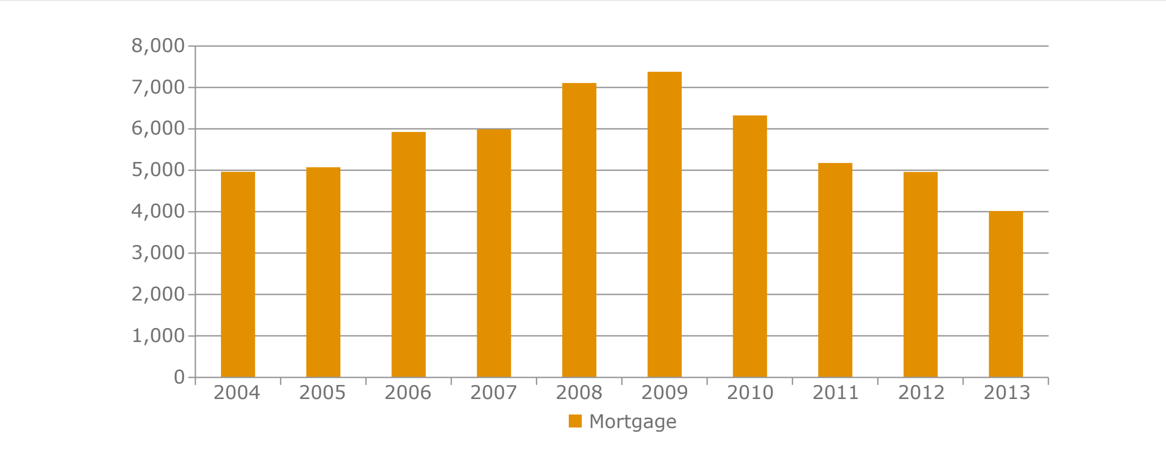
IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR). Hungarian mortgage bonds comply with the requirements of Article 52(4) UCITS as well as with those of Article 129(1) CRR.[1]

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.

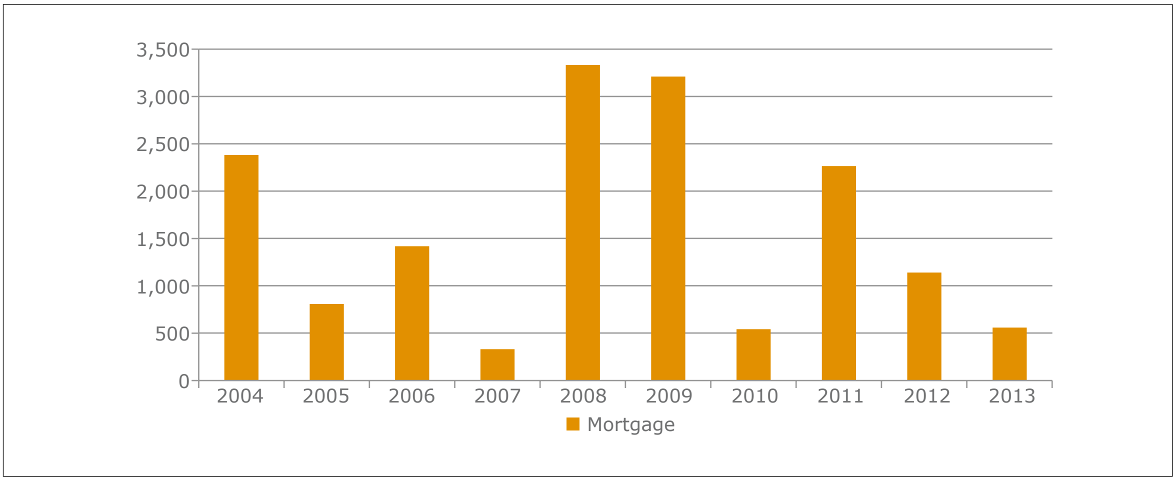
1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2004-2013, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2004-2013, EUR M



Source: EMF/ECBC

Issuers: There are three mortgage banks issuing mortgage bonds on the Hungarian market: OTP Jelzálogbank Zrt. (OTP Mortgage Bank Ltd.), FHB Jelzálogbank Nyrt. (FHB Mortgage Bank Ltd.) and UniCredit Jelzálogbank Zrt. (UniCredit Mortgage Bank Ltd).

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/27/Hungarian_Covered_Bonds

3.15 ICELAND

By Eiríkur Magnús Jensson and Kristín Erla Jónsdóttir, Arion Bank

I. FRAMEWORK

In Iceland, the issuance of covered bonds is governed by the Icelandic Covered Bond Act, which came into force on 14 March 2008 (Lög nr. 11/2008 um sértryggð skuldabréf, hereinafter the "ICBA"). The ICBA supersedes the general bankruptcy law and grants covered bond investors a priority claim on eligible cover assets (ICBA: Chapter VII, Article 14). Regulatory provisions no. 528/2008 (Reglur nr. 528/2008, hereinafter the "ICBR") established by the Icelandic Financial Supervisory Authority (Fjármálaeftirlitið, hereinafter the "FME") complement the legislation. These regulations define in more detail the criteria for obtaining a covered bond issuance 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 FME grants licences for the issuance of covered bonds. Licences to issue covered bonds can only be granted to commercial banks, savings banks and credit undertakings. The issuer must meet certain criteria to qualify for the license. These criteria include the submission of a financial plan, confirmed by a public accountant, proving the issuer's financial stability for at least the next three years; a description of the proposed covered bond issuance and how the issuer intends to organise and administrate the covered bond issuance; and the covered bond register as well as written confirmation from the issuer that he and the planned bond issue comply with the ICBA and ICBR. The FME has the right to withdraw the licence should the issuer be in material breach of the ICBA or if the issuer has failed to issue covered bonds within one year of receiving the licence (Figure 1).

> Figure 1: Licence needed to issue covered bonds

Requirements for issuance licence

- Issuer must supply the FME with a board resolution that the board approves the application for a covered bond licence.
- Description of the proposed bond issuance and how the issuer intends to keep and organise the covered bond register.
- Information about the covered bond register, e.g. how the issuer will maintain the register as well as how the register will be supervised.
- The FME can allow an issuer to convert previously issued bonds used to finance assets that are eligible under ICBA into covered bonds.
- The issuer must submit a financial plan, confirmed by a public accountant, proving the issuer's financial stability for at least the next three years; a description of the proposed covered bond issuance and how the issuer intends to organise and administrate the covered bond issuance; and the covered bond register as well as written confirmation from the issuer that he and the planned bond issue comply with the ICBA and ICBR.
- The issuer must submit information about IT systems used in relation to the covered bond issuance.
- The issuer must submit any other information that is relevant for the proposed bond issuance.

The cover assets represent a claim of the covered bond issuer 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 a single cover asset and a 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 investors. It should also be noted that covered bond investors enjoy recourse to the insolvency estate of the issuer, ranking pari passu with senior unsecured investors.

III. COVER ASSETS

Eligible assets in the covered bond register are mortgage loans and public sector assets (ICBA Chapter II, Article 5). The ICBA does not specify separate cover pools for mortgage and public sector cover assets. Both asset classes can be mixed in one cover pool. Icelandic covered bond issuers have issued covered bonds where the asset register consists exclusively of residential mortgages.

Eligible assets according to ICBA are:

> Mortgages secured by residential housing in member states[1];

> Mortgages secured by industrial, office or commercial property in member states;

> Mortgages secured by farms and other real estate used for agricultural purposes in member states; and

> Public sector assets defined as bonds issued by the Icelandic state or other member state, municipality in Iceland or in another member state, or guaranteed by such member state.

Derivative contracts

The ICBA 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 a demand by the counterparty. Derivative counterparties must have a rating from rating agency approved by the FME. The minimum is a long-term rating of A3/A-/A- (Moody's/S&P/Fitch) or short-term rating of P2/A2/F2. If the counterparty's rating falls below the minimum level, the issuer of covered bond can:

> Request additional collateral;

> Terminate the derivative contract and open a new contract with a counterparty that meets the minimum rating requirement, or;

> Request that the counterparty provide a guarantee from a third party that meets the minimum rating requirement.

Substitute assets

The ICBA allows for the inclusion of the following substitute assets:

> Demand deposits with a regulated financial firm;

> Deposits with or claims against a member state or central bank in a member state;

> Claims against other legal entities which, in FME's estimation, do not involve greater risk than those referred to in the two points above of this paragraph.

1 Member state: a state which is a party to the Agreement on the European Economic Area or the European Free Trade Association Treaty, or the Faroe Islands.

FME may approve as substitute collateral the following claims:

> Claims against municipalities in member states;

> Claims against a regulated financial firm other than those referred to the point above (of the first paragraph), provided the final maturity is within one year of their issuance;

> Claims against foreign development banks listed in rules adopted by FME;

> Claims against other legal entities which do not involve greater risk than the substitute collateral referred to the three points above of this paragraph.

Substitute collateral may not comprise more than 20% of the value of the cover pool. The FME may authorise an increase in the proportion of substitute collateral in the cover pool to as much as 30% of its value.

IV. VALUATION AND LTV CRITERIA

The ICBA defines valuation principles for properties that act as a collateral for mortgages in the cover pool (ICBA: Chapter III, Article 7). An assessment of the market value of real estate shall be based on the selling price in recent transactions with comparable properties. If the market value of real estate is not available, it shall be determined by a specific valuation. The valuation shall be based on generally accepted principles for market valuation of real estate. Data on real estate price developments from the Land Registry of Iceland of Iceland, for instance, may be used as a basis, together with other systematic collection of real estate price data.

If an issuer assesses the market value of real estate, the independent inspector provided for must verify that the appraisal is based on accepted methodology. The inspector may re-assess the market price of one or more properties if he/she regards the valuation as incorrect.

An appraisal of the market value of real estate must be in writing and must specify what methodology is used, who has carried out the appraisal and when it was made.

For the various mortgage types eligible as cover, the maximum LTV ratios apply (ICBA: Chapter III, Article 7):

> 80% of the value for real estate, side-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.

V. ASSET - LIABILITY MANAGEMENT

The ICBA requires that the nominal value of the cover assets at all times exceed the aggregate nominal value of claims arising from outstanding covered bonds against the issuer (ICBA: Chapter V, Article 11). 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 FME. The FME defines the stress test for interest-rate risk as a sudden and sustained parallel shift in the reference curve by 100bps up and down. The reference curve is based on Icelandic government bonds for covered bonds in Icelandic krona but swap rate curves for other currencies. 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 (ICBR: Chapter 4, Article 8). The ICBA does not require a mandatory level of minimum overcollateralization (OC). However, the issuer can adhere the to a self-imposed OC level for structural enhancement, as the ICBA 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 (ICBA: Chapter V, Article 11). The issuer should be able to account for these funds separately.)

VI. TRANSPARENCY

The issuers are already presenting information regarding their cover pool and outstanding covered bonds on a monthly or at least on quarterly basis. This information is today on the issuer's website.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The covered bond issuers fall under the special supervision of the FME. The financial regulator monitors the institutions' compliance with the ICBA and other related regulatory provisions (e.g. ICBR). If the covered bond issuer is in material breach of its obligation under the legal framework, the FME can issue a warning or revoke the issue license altogether. The FME 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 FME must determine how the operations should be wound up (ICBA: Chapter IX, Articles 24–29).

For each issuing institution, the FME must appoint an independent and suitably qualified cover pool inspector, 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 ICBA. 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 FME on an annual basis and must notify the FME as soon as he/she learns about an event deemed to be significant to the supervisory authority (ICBA: Chapter VII, Articles 21–23).

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

Cover register

The issuer must keep a register of eligible cover assets, substitute assets, derivative contracts and outstanding covered bonds (ICBA: Chapter 6, Section 13). The law specifies the form and content of such a register, which must be easily accessible to the FME and the cover pool inspector. The registration legally secures covered bond holders and derivatives counterparties a priority claim on the cover pool in the event of issuer insolvency (ICBA: Chapter 7, Section 14). 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 flow accruing from the cover assets after issuer insolvency must be registered in the cover pool.

Issuer insolvency

In the event of issuer insolvency, the registered cover assets and the respective covered bonds are segregated from the general insolvency estate. An 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 ICBA. However, the cover pool does not constitute a separate legal estate.

Cover pool insolvency and preferential treatment

In the event that the cover pool breaches eligibility criteria, covered bonds are accelerated. Covered bond investors and derivative counterparties would have priority claim on the proceeds from the sale of the cover assets, ranking pari passu among themselves. If the proceeds are insufficient to repay all liabilities on outstanding covered bonds, covered bond investors and derivative counterparties have an ultimate recourse to the insolvency estate of the issuer, ranking pari passu with senior unsecured investors.

Survival of OC

Any overcollateralization (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 are 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 interest 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. If the cover pool assets later prove to be insufficient, these advance dividend payments can be reclaimed.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR). Icelandic covered bonds comply with the criteria of UCITS 52(4) and with the covered bond criteria defined in Article 129(1) CRR.[2] The ICBA explicitly lists mortgages against property for agricultural purposes and mortgages against the pledging of tenant-owner rights as eligible cover assets, while the CRR does not. In addition, issuers can impose self-restrictions to ensure that their covered bond issues comply with the CRR. Icelandic covered bonds are not eligible for repo transaction with the Sedlabanki (the Icelandic Central Bank).

X. ADDITIONAL INFORMATION

Legislative covered bonds in Iceland

Arion Bank and Íslandsbanki were both granted a licence to issue covered bonds under ICBA in the fall of 2011 and both followed up by issuing covered bonds denominated in Icelandic krona to domestic investors. Landsbankinn was granted a licence to issue covered bonds in April 2013 and issued their first covered bonds in June 2013. The banks use their covered bond programs to fund their residential mortgage portfolios.

A specific attribute of the Icelandic mortgage market is that the largest majority of Icelandic mortgages are inflation linked. This means that the principal of each mortgage follows the changes in consumer prices in Iceland. This has changed since 2011 when the banks started to offer fixed rate loans that were not tied to inflation. Both Arion Bank and Íslandsbanki have issued both inflation linked covered bonds and normal fixed rate covered bonds. Landsbankinn has only issued normal fixed rate covered bonds. Figure 2 shows an overview of covered bonds issued under ICBA. Normally, the bonds are registered at the Nasdaq OMX Iceland (NASDAQ OMX Group) or another European stock exchange.

2 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 2: Overview of covered bonds issued under ICBA

Issuer	Currency	Inflation linked (Yes/No)	Interest rate	Issue date	Maturity date	Amount outstanding (EUR m)*
Arion Bank	ISK	Yes	3.60%	17.02.2012	21.02.2034	15.8
Arion Bank	ISK	No	6.50%	16.05.2012	16.05.2018	27.4
Arion Bank	ISK	Yes	2.50%	12.07.2013	12.07.2019	28.4
Íslandsbanki	ISK	Yes	3.50%	07.12.2011	07.11.2016	25.3
Íslandsbanki	ISK	Yes	2.84%	07.03.2012	07.03.2019	41.9
Íslandsbanki	ISK	Yes	3.45%	07.03.2012	07.03.2024	53.5
Íslandsbanki	ISK	No	6.398%	25.10.2012	25.10.2015	15.9
Íslandsbanki	ISK	No	6.25%	22.10.2013	22.10.2016	10.7
Landsbankinn	ISK	No	6.30%	10.06.2013	10.06.2016	21.6

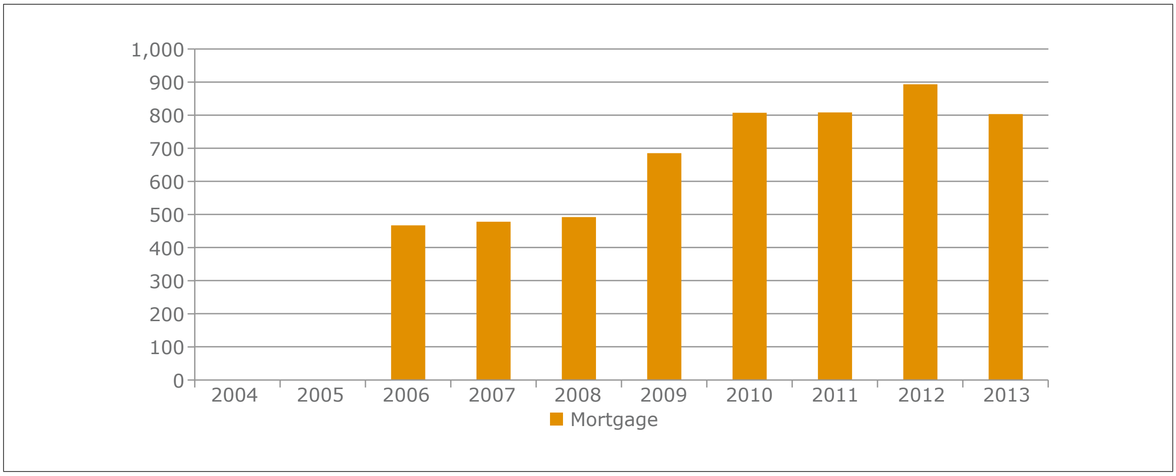
* EUR/ISK exchange rate 158,29

Covered bonds in Iceland prior to the financial crisis of 2008

The legislation on covered bonds (ICBA) came into force in March 2008 only a few months before the collapse of the Icelandic financial system in October month of the same year. Covered bonds based on the legislation had not been issued prior to the crisis of 2008 although one bank had been granted a licence from the FME to issue covered bonds without ever issuing bonds.

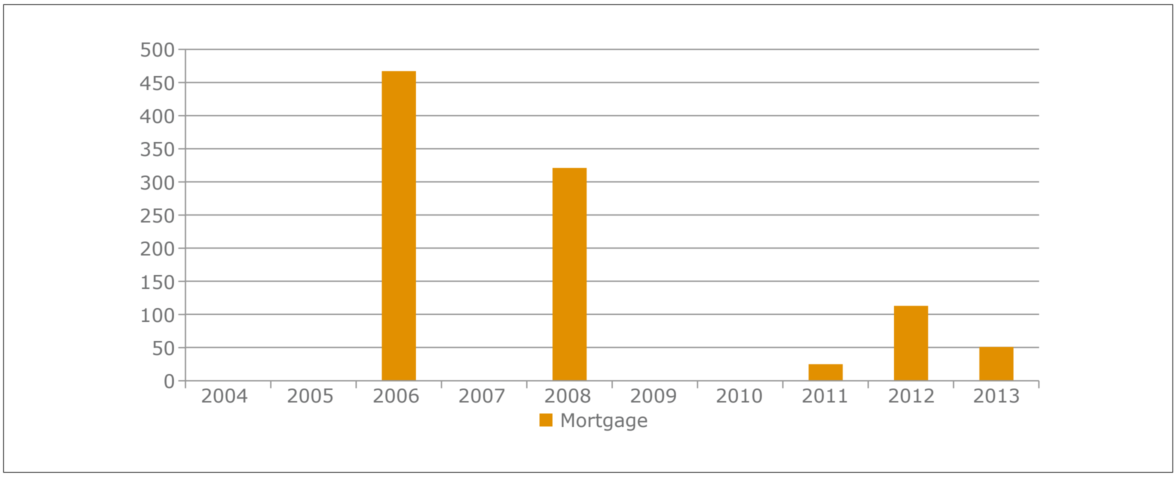
Both Glitnir and Kaupthing bank and other smaller financial institutions set up structured covered bond programs in 2006 and 2007. The bonds issued of these programs were mainly used as collateral in repo transactions with the Central bank of Iceland and/or other counterparties. A small minority of these bonds was sold to other investors. The holders of the structured covered bonds did not take a loss on their holding despite the bankruptcy proceedings of the issuers. The largest of these structured covered bond programs was the Kaupthing ISK 200 bn covered bond program that was restructured in late 2011 when Arion bank took over as issuer and acquired the mortgages under the program. The book value of outstanding Arion Bank structured covered bonds is EUR 772 million as of 31 December 2013.

> Figure 3: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

> Figure 4: Covered Bonds Issuance, 2004-2013, EUR m



Source: EMF/ECBC

Issuers: There are currently three issuers in Iceland - Arion Bank, Íslandsbanki and Landsbankinn.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/108/Icelandic_Covered_Bonds

3.16 IRELAND

By Nick Pheifer, DEPFA BANK and Sinéad Gormley, Bank of Ireland

I. FRAMEWORK

Irish covered bonds benefit from the protection of specialist covered bond legislation in the Irish Asset Covered Securities Act 2001 and the Asset Covered Securities (Amendment) Act 2007 (the "ACS Acts") and the regulations and regulatory notices issued thereunder. The framework provides for the issuance of asset covered securities ("ACS") secured on public credits, mortgage credits (each, as defined below) and commercial mortgage credits (being obligations secured on commercial property assets). There is currently no issuer of ACS secured on commercial mortgage credits in the Irish market and consequently this chapter focuses on the framework applicable to ACS secured on public credits and mortgage credits.

II. STRUCTURE OF THE ISSUER

An issuer of ACS (an "ACS Issuer") must hold a banking licence and be registered under the ACS Acts as a designated credit institution. It is required to limit the scope of its banking activities to certain permitted business activities. An ACS Issuer is therefore subject to regulation by the Central Bank of Ireland (the "CBI") in its capacity as a bank and separately, in its capacity as an ACS Issuer. Each ACS Issuer will be registered as a designated public credit institution (authorised to issue public credit covered securities) and/or a designated mortgage credit institution (authorised to issue mortgage credit covered securities).

The ACS Issuer holds the assets backing the ACS on its balance sheet. The collection of either mortgage credit assets or public credit assets (the "cover assets") backing the issue of ACS (the "cover pool") is described as dynamic or open in the sense that the ACS Issuer may move cover assets in and out of the cover pool provided that it does so in accordance with the provisions of the ACS Acts. One such control is that the ACS Issuer must maintain a register (a "cover register") of all ACS issued, all cover assets hedge contracts and the cover assets (including any substitution assets and any cover assets constituting over-collateralisation) and any amendment to the cover register can only be effected with the approval of a cover-assets monitor (the "CAM") which is an independent professional third party, or the CBI (see further section VII below).

Statutory preference

The claims of ACS holders are protected by a statutory preference under the ACS Acts. As preferred creditors, upon an ACS Issuer insolvency, ACS holders are entitled to have recourse to the cover assets included in the cover pool ahead of all other creditors of the ACS Issuer other than the super-preferred creditors (i.e. the CAM and NTMA - see further section VIII below) and pari passu with other preferred creditors (such as the pool hedge counterparties – see further section V below). In this way the ACS holders have protection against the general Irish insolvency laws.

Restriction on business activities

The ACS Acts provide that an ACS Issuer may not carry on a business activity other than a permitted business activity as set out in the ACS Acts. Permitted business activities comprise dealing in and holding public credit assets or mortgage credit assets (depending on the type of designation of ACS Issuer) and limited classes of other assets, engaging in activities connected with the financing and refinancing of such assets, entering into certain hedging contracts, holding collateral under cover assets hedge contracts (referred to in the ACS Acts as "pool hedge collateral") and engaging in other activities which are incidental or ancillary to these activities. The ACS Acts limit the scope of non-core ACS business that an ACS Issuer can undertake by restricting its dealing in or holding of financial assets that are not otherwise eligible for inclusion in the cover pool to 10% of the total of all the ACS Issuer's assets. There is also a similar 10% limit imposed on the volume of non-cover pool-eligible OECD assets that an ACS Issuer can acquire. In addition, designated mortgage credit institutions must maintain the aggregate prudent loan to value ("LTV") of their overall mortgage books at or below 100%.

III. COVER ASSETS

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

Designated public credit institutions

The classes of asset eligible for inclusion in the cover pool of a designated public credit institution ("public credit assets") are financial obligations (collectively, "public credits"), including obligations given as a guarantor or surety and indirect or contingent obligations, in respect of money borrowed or raised (whether in the form of a security that represents other public credit that is securitised or not) where the obligor is any one of the following:

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

> Sovereigns in Australia, Canada, Japan, New Zealand, the Swiss Confederation or the USA (each, an "Eligible Non-EEA Country");

> Sub-sovereigns in any Eligible Non-EEA Country; and

> Multilateral development banks or international organisations, in each case which qualify as such for the purposes of the Capital Requirement Regulation ("CRR").

Risk-weighting and credit worthiness tests apply to the categories of cover assets outside the EEA countries to comply with the CRR covered bond eligibility requirements. Sovereign obligations from an Eligible Non-EEA Country must have an independent credit rating of at least step 1. Sub-sovereign obligations from an Eligible Non-EEA Country must have an independent credit rating of at least step 1 and a risk weighting at least equal to that of an institution, central government or central bank. Sovereign and Sub-sovereign obligations from an Eligible Non-EEA Country with credit ratings below step 1 but at least step 2 may also be included in the cover pool provided that in total they do not exceed 20% of the nominal amount of outstanding ACS.

Designated mortgage credit institutions

Those assets eligible for inclusion in the cover pool of a designated mortgage credit institution ("mortgage credit assets") are financial obligations (collectively, "mortgage credits"), including obligations given as a guarantor or surety and indirect or contingent obligations, in respect of money borrowed or raised (whether in the form of a security that represents other mortgage credit that is securitised or not) that are secured by a mortgage, charge, or other security on residential or commercial property that is located in any EEA country or any Eligible Non-EEA Country. This is subject to a concentration limit, for mortgage credit assets secured on commercial property, of 10% of the total prudent market value of all mortgage credit assets and substitution assets in the cover pool. Non-performing mortgage credit assets may not be included in a cover pool. Furthermore, a mortgage credit asset may not be counted as part of a cover pool if a building related to that mortgage credit asset is being or is to be constructed until the building is ready for occupation as a commercial or residential property. A mortgage credit institution may also include securitised mortgage credits in its cover pool subject to certain credit quality and other criteria and a concentration limit of 10% of the aggregate value of the related outstanding ACS. To date, designated mortgage credit institutions have not included securitised mortgage credit assets in their cover pools.

Substitution assets

Substitution assets can be included in any cover pool provided that they comply with applicable CRR requirements and certain other restrictions. These are deposits having a minimum credit rating of Step 2 and a maximum maturity of 100 days with eligible financial institutions.

IV. VALUATION AND LTV CRITERIA

Designated public credit institution

Public credit assets maintained in the cover pool of a designated public credit institution are ascribed a prudent market value equal to 100% of the amount of the related public credit outstanding on the date of valuation.

Designated mortgage credit institution

The maximum prudent LTV levels for mortgage credit assets included in the cover pool of a mortgage credit institution are 75% for mortgage credit assets backed by residential property and 60% for those backed by commercial property. Prudent LTV levels for mortgage credit assets in the cover pool can exceed the 75% threshold, however the balance of the mortgage credit above this threshold is disregarded for valuation purposes. The inclusion in the cover pool of mortgage credit assets secured on commercial property is restricted to 10% of the prudent market value of all mortgage credit assets and substitution assets included in the cover pool at any time. Cover pool data indicates however, that designated mortgage credit institutions have not included assets secured on commercial property in their cover pools to date.

A designated mortgage credit institution is first required to determine the market value of a property asset at the time of origination of the mortgage credit asset secured on it. It is market practice for such property valuations to be conducted by independent valuers. The designated mortgage credit institution is then required to calculate the prudent market value of such property asset at the time of inclusion of the related mortgage credit asset in the cover pool and also at such intervals (at least once per year) as may be specified by the CBI. In addition, a designated mortgage credit institution is required to calculate the prudent market value of mortgage credit assets and securitised mortgage credits included in the cover pool on a quarterly basis, or more frequently if so instructed by the CAM, for the purposes of demonstrating compliance with the asset-liability and over-collateralisation requirements of the ACS Acts. In practice, the prudent market value of relevant property assets is calculated on a quarterly basis also as this calculation forms part of the valuation process for mortgage credit assets.

For these subsequent calculations, the designated mortgage credit institution must apply the house price index published by permanent tsb and/or the house price index published by the Irish Central Statistics Office (depending on the date of origination) to the valuation obtained at origination, with same being verified by the CAM on a monthly basis.

V. ASSET-LIABILITY MANAGEMENT

The ACS Acts include important asset-liability controls to minimise various market risks.

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

Over-collateralisation: The prudent market value of the cover pool must be at least 3% greater than the total of the principal amount of the related ACS in issue (see also Over-collateralisation below).

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

Currency matching: Each cover asset must be denominated, after taking into account the effect of any cover assets hedge contract, in the same currency as the related ACS.

Interest rate risk control: The net present value changes on the balance sheet of an ACS Issuer arising from (i) 100bps upward shift, (ii) 100bps downward shift and (iii) 100bps twist, in the yield curve, must not exceed 10% of the ACS Issuer's total own funds at any time.

Hedge contracts

Hedge contracts are used in the cover pool to minimise risks on interest rates, currency exchange rates, credit or other risks that may adversely affect the ACS Issuer's business activities that relate to an ACS or cover assets. All such hedge contracts are required to be entered on the cover register by the ACS Issuer. Once so entered, pool hedge counterparties rank as preferred creditors, pari passu with the ACS holders, provided they are not in default of their financial obligations under that hedge contract. Upon the insolvency of an ACS Issuer, a hedge contract will remain in place subject to its terms. Any collateral posted under a hedge contract by a pool hedge counterparty must be recorded on a separate register maintained by the ACS Issuer.

Over-collateralisation

The ACS Acts prescribe a minimum over-collateralisation of ACS for designated mortgage credit institutions and designated public credit institutions of 3% calculated on a present value basis. It is also possible for ACS Issuers to commit by contract to higher minimum levels of over-collateralisation and the market practice has been for ACS Issuers to contractually commit to higher levels. The CAM is responsible for monitoring the levels of legislative and contractual over-collateralisation. Upon an ACS Issuer insolvency, ACS holders will benefit from any cover assets which make up the over-collateralisation to the extent of their claims.

VI. TRANSPARENCY

Disclosure in financial statements

All ACS Issuers are required to make specific disclosures in relation to cover assets included in their cover pools in their annual financial statements.

Designated public credit institutions

A designated public credit institution is required to disclose:

> the geographic location of its public credit assets and the volume and percentage of assets in each such location; and

> details of public credit assets secured on loans to multilateral development banks and international organisations and the volume and percentage of such assets.

Designated mortgage credit institutions

A mortgage credit institution is required to disclose in respect of the date to which its financial statements are made up, details of:

> the number of mortgage credit assets, broken down by amount of principal outstanding;

> volume and percentage of assets in each geographic location;

> the number and principal amounts outstanding of non-performing mortgage credit assets;

> whether or not any persons who owed money under mortgage credit assets had, during the immediately preceding financial year (if any), defaulted in making payments in respect of those assets in excess of EUR 1,000 (so as to render them non-performing for the purposes of the ACS Acts), and if so, the number of those assets that were held in the cover pool;

> the number of non-performing mortgage credit assets replaced with other assets;

> the total amount of interest in arrears in respect of mortgage credit assets that has not been written off;

> the total amounts of principal repaid and interest paid in respect of mortgage credit assets; and

> the number and the total amount of principal outstanding on mortgage credits that are secured on commercial property.

Covered Bond Label

ACS Issuers have agreed two National Transparency Templates ("NTTs"), the Mortgage Sector ACS Transparency Template ("MS NTT") and the Public Sector ACS Transparency Template ("PS NTT"), for the purposes of the ECBC's Covered Bond Label (the "Label"). Both NTTs track the list of recommended transparency items set out in the ECBC's Guidelines for National Transparency Templates. In particular, the MS NTT includes a summary of the loans in the cover pool, a breakdown of the cover pool by loan balance, an analysis of arrears, a summary of outstanding ACS and cover pool valuation metrics, including prudent market valuation and over-collateralisation levels. The MS NTTs are completed and published on a quarterly basis together with access to archive data going back for a period of at least 6 years.

To date, two designated mortgage credit institutions have applied for and obtained the Label in respect of their ACS issuance programmes.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

One of the key features of the ACS legislation is the rigorous monitoring role undertaken by the CAM. The CAM is appointed by the ACS Issuer with such appointment being approved by the CBI.

There are strict eligibility requirements for CAMs. A CAM must be a body corporate or partnership, comprising personnel or partners who are members of a professional representative body. It must demonstrate to the CBI that it is experienced and competent in (i) financial risk management techniques, (ii) regulatory compliance reporting and (iii) capital markets, derivatives, and, as applicable, public credit business and mortgage credit business. The CAM must also demonstrate that it has sufficient resources at its disposal and sufficient academic or professional qualifications and experience in the financial services industry to satisfy firstly, the designated credit institution and secondly, the CBI, that it is capable of fulfilling this role.

The CAM is responsible for monitoring the cover pool, the ACS Issuer's compliance with specific provisions of the ACS Acts and reporting any breaches of same to the CBI. The CAM issues regular reports to the ACS Issuer (every 1-4 weeks) and submits a report on a quarterly basis to the CBI.

Some of the CAM's principal obligations include: ensuring that the matching requirements of the ACS Acts with respect to the cover assets and the ACS are met; ensuring that the asset eligibility requirements are met; approving any inclusion in or removal from the cover register, of a cover asset, ACS or hedge contract; checking that the level of substitution assets included in the cover pool does not exceed the prescribed percentage; and ensuring that the legislative and contractual levels of over-collateralisation are maintained.

The CBI is given statutory responsibility for supervising ACS Issuers. The CBI may, with the consent of the Minister for Finance, revoke the registration of an ACS Issuer and/or suspend its business if such ACS Issuer breaches any provision of the ACS Acts. In addition, the CBI has wide-ranging powers under the Irish Central Banking legislation to impose significant fines and administrative sanctions on ACS Issuers and/or their senior management for contraventions of the ACS Acts.

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

As noted above under section II, an ACS Issuer holds its cover assets on its balance sheet. However, the cover assets are ring-fenced from the other assets of the ACS Issuer for the benefit of ACS holders by virtue of (i) their being recorded in the cover register, and (ii) a statutory preference created by the ACS Acts.

Segregation: Cover register

Each ACS Issuer must maintain a cover register including the details of its ACS in issue, the cover assets and substitution assets backing its ACS and any cover assets hedge contracts in existence. The cover register is important as a cover asset or a cover assets hedge contract cannot be described as such unless and until it is recorded on the register. Their registration is prima facie evidence of such assets and hedge contracts being included in the cover pool, entitling the ACS holders and pool hedge counterparties to benefit from the insolvency protection specified in the ACS Acts in respect of such assets and hedge contracts. An ACS Issuer may only remove or amend a register entry with the consent of the CAM or the CBI which further safeguards the interests of ACS holders.

Preferential treatment of ACS holders

Once a cover asset has been entered in the cover register, it will remain a cover asset for the benefit of ACS holders and other preferred creditors until the CAM or the CBI has consented to its removal from the cover register and consequently, the cover pool. Cover assets included in a cover pool do not form part of the assets of the ACS Issuer for the purposes of insolvency until such time as the claims of ACS holders and other preferred creditors under the ACS Acts have been satisfied.

If the claims of the ACS holders (and other preferred creditors, including the pool hedge counterparties) are not fully satisfied from the proceeds of the disposal of the cover assets, such parties are, with respect to the unsatisfied part of their claims, to be regarded as unsecured creditors in the insolvency process.

Impact of insolvency proceedings on ACS and hedge contracts

Upon insolvency of an ACS Issuer, all ACS issued remain outstanding and all cover assets hedge contracts will continue to have effect, subject in each case, to the terms and conditions of the documents under which they were created.

The claims of ACS holders on the cover pool are protected by operation of law. Cover assets and hedge contracts that are included in a cover pool are not liable to interference by a bankruptcy custodian or similar person whether by attachment, sequestration or other form of seizure, or to set-off by any persons, that would otherwise be permitted by law so long as claims secured by the insolvency provisions of the ACS Acts remain unsatisfied. ACS holders have recourse to cover assets ahead of all other non-preferred creditors regardless of whether the claims of such other creditors are preferred under any other enactment or any rule of law and whether those claims are secured or unsecured.

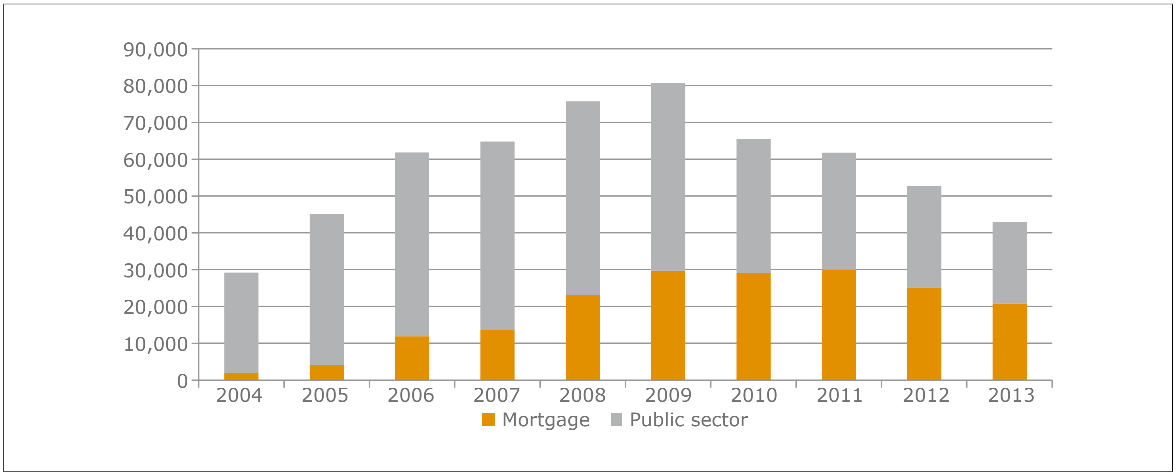
The role of the manager and access to liquidity in case of insolvency

The ACS Acts makes provision for the management of the asset covered securities business of an ACS Issuer upon an ACS Issuer insolvency through the services of the Irish National Treasury Management Agency ("NTMA"). If no suitable manager can be found by the CBI or the NTMA, the NTMA will attempt to locate an appropriate body corporate as a new parent entity for the ACS Issuer. Failing that, the CBI will appoint the NTMA to act as a temporary manager until a suitable manager or new parent entity is found. Upon appointment, a manager will assume control of the cover assets, the asset covered securities business and all related assets of the ACS Issuer. The manager is required to manage the ACS business of the ACS Issuer in the commercial interests of the ACS holders and the pool hedge counterparties. The manager will have such powers as may be designated to it by the CBI under its notice of appointment. It is possible for a manager to obtain a liquidity facility through the use of a hedge contract, such hedge contract if recorded in the cover register would constitute a cover assets hedge contract for the purposes of the ACS Acts and the pool hedge counterparty would rank pari passu with ACS holders and any other pool hedge counterparties.

IX. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

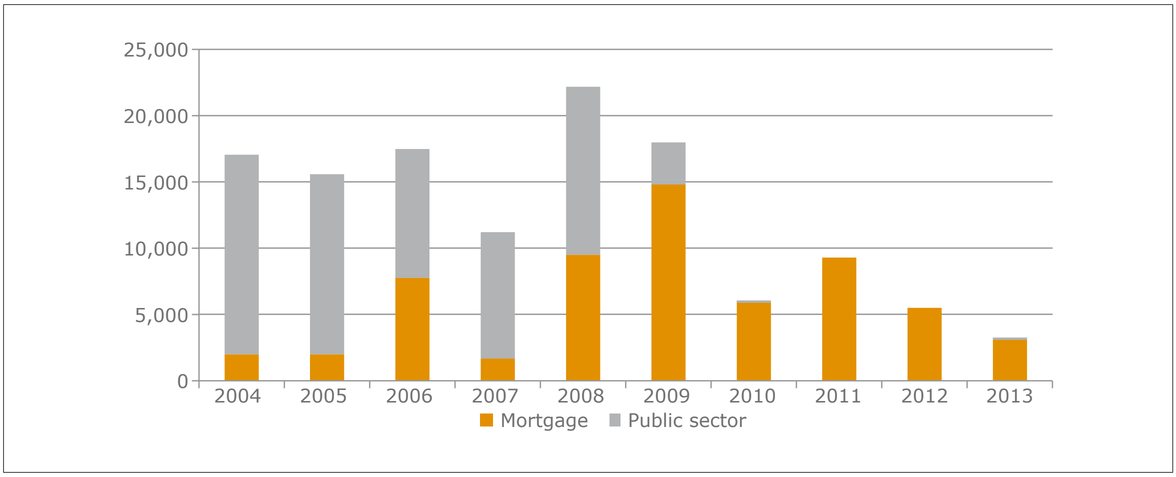
The ACS meet the requirements of UCITS 52(4) and currently benefit from a risk-weighting of 10% as applied by the CBI. The eligibility of cover assets set out in the ACS Acts also match the criteria for the preferential risk-weighting of covered bonds set out in the CRR.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2004-2013, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2004-2013, EUR M



Source: EMF/ECBC

Issuers: There are five ACS Issuers with outstanding covered bonds - Bank of Ireland Mortgage Bank, DEPFA ACS BANK, EAA Covered Bond Bank plc, AIB Mortgage Bank and EBS Mortgage Finance.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/28/Asset_Covered_Securities_-_ACS

COVERED BOND LABEL : AIB Mortgage Bank ACS (Asset Covered Securities); Bank of Ireland Mortgages ACS (Asset Covered Securities)

3.17 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:

> own funds not lower than EUR 250 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), that qualify for the credit quality step 1 under the Standardised approach. In case the covered bonds are backed by notes issued under a securitisation transaction for more than 10% of the issuance nominal value, the following additional conditions must be fulfilled:

> the residential or commercial mortgage loans must have been originated within the banking group of the issuer;

> the issuer or an entity consolidated in the same banking group holds the risk underlying the entire junior tranche;

> the issuer and the SPV are able to verify, on an ongoing basis, the eligibility and the volumes of the securitized assets and to provide the asset monitor with all the relevant information it may require to perform its controls.

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 Figure 1)

> FIGURE 1

Regulatory capital level		Transfer limitations
Class A	Tier 1 ratio ≥ 9% and Core Equity Tier 1 ratio ≥ 8%	No limitations
Class B	Tier 1 ratio ≥ 8% and Core Equity Tier 1 ratio ≥ 7%	Eligible assets can be transferred up to 60% of total
Class C	Tier 1 ratio ≥ 7% and Core Equity 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, own funds of at least €250 million and a consolidated total capital ratio of at least 9%. It is also provided that eligible assets may be assigned to the SPV only subject to a series of restrictions, graduated based on the total capital ratio and Tier 1 ratio at the consolidated level.

Although in some European countries the issuance of covered bond is subject to a "licence" granted by the Supervisory Authority upon the fulfilment of specific requirements, the Italian legislator has decided to make a different choice. Rather than introducing a "licence" system, it has defined a series of requirements and limitations to issuance which together can be de facto considered as the objective basis upon which to grant an issuance authorization. Moreover, it must be considered that such requirements and limitations are in most cases stricter than those required by other regulatory frameworks.

Furthermore, Italian regulation prescribes that the monitoring of the regularity of the transaction and of the integrity of the collateral securing investors must also be performed by an external asset monitor (AM) appointed by the issuer. The AM must be an auditing firm possessing the professional skills required to perform such duties and must be independent from the bank engaging it (e.g. it cannot be the same firm appointed to audit the accounts of the issuing bank) and of any other person participating in the transaction. It has to report at least once a year to the Board of Directors and to the internal audit department of the bank.

Although no specific reporting to the Bank of Italy is prescribed by law, in practice the AM will report to the Supervisor any material anomaly found. It must also be considered that the AM's report is reviewed by the bank's auditor which reports regularly to the Bank of Italy. Should such report contain negative evaluations, the bank's auditor is obligated to bring the issue to the Bank of Italy's attention.

In general terms, specific control requirements on banks issuing covered bonds find their primary source from EU and national legislation. Additionally, in consideration of the peculiarities of a covered bond transaction, the Bank of Italy assigns to issuers the primary responsibility to evaluate the risk involved in the operations, to arrange a proper control mechanism and to ensure its functioning through the time. In particular, at least every six months and for each operation, issuers have to check: i) the quality of the cover pool; ii) compliance with the predetermined ratio between outstanding covered bonds and cover assets; iii) compliance with transfer limitations and asset integration requirements; iv) the performance of any derivative agreement entered into in order to hedge risks.

As far as information flows are concerned, it is provided that issuing/transferring banks shall acquire, from all the parties involved in the structuring of the covered bonds, information relating to:

> the possessory titles of the transferred assets (in order to be able to track down each borrower whose loan has been transferred to the SPV);

> the performance of the transferred assets (in order to monitor the "health" of the cover assets).

This information is necessary to issuing/transferring banks in order to perform both the abovementioned controls in terms of cover pool monitoring and the regulatory reporting (i.e. reporting of defaulted loans to the Bank of Italy's *Centrale dei Rischi*).

VI. TRANSPARENCY

In 2012, the main Italian OBG issuers, coordinated by the Italian Banking Association, worked together to create a transparency template, consistent with the guidelines of the ECBC Label Initiative. The OBG transparency template is available online on the Covered Bond Label website (https://www.coveredbondlabel.com) and each participating OBG issuer has published a completed version on its own website.

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

As provided for by the secondary legislation enacted by the Italian Ministry of Economy, the guarantee granted by the SPV to the covered bondholders, must be irrevocable, first-demand, unconditional and independent from the issuing bank's obligations on the covered bonds. It will be callable upon non-payment and bankruptcy of the issuing bank, and it will be limited to cover pool asset value to ensure bankruptcy remoteness of the SPV.

The SPV is a financial intermediary, registered in the "special list" provided for by article 107 of the Banking Law, and therefore subject to the Bank of Italy's supervision.

Covered bondholders will have the right, represented exclusively by the SPV, to file a claim with the issuing bank for full repayment of the covered bonds. In case of liquidation of the issuing bank, the SPV will be exclusively responsible to make payments to covered bondholders (as well as other counterparties) and will represent covered bondholders in proceedings against the issuing bank.

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

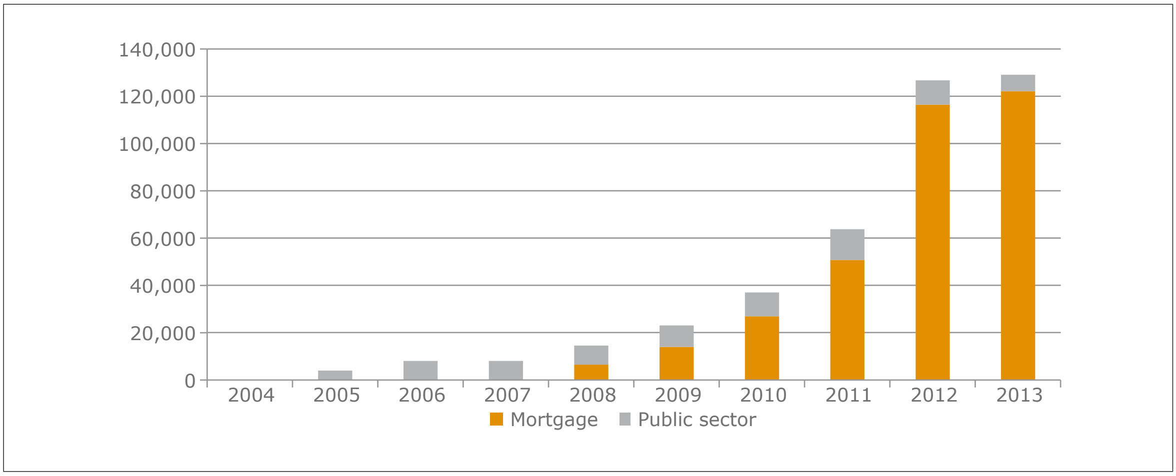
In case the proceeds obtained as a result of the liquidation procedure are insufficient to meet the obligations to bondholders in full, investors would still have an unsecured claim against the issuer for the shortfall.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 (7) of the Capital Requirements Regulation (CRR), also considered that a recent update of Bank of Italy's OBG regulation establishes that the asset monitor must verify, among other things, that the information disclosed to investor as per Article 129 (7) of the CRR are complete, accurate and provided in a timely manner. Italian covered bonds fulfil both the criteria of Article 52(4) UCITS and Article 129(1) CRR.[1] They are also eligible in repo transactions with the Bank of Italy.

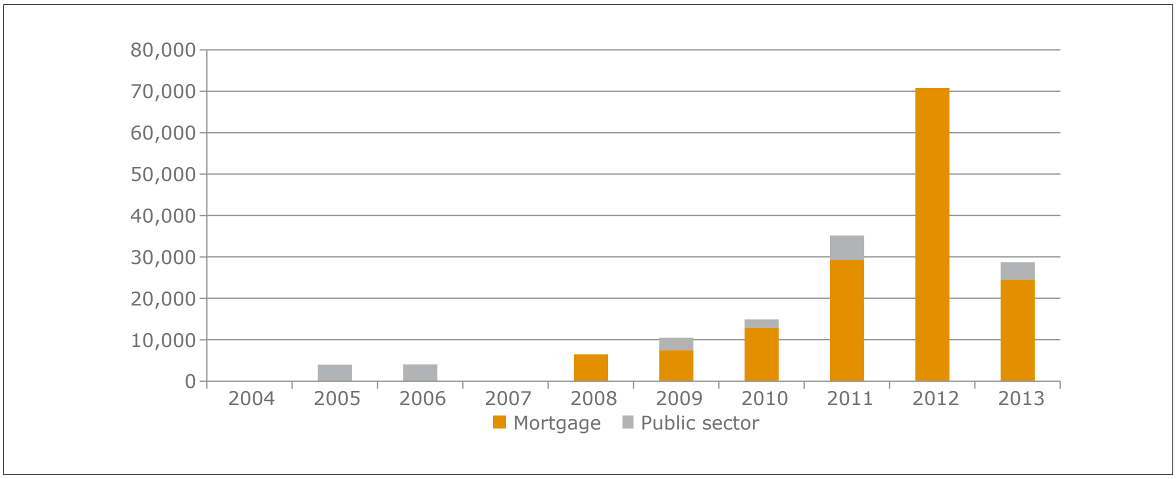
1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2004-2013, EUR m



Source: EMF/ECBC

Issuers: Unicredit, Intesa Sanpaolo, Banca Popolare di Milano, Monte dei Paschi di Siena, Banco Popolare, Cariparma, UBI, Mediobanca, Deutsche Bank, Carige, Bper, Credem, BNL.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/31/Obbligazioni_Bancarie_Garantite_-_OBG

Covered Bond Label : Banca Carige S.p.A. Credit Home/Commercial Loan; Intesa Sanpaolo S.p.A. CB Ipotecario S.r.l.; Intesa Sanpaolo S.p.A. CB Pubblico S.r.l.; UniCredit BpC Mortgage s.r.l.

3.18 LATVIA

By Kaspars Gibeiko

I. FRAMEWORK

In Latvia, the legal basis for covered bond issuance is the Law on Mortgage Bonds (HKZL – Hipotekāro ķīlu zīmju likums) from 10 September 1998 and subsequent amendments to the HKZL (1 June 2000, 5 July 2001, 6 November 2002 and 25 October 2006). The insolvency and bankruptcy procedure is captured both by the HKZL (Section 4) and the Law on Credit Institutions (Articles 561, 161 and 191).

II. STRUCTURE OF THE ISSUER

There is no specialised banking principle in Latvia. As a result every registered bank can issue mortgage-backed covered bonds. The minimum requirements a bank must fulfil in order to issue mortgage bonds are as follows:

> Tier1 and Tier2 capital should be not less than stated in the Law on Credit Institutions;

> Provision of the banking services specified in Article 1, Clause 4 of the Law on Credit Institutions without any restrictions imposed by the Financial and Capital Market Commission (FCMC);

> Submission of rules approved by the bank's supervisory board regarding the valuation of the real estate to be mortgaged and the management of the mortgage bond cover register to the FCMC.

The issuer holds the cover assets on his balance sheet and the cover assets are not transferred to a different legal entity. All obligations from mortgage bonds are obligations of the issuing bank as a whole, to be paid from all the cover assets of the issuer. In the case of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved for the claims of the mortgage bond holders.

The HKZL does not prescribe the issuing bank to have separate employees to manage the cover pool, but it prescribes that the cover assets are managed separately from other assets of the issuer. Therefore, if employees of the bank are involved both in the management of the cover assets and the management of non-cover assets, separation of the duties and responsibilities should be clearly stipulated in the bank's by-laws and internal procedures. There are also no specific requirements regarding the outsourcing of the management of cover assets in the Latvian covered bond legislation.

III. COVER ASSETS

Cover assets can be eligible mortgage loans or loans secured by either guarantees of the Latvian Government or guarantees of the local governments.

Up to 20% of the nominal volume of outstanding mortgage bonds and interest expenses (substitute cover) may consist of:

> cash;

> balances with the central banks of the EU member states; and

> securities issued and guaranteed by the EU member state governments up to 95% of their market value whilst not exceeding the face value of these securities or securities issued by the EU member state's financial institution and traded on the EU regulated securities market up to 95% of their market value whilst not exceeding the face value of these securities.

The eligible mortgage assets are restricted in geographical scope to the extent that a property that secures a mortgage loan should be registered with the EU member state's property register. This means that only properties which are registered in the EU member state can be used as collateral for mortgage loans included in the cover pool. The loans secured by Latvian sovereign and sub-sovereign guarantees are not restricted by geographical scope, but they are restricted by loan purpose; loans which finance public and infrastructure projects are eligible.

Derivatives are eligible for cover pool inclusion for the purpose of mitigating currency - and interest rate risk. The volume of derivatives is not limited and the general documentation used is the standard for derivatives.

IV. VALUATION AND LTV CRITERIA

Property valuation is regulated in Article 15 of the HKZL. Property valuation is carried out according to the international valuation standards. The basis for property valuation is market value. Professionals responsible for the determination of the market value of a property must be in possession of a relevant professional qualification. In addition to that, Article 151 (introduced by the amendment to the HKZL on 25th of October 2006) stipulates that the market value of property registered in the EU member state is determined by the persons who have received professional, real estate valuation, licence according to the legislation of particular EU member state.

The issuer is responsible for the monitoring of the property value. The frequency of monitoring is not defined by the HKZL, but it is prescribed by the regulations of the FCMC and by-laws of the issuer.

Article 14 of the HKZL stipulates that a mortgage loan together with debts previously registered with the national property register may not exceed 75% of the market value of residential property and 60% of the market value of other type of property.

V. ASSET - LIABILITY MANAGEMENT

Article 9 of the HKZL stipulates the following requirements to the asset-liability management of the cover pool:

> the total volume of the cover assets must be larger than the total volume of outstanding mortgage bonds at their face value by at least 10% of the risk weighted value of the cover assets, where risk weighted value of the cover assets is calculated based on specific weights of each type of the cover assets;

> The currency of the cover assets and that of the outstanding mortgage bonds may differ only if the issuer has taken all the necessary measures to prevent the currency risk in the cover pool;

> The total interest income from the cover assets must exceed the total interest expenses on outstanding mortgage bonds;

> The cash-flows from the outstanding mortgage bonds (in accordance with the mortgage prospectus) must always be covered by the cash-flows from the cover assets in terms of volumes and maturities;

> The issuer of the covered bonds has to prepare a report on the cash-flow mismatches and submit it to the FCMC on a semi-annual basis.

The latest amendment to the HKZL stipulates that the issuer should separate loans secured by a mortgage and loans secured by central or municipal governments. This requirement was introduced in order to separate mortgage bonds and public sector bonds.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The Latvian covered bond legislation does not require the appointment of a special entity to monitor the cover pool. Instead, the cover pool is managed by the issuing bank and it is the issuing bank's responsibility to set up a system to ensure that the cover pool is managed properly. In some banks, monitoring of the cover pool is executed by the internal audit department.

The FCMC supervises cover pools. It inspects cover pool (quality and eligibility of the cover assets, quality of the asset-liability management) during regular banking supervisory audits which are carried out on average every two years.

The FCMC has the right to suspend the issue of mortgage bonds under the following circumstances:

> The issuing bank does not comply with the conditions laid down in the Law on Mortgage Bonds;

> The issuer does not ensure that the redemption and interest payments on outstanding mortgage bonds are always covered by the principal and interest payments of the cover assets of a higher value;

> By-laws on the valuation of properties securing the mortgage assets and by-laws on the management of cover pool submitted to the FCMC are not followed.

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

A cover register facilitates the identification of the cover assets, because all the cover assets, including substitute cover as well as derivatives, are recorded in the cover register. The type and scope of the information recorded regarding the cover assets in the cover register are determined by FCMC regulations.

The legal effect of registration is the fact that in the case of insolvency of the issuer, the assets which form part of the separate legal estate can be identified and all assets recorded in the cover register qualify as part of this separate legal estate.

Asset segregation

A cover pool is a part of the general estate of the issuing bank as long as the issuer is solvent. If the insolvency proceedings are opened, by operation of law, the assets recorded in the cover register are excluded from the insolvency estate of the issuer. Those assets will not be affected by the opening of the insolvency proceedings, but automatically form a separate legal estate.

After the opening of the insolvency proceedings, a special cover pool administrator initiated by the FCMC and appointed by court carries out the administration of the cover assets.

Impact of insolvency proceedings on covered bonds and derivatives

Covered bonds do not automatically accelerate when the issuing institution becomes insolvent, but will be repaid at the time of their contractual maturity. The same applies to derivatives which are registered in the cover register and form part of the cover pool. During an insolvency procedure, derivatives' counterparties have the same rights as the holders of mortgage bonds.

Preferential treatment of covered bond holders

Covered bond holders enjoy a preferential treatment as the HKZL and the Law on Credit Institutions stipulates the separation of the cover assets in a case of the insolvency of the issuing bank. According to Article 191 of the Law on Credit Institutions, mortgage bond holders have the first access rights to the cashflows generated by the assets recorded in the cover register.

In the case of insolvency of the issuer, it is forbidden to modify the content of the cover register and all cash flows from the cover assets must be accrued within it. As long as there is sufficient cover, a moratorium on the insolvency's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of covered bond holders.

Only in the case of over-indebtedness or insolvency of the cover assets shall the FCMC file an application to court regarding the insolvency of the cover register (Article 26 of the HKZL). Insolvency of the cover pool is the only catalyst which could the trigger acceleration of covered bond.

Access to liquidity in case of insolvency

With the appointment of the cover pool administrator, the right to manage the cover assets is transferred to him by law. Thus, the cover pool administrator has first access to the cover assets and collects the cash flows according to their contractual maturity.

The cash-flows from the cover assets may only be used for the following purposes and the use of assets in any other manner is inadmissible:

> Disbursements to mortgage bond holders if the term for interest payments or mortgage bond redemption has become due;

> Purchase of mortgage bonds issued by the issuer itself with their subsequent redemption in the public securities market at a price not exceeding the face value of the mortgage bonds if the remaining cover assets are sufficient to cover outstanding mortgage bonds;

> Payments under derivatives' agreements concluded on the cover asset risk mitigation, provided that the contracting parties have met the conditions of such agreements.

The cover pool administrator is permitted, in case of the insolvency of the issuer, to exceed the substitute cover limit.

No specific regulation exists with respect to the insolvency remoteness of voluntary overcollateralisation. However, the cover pool administrator is not allowed to use voluntary overcollateralisation until all payments to mortgage bond holders are made fully and on time.

The cover pool administrator may carry out legal transactions in respect of the cover pools in so far as this is necessary for an orderly settlement of the cover pool and for the full and timely satisfaction of the cover pool's creditors.

Sale and transfer of mortgage assets to other issuers

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

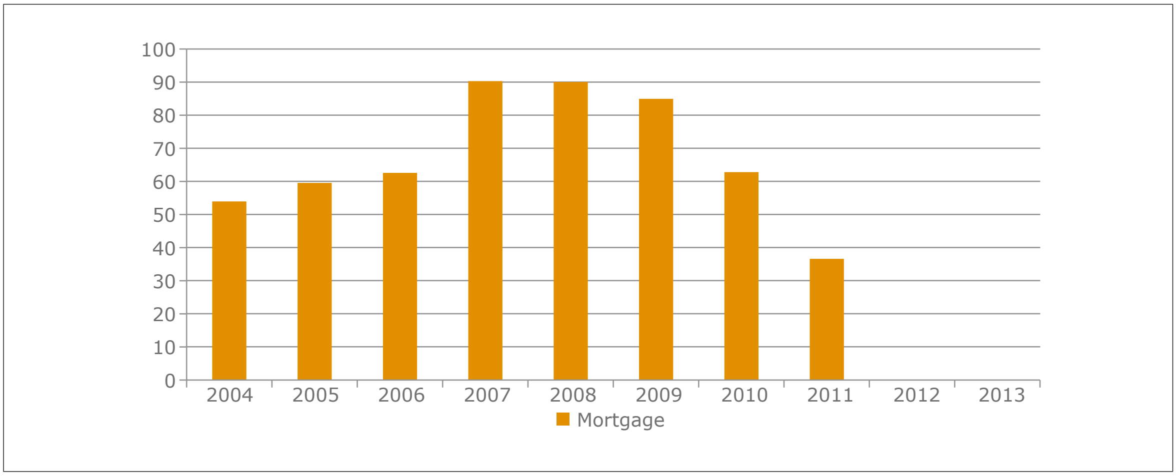
VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR). Latvian mortgage bonds comply with the requirements of Article 52(4) UCITS Directive as well as with those of Article 129 CRR.[1] 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.

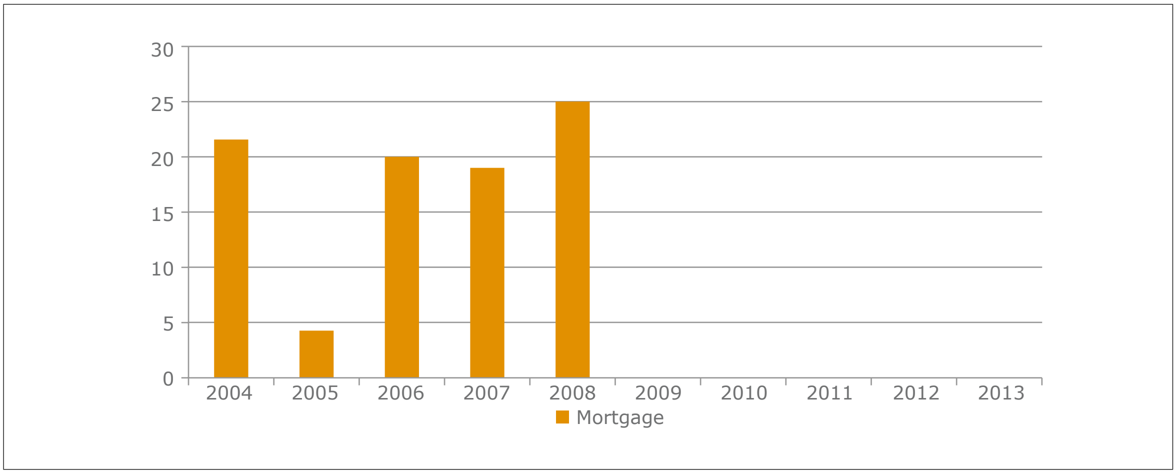
1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2004-2013, EUR m



Source: EMF/ECBC

3.19 LUXEMBOURG

By Frank Will, HSBC, and Reinolf Dibus, Hypothekenbank Frankfurt International S.A.

I. FRAMEWORK

The issuance of Lettres de Gage is regulated by Articles 12-1 to 12-12 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, by the Act of 24 October 2008 and by the Act of 27 June 2013. The Lettres de Gage regulations are supplemented by the *Commission de Surveillance du Secteur Financier* (CSSF) 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 introduced in June 2013 are as follows:

> Part 1 Chapter 1 Section 3 on Lettres de Gage in the law on the Financial Sector act has been completely replaced by a new version. Articles have been restructured, amended and added.

> The geographical scope for asset acquisition is now worldwide but with requirements according to credit quality steps for countries outside the EU, EEA and OECD.

> The Luxembourg issuers are now allowed to issue Lettres de Gage Mutuelles backed by a system of institutional guarantee.

> The rating of eligible securitizations now refers to rating agencies on the list established by ESMA, no longer to S&P, Moody's and Fitch.

> An explicit definition of public enterprise, which was formerly the accepted interpretation of this term, is now mentioned in the law.

> It is explicitly stipulated as a clarification that the cover assets have to be the property of the bank.

> There is now a legal obligation for the issuers to publish information on the cover pools, the lettres de gage and the issuers.

The bankruptcy regulations have also been completely revised. If the court declares open one of the procedures provided for in the law on the financial sector, i.e. suspension of payments or compulsory liquidation, this decision entails the separation of the bank into the cover pools and additional activities. The cover pools with their corresponding bonds and their corresponding reserve with the central bank continue as proprietary compartments of a mortgage bank with limited activity. This bank still holds a banking licence. The court can also open a procedure of suspension of payments or compulsory liquidation for a cover pool, but this does not affect the other cover pools.

The CSSF is no longer administrator of cover pools in the case of bankruptcy of the Lettres de Gage bank but one or several administrators nominated by the court.

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, public sector financing, and lending guaranteed by movable assets which were primarily funded by issuing Lettres de Gage Hypothécaires, Lettres de Gage Publiques and Lettres de Gage Mobilières. Lettres de gage Mobilières were introduced in the amendment in October 2008. According to the last covered bond law amendments in 2013, the Luxembourg issuers are also allowed to issue Lettres de Gage backed by institutional guarantees (Lettres de Gage Mutuelles). They can grant loans to credit institutions in the EU, the EEA and the OECD or loans that are guaranteed by them, on the condition that these credit institutions belong to a system of institutional guarantee. This system has to be recognized by a supervisory authority and guarantee to support its members in the case of economic difficulties.

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, potentially several more for the various forms of Lettres de Gage Mobilières and one for the cover assets backing Lettres de Gage Mutuelles. 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, the various forms of Lettres de Gage Mobilières (including any derivatives benefiting from the preferential treatment) and the Lettres de Gage Mutuelles 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 June 2013, there are four asset classes: mortgage assets, public sector exposures, movable assets, i.e. mortgage loans on ships, aircrafts, trains or other classes of movable assets, and assets backed by a system of institutional guarantee. There is only one regional limitation in place. Credit institutions that are members of a system of institutional guarantee have to be established in a member state of the EU, EEA or OECD. For all other cover assets the restriction to this region has been abolished. In return, a criterion regarding the credit quality of the assets has been introduced. The respective cover pools can contain 50% assets from outside the EU, EEA and OECD, if a rating agency registered on the list at ESMA grants a rating of the first credit quality step to these assets, and 10%, if the rating is of the second credit quality step.

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 or bonds satisfying the conditions set out in article 43 (4) of the law of 17 December 2010 concerning undertakings for collective investments.

It is also possible to hold the cover assets indirectly through a third-party bank.

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.

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 rating of the first credit quality step by a rating agency that is registered on the list by ESMA. The law allows only true sale transactions and synthetic securitisations are explicitly excluded.

Any kind of obligation 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 is an explicit transparency requirement. The issuers have to publish information on the composition of the cover pool, the bonds and the issuers. The details of which are defined by the CSSF.

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 is 80% of the estimated realisation value. The LTV ratio is 60% 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

There is a minimum overcollateralisation level of 2% on a nominal basis as well as on a net present value basis. The Luxembourg regulator has the right to review and adjust these overcollateralisation levels. Any mismatches in terms of currency or interest rate risk have to be hedged and the respective hedge instruments have to be included in the collateral pool. In addition, there are the requirements imposed by the rating agencies.

The special auditor has to ensure that there is always sufficient collateral in the pool. This has to be certified by the special auditor when Lettres de Gage are issued. Cover assets may only be removed from the cover pool when the prior written consent of the special auditor has been received and provided that the remaining cover assets are sufficient to guarantee the legally protected cover.

The calculation of the nominal value and of the net present value of the collateral pool as well of the outstanding Lettres de Gage volume must be reported to the supervisory authority on a monthly basis.

VI. TRANSPARENCY

There is an explicit transparency requirement. The issuers have to publish information on the composition of the cover pool, the lettres de gage and the issuer. The details of which will be defined by the CSSF. This is in line with the ECBC Label Initiative.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The supervisory authority of covered bond issuers is the CSSF, as already mentioned above. The CSSF has a specialised department which is responsible for supervising the Lettres de Gage issuers. It is entitled to demand relevant reports and intercede if liquidity problems have been identified at a bank.

The CSSF is also responsible for the approval of the various types of covered bonds secured by movable assets. Definitions, the details on which types of movable assets qualify and other practical issues will be clarified in a separate CSSF Circular.

For the independent control of the cover pool a special auditor which is recommended by the Lettres de Gage issuer has to be approved by the supervisory authority. Only auditing firms which satisfy the conditions set forth in the law of 2009 regarding *réviseurs d'entreprises* (independent auditors) can be appointed as special auditors. The issuer communicates the names of the partners of these auditing firms who will fulfil the function to CSSF. The special auditor must have a suitable qualification and must be able to call upon the experience and technical expertise of a recognized international auditing firm.

The special auditor is continuously responsible for monitoring the collateral pool and the outstanding Lettres de Gage. The auditor 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. The auditor is obliged to inform the supervisory authority immediately, should any of the prudential limits be violated. The Lettres de Gage issuer is also obliged to immediately inform the supervisory authority of the violation of any limits.

Rating agencies do not play any mandatory role in the monitoring process. The issuers comply with the rating agencies' requirements on a voluntary basis.

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

The cover registers for mortgage, public sector and moveable assets and assets backed by a system of institutional guarantee 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 procedure of suspension of payments or compulsory liquidation is opened for a Lettres de Gage issuer, 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 continue with their corresponding Lettres de Gage and their corresponding reserve at the Luxembourgish Central Bank as proprietary compartments of a Lettres de Gage bank with limited activity. The cover pools do not become separate legal entities. The legal entity of the bank remains unchanged. The banking license continues for the bank with limited activity in order to achieve the purpose of administering the cover pool up to the final maturity of the last outstanding Lettre de Gage. The court nominates one or several administrators for the cover pools. This administrator is different from the general bankruptcy administrator. If a procedure of suspension of payments or compulsory liquidation is opened for one cover pool, the other pools are not affected by this decision and continue.

Impact of insolvency proceedings on Lettres de Gage and derivatives

Lettres de Gage do not automatically become due when a procedure of suspension of payments or compulsory liquidation is opened for the issuing bank. 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. But the salary of the administrator and the other fees that are necessary for continuing the bank with limited activity rank first before the claims of the Lettres de Gage holders and the derivative counterparties, which rank pari passu. The general bankruptcy administrator has no direct access to the assets in the collateral pool.

Access to liquidity in case of insolvency

The administrator nominated by the court administers the cash flows resulting from the cover assets and according to the Article 12-10 (5). The administrator can issue lettres de gage for the account of the lettres de gage bank with limited activity. He or she can approach the Luxembourgish Central Bank for liquidity, where the conditions to be fulfilled as a counterparty for transactions within the framework of monetary politics depend on the Eurosystem.

The administrator 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. But the overcollateralisation in a cover pool serves to pay for the expenses for the continuation of the bank with limited activity as well as absorb losses.

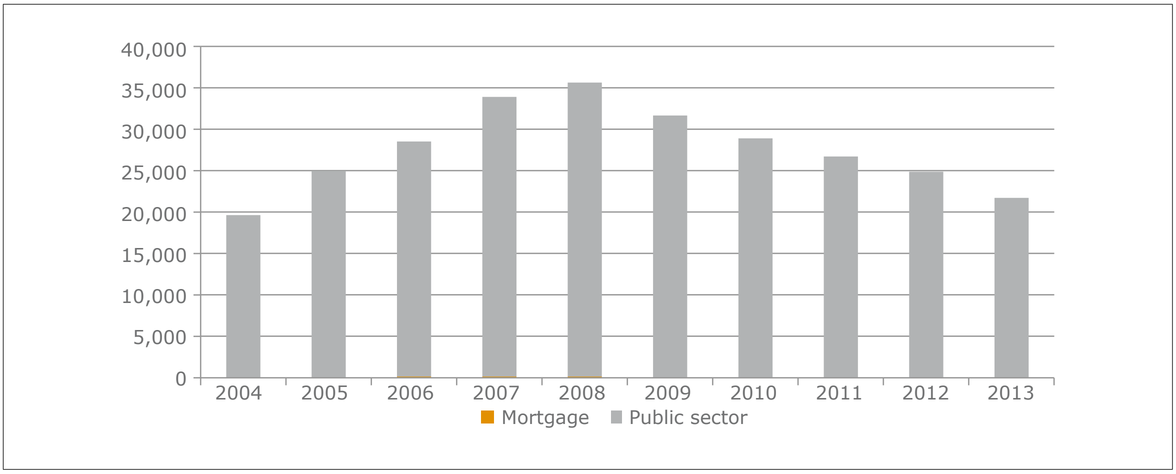
IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The Luxembourgish covered bond legislation fulfils the criteria of Article 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)). In its current format, the Lettres de Gage legislation does not fulfil the requirements set out in Article 129 of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, the Capital Requirements Regulation (CRR), together with Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, the Capital Requirements Directive (CRD), implementing the Basel III rules into European law.[1] The last two amendments of the Luxembourg covered bond legislation did not make the Lettres de Gage legislation CRR-compliant. However, it should be possible for issuers to make their outstanding Lettres de Gage "CRR compliant" by limiting their cover pool exposure.

Lettres de Gage are principally eligible for repo transactions with the European central bank. However, on 28 November 2012, the ECB announced amendments of its eligibility criteria for its repo transactions. The changes entered into force on 3 January 2013. Covered bonds with external, non-intra group securitisations in the cover pool are no longer eligible as collateral for repo transactions as of 31 March 2013. To smooth the impact for existing programmes, the ECB granted a grandfathering period of two years until 28 November 2014 for already issued covered bonds. This means that new covered bonds with external RMBS or other ABS (both group-internal or external) in the cover pool are no longer repo eligible from the end of March 2013 although tap issues of grandfathered covered bonds will remain eligible during the grandfathering period, as long as no additional external RMBS or other ABS are added to the cover pool.

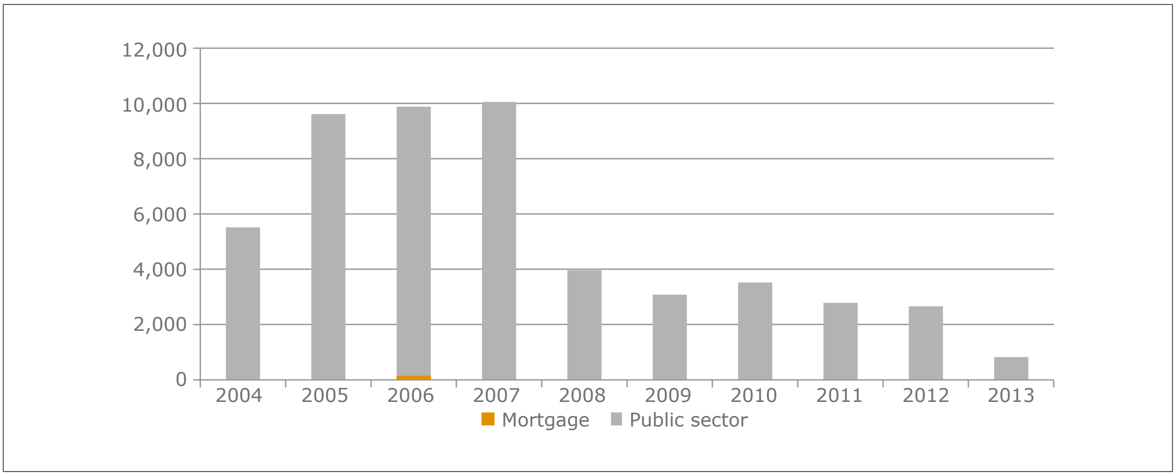
1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2004-2013, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2004-2013, EUR M



Source: EMF/ECBC

Issuers: Dexia LdG Banque, Erste Europäische Pfandbrief- und Kommunalkreditbank, Hypothekenbank Frankfurt International, Hypo Pfandbrief Bank International, NORD/LB Covered Finance Bank, Société Générale Lettres de Gage.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/84/Lettres_de_Gage_publiques, http://www.ecbc.eu/framework/85/Lettres_de_Gage_hypoth%C3%A9caires, http://www.ecbc.eu/framework/86/Lettres_de_Gage_mobili%C3%A8res, and http://www.ecbc.eu/framework/105/Lettres_de_Gage_mutuelles.

3.20 THE NETHERLANDS

By Thijs Naeije, ABN AMRO Bank N.V., Kees Westermann and Miranda Gossen, Rutgers & Posch

HEALTH WARNING

The CB Regulations (as defined below) are in the process of being amended. The amendments aim to further strengthen the CB Regulations and are expected to come into effect as of 1 January 2015. The amendments are at this stage (i.e. July 2014) not yet final and are therefore not addressed in this chapter. As a result, this chapter will by definition be outdated as soon as the amendments become effective.

I. FRAMEWORK

The Dutch regulations for the issuance of covered bonds (the "CB Regulations") came into force on 1 July 2008.

The CB Regulations implement Article 52, paragraph 4 of Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS IV) (as such paragraph may be amended, replaced and/or supplemented from time to time, "Article 52(4) UCITS") and are a collection of rules forming part of two layers of secondary legislation implementing the Dutch Financial Supervision Act (*Wet op het financieel toezicht*; "Wft"): the Wft Prudential Rules Decree (*Besluit prudentiële regels Wft*) and the Wft Implementing Regulation (*Uitvoeringsregeling Wft*).

Covered bonds issued pursuant to and in accordance with the CB Regulations are subjected to supervision by, and registration with, the Dutch Central Bank (*De Nederlandsche Bank N.V.*; "DNB") ("DNB-registered covered bonds"). DNB-registered covered bonds are also included in the list made publicly available pursuant to Article 52(4) UCITS.

The CB Regulations are "principle based" and therefore, do not contain a detailed set of provisions or rules applying to the issuance of DNB-registered covered bonds. Like any other issuance of debt instruments and legal transfers of assets made in accordance with Dutch law, the issuance of a DNB-registered covered bond and the legal transfer of cover assets are subject to the provisions of the Dutch Civil Code and the Dutch Bankruptcy Code.

The CB Regulations include various requirements relating to issuers, owners of the asset pool, eligible assets and the contractual arrangements made in respect of such assets. The CB Regulations also require a valid safeguarding of sufficient cover assets for holders of DNB-registered covered bonds.

II. STRUCTURE OF THE ISSUER

Under the CB Regulations, the issuer must be a licensed bank with its registered office in The Netherlands. In this respect the issuer falls under the general banking supervision by DNB and as such the issuer must fulfil all regulatory requirements with regard to solvency, liquidity, business operations et cetera. For a description of the covered bond company (the "CBC") and the security trustee, please see paragraph VIII below.

III. COVER ASSETS

The CB Regulations list the general requirements of Article 52(4) UCITS and therefore regard compliance of covered bonds with Article 129, paragraph 1 (as such paragraph may be amended, replaced and/or supplemented from time to time, "Article 129 CRR") of Regulation (EU) no. 575/2013 on prudential requirements for credit institutions and investment firms (as amended from time to time, the "CRR") as an option instead of a requirement. Consequently, DNB-registered covered bonds comply with Article 52(4) UCITS and, only if the relevant issuer so elects, also with Article 129 CRR.[1]

1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

The CB Regulations include certain criteria as to which assets may be included in an asset pool for the purposes of a DNB-registered covered bond. Whilst the CB Regulations include a limitation on the laws that may govern a relevant asset, they do not contain a list of assets that may serve as collateral for the purposes of a DNB-registered covered bond. Consequently, under the CB Regulations an issuer of a DNB-registered covered bond has the flexibility to choose the type of assets that can serve as collateral for the purposes of a DNB-registered covered bond. However, where it is intended that such covered bonds obtain preferential treatment under the CRR and Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV), they must meet the detailed requirements on cover assets set out in Article 129 CRR.

To date, all DNB-registered covered bond programmes are registered as compliant with Article 129 CRR and are backed by residential mortgage loans. In addition, they allow for inclusion of substitution assets, meaning euro-denominated:

> Cash; or

> Other assets eligible to collateralise covered bonds under Article 129 CRR (or its predecessor provisions under the so-called Capital Requirements Directive as in effect until 1 January 2014), subject to minimum rating and maximum percentage requirements (this differs per programme).

All DNB-registered covered bond programmes allow for inclusion of non-Dutch residential mortgage loans subject to certain restrictions, but are in practice only backed by a cover pool consisting of Dutch residential mortgage loans.

IV. VALUATION AND LTV CRITERIA

Article 129 CRR 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 higher loan-to-value ("LTV") ratio. To date, all DNB-registered covered bond programmes take a two-step approach towards LTV ratio's of Dutch residential mortgage loans, as follows:

> A loan is only eligible for the cover pool if its LTV ratio did not exceed a designated percentage, the level of which depends on the programme and type of residential mortgage loan involved; and

> Once a loan forms part of the cover pool, the maximum value attributed to it in the asset cover test is a designated percentage (the "LTV Cut-Off Percentage") of the value of the underlying mortgaged property at such time.

Currently, in all DNB-registered covered bond programmes an LTV Cut-Off Percentage is applied to Dutch residential mortgage loans of 80%, being the maximum LTV ratio prescribed by Article 129 CRR for residential mortgage loans. Any excess value of the loan over the LTV Cut-Off Percentage would serve as extra credit enhancement.

The CB Regulations do not prescribe whether the foreclosure value or the market value should be taken into account when calculating the value of the underlying mortgaged property. However, as and for as long as each DNB-registered covered bond programme is registered as compliant with Article 129 CRR, the relevant issuer will be required to comply with the valuation requirements following from Article 129 CRR.

V. ASSET - LIABILITY MANAGEMENT

All DNB-registered covered bond programmes require a minimum level of over-collateralisation which is taken into account in a monthly asset cover test, where the actual over-collateralisation percentages used range from approximately 35 to 45%.

Until September 2013, all DNB-registered covered bond programmes were hard and/or soft bullet programmes. In September 2013, the first conditional pass-through programme was registered by DNB. Hard/soft bullet and conditional pass-through programmes are treated separately hereinbelow.

Hard/soft bullet programmes

All hard/soft bullet DNB-registered covered bond programmes require the issuer to establish a reserve fund equal to, in short, 3 months' interest payments on the covered bonds plus certain costs and expenses for 3 months (or a comparable amount) if the issuer's credit rating falls below F1 (short term) and/or A (long term) (Fitch)/P-1 (short term) (Moody's)/A-1 (short term) (S&P) (depending on the rating agency involved).

Under all hard/soft bullet DNB-registered covered bond programmes, a total return swap in relation to the cover assets is entered into at inception of the programme. The total return swap basically swaps the different types of interest to be received on the cover assets to 1 month's EURIBOR. In addition, an interest rate swap or structured swap is entered into each time a series of 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.

To mitigate liquidity risk on principal payments, all hard/soft bullet DNB-registered covered bond programmes use either:

> In the case of hard bullet covered bonds, a pre-maturity test which is taken on each business day falling 12 months or less prior to the maturity of the relevant DNB-registered covered bonds. The pre-maturity test is failed if on the relevant test date the issuer's short term rating falls below F1+ (Fitch)/P-1 (Moody's)/A-1(S&P) or long term rating falls below A (S&P). A breach of the pre-maturity test requires (a) the issuer to cash-collateralise the relevant maturing DNB-registered covered bonds or (b) the CBC to procure alternative remedies in relation to the relevant maturing DNB-registered covered bonds such as a guarantee of the issuer's obligations, a liquidity facility and/or a sale or refinancing of cover assets; or

> In the case of soft bullet covered bonds, a 12 months' maturity extension. The possible extension applies (a) only to the CBC after an issuer event of default has occurred, (b) only to any final redemption amount payable by the CBC in relation to a series of covered bonds which was not repaid on its scheduled maturity date and (c) unless the CBC has sufficient funds available on an earlier monthly payment date to pay the relevant final redemption amount.

Conditional pass-through programme

The currently sole conditional pass-through DNB-registered covered bond programme requires the issuer to establish a reserve fund equal to, in short, 3 months' interest payments on the covered bonds plus an additional amount.

Under the conditional pass-through DNB-registered covered bond programme (unlike in hard/soft bullet programmes), no total return swap is entered into at inception of the programme. Instead, as part of the asset cover test an amount is deducted which in short resembles the aggregate remaining interest due on the covered bonds minus the expected revenues of the cover pool. Such additional deduction in the asset cover test results in extra over-collateralisation.

To mitigate liquidity risk on principal payments, the conditional pass-through DNB-registered covered bond programme uses maturity extension. This extension applies for covered bonds which have turned into pass-through. A particular series of covered bonds will only turn into pass-through when (1) an issuer event of default has occurred, (2) the series reaches its scheduled maturity date and (3) the available cash combined with the proceeds of a partial sale of the cover pool would not be sufficient to redeem the series in full. If the amortisation test is breached, all series of covered bonds turn into pass-through.

If a covered bond is in pass-through mode, a sale of cover assets is attempted every six months. During each six months period all available cash is passed through pari passu to all pass-through covered bonds. If the proceeds of a sale of cover assets would not be sufficient to redeem the covered bond in full, this six month extension cycle is repeated, with a maximum total extension of 32 years.

VI. TRANSPARENCY

The Dutch issuers of DNB-registered covered bonds use a Dutch national transparency template, which is based on a template developed for Dutch residential mortgage-backed securities, in order to harmonise reporting to investors in DNB-registered covered bonds. The Dutch national transparency template is generally in line with the guidelines of the ECBC's Covered Bond Label initiative and can be found on the website of the Covered Bond Label www.coveredbondlabel.com. The reports can be found on the relevant issuer's website. Links to these pages are also available on the website of the DACB (as defined below): www.dacb.nl.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Under all DNB-registered 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.

When reviewing a Dutch covered bond programme submitted to it for registration under the CB Regulations, DNB requires:

> A valid safeguarding of sufficient cover assets for the covered bondholders. The assets must be validly transferred by the issuer to the CBC and pledged by the CBC to the security trustee;

> The covered bonds to have a credit rating of at least AA-/Aa3;

> A healthy ratio between the programme/issuance amount on the one hand and, on the other hand, (a) the value of the cover assets, (b) the value of the remaining assets of the issuer eligible for addition to the cover assets and (c) the consolidated balance sheet of the issuer (the latter to protect other stake-holders); and

> The issuer to have solid and effective strategies and procedures for verifying and procuring the sufficiency of the cover assets, taking into account the composition of the cover assets, the over-collateralisation and the applicable risks and stress tests.

The register of DNB-registered covered bond programmes is available on-line and can be found at http://www.toezicht.dnb.nl/en/2/2/51-202602.jsp (click on: Searching in the register).

Once a Dutch covered bond programme is registered by DNB, the issuer will have ongoing administration and reporting obligations towards DNB:

> It must keep a record of all DNB-registered covered bonds issued and of all assets serving as cover assets;

> It must demonstrate at least quarterly that the DNB-registered covered bonds continue to meet the criteria summarised above, by granting DNB access to the records referred to in the previous paragraph and, for instance, audit reports, credit rating reports and reports regarding the cover assets. This is without prejudice to the general authority of DNB to request information from the issuer on the basis of its regular banking supervision powers;

> It must demonstrate at least annually to DNB that it has solid and effective strategies and procedures for verifying and procuring the sufficiency of the cover assets, taking into account the composition of the cover assets, the over-collateralisation and the applicable risks and stress tests;

> Annually, within six months of the close of its financial year, it must submit to DNB the annual financial statements and the annual report of the CBC;

> It must immediately notify DNB if, for as long as any DNB-registered covered bond is outstanding (a) changes occur in respect of the data, transaction documents or other submitted documents, as a result of which the outstanding DNB-registered covered bonds are or will no longer be compliant with the requirements for registration; or (b) significant changes are made in the covered bond programme or the conditions of the DNB-registered covered bonds; and

> Before it issues any further DNB-registered covered bonds, (a) it must ascertain that the requirements for registration are complied with (there is no need to have the further DNB-registered covered bonds assessed by DNB); and (b) if the ratio between the total nominal value of the DNB-registered covered bonds and the consolidated balance sheet total of the issuer increases beyond what DNB had determined to be a healthy ratio, the issuer must demonstrate to DNB that the new ratio can be considered healthy.

If the DNB-registered covered bonds no longer meet the requirements set by the CB Regulations or if the issuer no longer complies with its ongoing administration and reporting obligations towards DNB, DNB can impose sanctions, like a fine or an issuance-stop. DNB may disclose such sanctions in its register and via its website. DNB is entitled to ultimately delete the registration of a DNB-registered covered bond programme. In practice it is not very likely that DNB would ever exercise its deregistration authority. Apart from verbal assurance this is confirmed by the explanatory notes to the CB Regulations, which in short state:

> That deregistration will only occur (a) after due consideration of the interests of the issuer and the covered bondholders and (b) in the exceptional circumstance that DNB's supervision is no longer in the interest of the issuer and no longer grants protection to covered bondholders; and

> That the interests of the issuer and the covered bondholders include that the registration and supervision be maintained.

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

DNB-registered covered bonds are issued by a licensed bank and are guaranteed by the CBC owning the cover assets, thus creating dual recourse for the covered bondholders. An insolvency of the issuer does not in itself result in an insolvency of the CBC. The CBC is a special purpose vehicle set up as a bankruptcy-remote entity, as follows. It is a private company with limited liability (*besloten vennootschap met beperkte aansprakelijkheid*) wholly owned by an orphan foundation (*stichting*), with independent directors provided by a corporate services provider, no employees and no shareholders. It has a limited corporate objects clause, such 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.

The CBC pledges the cover assets to a security trustee, which is an orphan foundation especially established to act as a security trustee in relation to the relevant DNB-registered 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.

The regulations enabling the segregation of the cover assets and bankruptcy-remoteness of the CBC are set out in the Dutch Civil and Bankruptcy Codes.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

As explained above, DNB-registered covered bonds comply with Article 52(4) UCITS and, if the issuer so elects, also with Article 129 CRR.

X. ADDITIONAL INFORMATION

On 7 January 2011 the Dutch issuers established the Dutch Association of Covered Bond Issuers (the "DACB"). The main goal of the DACB is to represent the Dutch issuers and to act as a platform for the exchange of information among its members. The DACB's key objectives are to:

> Represent the interests of the Dutch issuers in discussions with legislative and regulatory authorities;

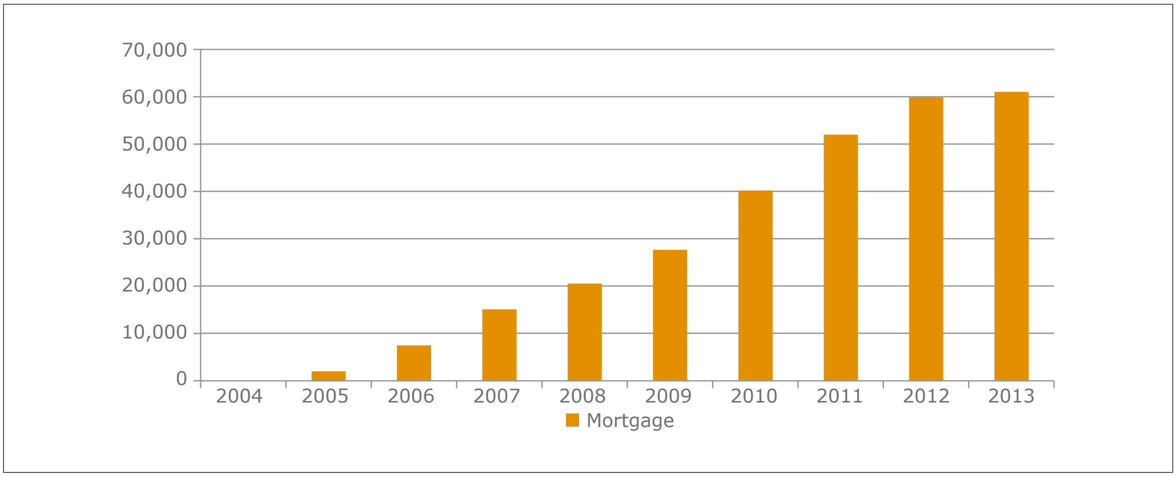
> Provide investors with information about the Dutch covered bond market;

> Participate on behalf of the Dutch issuers in international covered bond organisations like the ECBC; and

> Continuously improve the quality of the Dutch covered bond product offering.

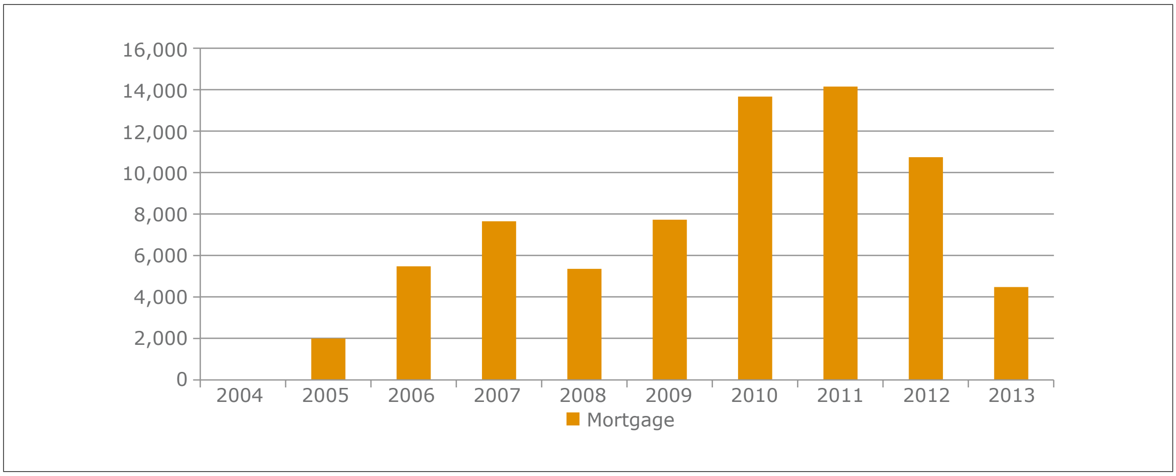
More information on the DACB and its members can be found at www.dacb.nl.

> Figure 1: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2004-2013, EUR m



Source: EMF/ECBC

Issuers: Currently, four DNB-registered covered bond programmes exist in The Netherlands: ABN AMRO Bank N.V., ING Bank N.V., SNS Bank N.V. and NIBC Bank N.V.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/65/Dutch_registered_CBs_programmes

Covered Bond · Label · : ABN AMRO Cover Pool; ING Bank; SNS Cover Pool; NIBC Conditional Pass-Through Covered Bond Programme.

3.21 NEW ZEALAND

By Geoff Martin, Kiwibank and Frank Will, HSBC

SUMMARY

The first covered bond was issued out of New Zealand in June 2010. At that time, New Zealand did not have a legislative covered bond framework and the domestic issuers used the well-tested general law-based covered bond approach following in the footsteps of the UK, France, and Canada. Since then, the regulatory authorities in New Zealand have developed dedicated covered bond legislation to support further growth of this market segment. In May 2012, the Minister of Finance introduced the Reserve Bank of New Zealand (Covered Bonds) Amendment Bill (Amendment Bill) into Parliament. Following a lengthy consultation process with the House of Representatives, the law on covered bonds came into force in December 2013, by virtue of the Reserve Bank of New Zealand (Covered Bonds) Amendment Act 2013.

Since the legislation has come into effect and following a 9-month transition period, banks will only be able to issue covered bonds under registered programmes. This means that programmes that existed before the legislation came into effect will have to be registered before New Zealand banks can issue new bonds under those programmes. Once programmes are registered, covered bonds issued under the programme prior to registration will also receive the benefit of the legislation. We expect all issuers to register.

I. FRAMEWORK

No covered bond regulation was in place in June 2010 when New Zealand covered bonds were first issued and issuance of covered bonds was neither prohibited nor limited by any prudential requirements or other regulation.

In October 2010, the central bank released a consultation paper on proposals for a regulatory framework to provide additional certainty to investors, and to improve the disclosure requirements in order to support the development of the covered bond market in New Zealand.

In January 2011, the Reserve Bank of New Zealand (RBNZ) introduced a regulatory issuance limit for the issuance of covered bonds by New Zealand banks (which came into force in April 2011). The regulation limits the value of assets encumbered for the benefit of covered bondholders to 10% of total assets of the issuing bank. At that time the RBNZ said that this was an initial limit and that its appropriateness would be reviewed by the Central Bank, taking into account the developments within the covered bond market in New Zealand.

In December 2011, the RBNZ conducted another public consultation. The final paper was in essence aligned with the earlier consultation paper. Following approval by Cabinet in April 2012, the Reserve Bank released a Cabinet paper and Regulatory Impact Statement confirming policy positions relating to the matters discussed in the Reserve Bank's December 2011 consultation paper on covered bonds.

In May 2012, the first reading on the Amendment Bill took place. Following its first reading, the Bill was referred to the Finance and Expenditure Select Committee. In February 2013 the second reading took place. Following a third and final reading, the Amendment Bill was passed by the Parliament and received Royal Assent in December 2013. It came into force on 10 December 2013.

The New Zealand covered bond legislation gave existing covered bond issuers nine months to register their covered bond programme with the RBNZ. Each issuance under the programme is also proposed to be registered with the RBNZ. Once a programme is registered existing issues under the programme will receive the benefit of legislation. In expectation of the introduction of a dedicated covered bond law, several existing covered bond issuers in New Zealand had already included a clause in their covered bond prospectus allowing them to exchange, without the consent of the trustees or the covered bond holders, any existing covered bond for a new covered bond. The exchange will provide that, amongst other things, each of the rating agencies when rating the existing covered bonds confirms in writing that any such new covered bonds will be assigned the same ratings as the existing covered bonds. The new bonds would be subject to the same economic terms and conditions as the existing bonds and would be identical in form, amount and denomination.

II. STRUCTURE OF THE ISSUER

As of July 2014, issuers from five New Zealand banking groups have issued covered bonds, being ANZ Bank New Zealand Limited (ANZ), ASB Bank Limited (ASB), Bank of New Zealand (BNZ), Westpac New Zealand Limited (Westpac) and Kiwibank Limited (Kiwibank). With the exemption of Kiwibank, all issuers are ultimately owned by Australian parent banks. However, the Australian parent companies ANZ, CBA, NAB and Westpac do not guarantee the covered bonds. Typically, NZD denominated bonds have been issued directly by the New Zealand banks, while non-NZD bonds have been issued through the London branches of their respective subsidiaries and are guaranteed by the New Zealand parent company. The RBNZ emphasised from the outset that it is supportive of the covered bond product. Banks can issue bonds backed by a dynamic pool of assets, and the covered bonds rank pari-passu to each other. The covered bonds are irrevocably guaranteed by the covered bond guarantor (CB guarantor) under the covered bond guarantee. The CB guarantor will only make payments under the bonds when (a) an issuer event of default has occurred, and a notice to pay is served on the CB guarantor or, (b) a CB guarantor event of default has occurred and a covered bond guarantee acceleration notice is served on the CB guarantor and the issuer.

Under the covered bond law, issuers are required to register with the RBNZ. As of July 2014, only Westpac NZ had registered with RBNZ. However, the other four issuers are expected to follow before the end of the 9-month deadline on 10 September 2014.

III. COVER ASSETS

The new covered bond law does not restrict the type of cover assets. The Reserve Bank stated on its website that the assets eligible to be included in the cover pool do not need to be prescribed by legislation because banks specify asset eligibility in programme documentation. In the Reserve Bank's opinion, legislative restrictions on cover pool assets may unnecessarily restrict an issuer's ability to develop covered bond programmes.

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 programmes are listed below:

> Denominated and repayable only in New Zealand Dollars (NZD);

> Secured by first ranking residential mortgages in New Zealand;

> Mortgage loans with a term not exceeding 30 years;

> Outstanding principal balance of no more than NZD 1.5 m (Westpac)/NZD 2.0 m (ANZ, ASB, Kiwibank)/ NZD 2.5 m (BNZ); and,

> Not in arrears/have not been in default for more than 30 days.

Some of the issuers have additional features beyond these requirements. Moreover, issuers are also allowed to hold liquid substitution assets. These assets, are subject to an overall limit of 10%-20% of the cover portfolio depending on the issuer (Westpac 20%, BNZ 15%, ANZ, ASB and Kiwibank 10%), with the exception of cash that has no limit.

IV. VALUATION AND LTV CRITERIA

In New Zealand, every property is typically valued during the underwriting process. All five existing covered bond programmes do not restrict the LTV limit for mortgage loans in the cover pool. However, in the case of ASB and Westpac, the Asset Coverage Test (ACT) caps the valuation of the property at 75%. In case of ANZ, BNZ and Kiwibank this cap is set at 80%. In effect, this means the maximum amount of a loan that can count in the ACT test is 75% or 80% of the property value respectively.

V. ASSET-LIABILITY MANAGEMENT

Issuance limit: As mentioned above, there is a regulatory issuance threshold which limits the value of assets encumbered for the benefit of covered bond holders to 10% of the total assets of the issuing bank. The RBNZ highlights that this is an initial limit and its appropriateness will be reviewed taking into consideration the development of the covered bond market. The RBNZ stated that the 10% limit is "similar to the limit set in Australia" of 8%. However, the limit is "specified differently" from Australia's. "The New Zealand limit applies at all times, whereas the Australian limit applies only at the time of issuance. In addition, if an Australian bank holds cover pool assets in excess of the limit, it must deduct the value of the excess amount from its capital in calculating its regulatory capital adequacy ratios: if a New Zealand bank breaches its cover pool limit, it is in breach of its conditions of registration."

Currency and interest hedging: The underlying mortgage loans are denominated in NZD. However, covered bonds can be issued in other currency denominations, which introduces currency risk for the issuer. Moreover, the interest payable for the covered bonds will not exactly match the interest received on the mortgage loans in the collateral pool. Under the existing covered bond programmes, the issuers are required to hedge the interest and currency risks.

Soft vs hard bullet structures: The existing issuers (ANZ, ASB, BNZ, Kiwibank and Westpac) can issue hard bullet covered bonds, or covered bonds with extendable maturity of one year ("soft bullet" bonds). Hard bullet covered bonds will be subject to a 12-month pre-maturity test giving the CB guarantor 12 months to raise liquidity by selling assets of the pool.

Over-collateralisation (OC): The issuers have committed to various OC levels under the prospectuses and to the rating agencies. The covered bond law only requires that the value of the cover pool assets is at least equal to the principal amount outstanding on the covered bonds.

VI. COVER POOL MONITOR AND BANKING SUPERVISON

The law stipulates that registered covered bond issuers must appoint an independent asset monitor. The asset monitor must either be a licensed auditor or an auditing firm (or person/firm that has been approved by the RBNZ). In this context independent means independent of both the issuer and any associated person of the issuer whereby a person's appointment as auditor does not affect his, her, or its independence.

The existing issuers provide investor reports on a monthly or quarterly basis. In addition, monthly or quarterly reports are prepared for the rating agencies. The agencies re-calculate the required asset percentage used in the ACT on a regular basis and prior to each issuance under the respective covered bond programme. On an annual basis the asset monitor checks the arithmetic accuracy of the calculations performed by the calculation manager (usually the issuer), with respect to the asset coverage test or amortisation test (as applicable).

The law introduces the requirement for an asset register to be maintained. The asset monitor also carries out an annual check that the asset register has been updated accurately and in a timely manner.

If the issuer rating of the calculation manager is downgraded below a certain trigger level, the asset monitor will check the arithmetic accuracy of the calculations performed by the calculation manager on a monthly basis. Moreover, (1) if the asset monitor identifies 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%, or (3) if the asset register has not been maintained as required, then the asset monitor will be required to carry out the applicable check on a monthly basis until the asset monitor is satisfied that no further inaccuracies exist.

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

The covered bonds are direct, unsecured, unsubordinated and unconditional obligations of the relevant issuer. In addition, the CB guarantor guarantees the payments of interest and principal of the covered bonds. The issuer provides a subordinated loan to the 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.

The mandatory registration required by the new covered bond law involves the recognition of a covered bond issued with the effect that the cover assets would be explicitly protected from the insolvency or statutory management of the issuer. The RBNZ must keep a public register of registered covered bond programmes and issuances under each programme. Moreover, the covered bond law requires that the cover pool assets are held by a Special Purpose Vehicle (SPV), which is a separate legal entity from the issuer.

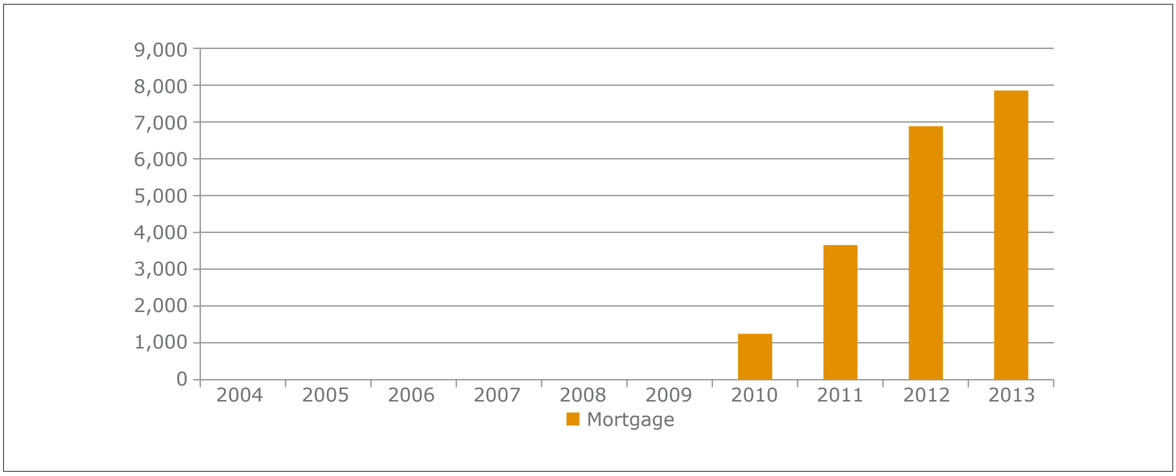
Under the existing covered bond programmes, the sale of the loans and their underlying security by the seller to the CB Guarantor is in the form of equitable assignment of the seller's rights, title, interest and benefit in and to the loans, their related security and the other assets which are being sold. The equitable assignment requires neither a notice to the borrowers nor a registration in the land registry. As a result, the legal title to the mortgage loans remains with the seller until legal assignment is delivered to the CB guarantor and notice of perfection of legal title is given to the borrowers. The perfection of title of the mortgage security to the CB guarantor will be triggered by certain trigger events including the notice to pay on the CB guarantor, downgrade of the issuer to sub-investment grade or insolvency of the issuer. The equitable assignment is a well-known procedure in the UK and is usually used by the covered bond issuers in the UK.

VIII. RISK WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

The RBNZ accepts NZD denominated AAA rated covered bonds for its Domestic Markets Operations. For maturities of less than three years the haircut is 5% while covered bonds with a maturity of three years or longer are subject to a higher haircut of 8%. This includes covered bonds issued by New Zealand banks.

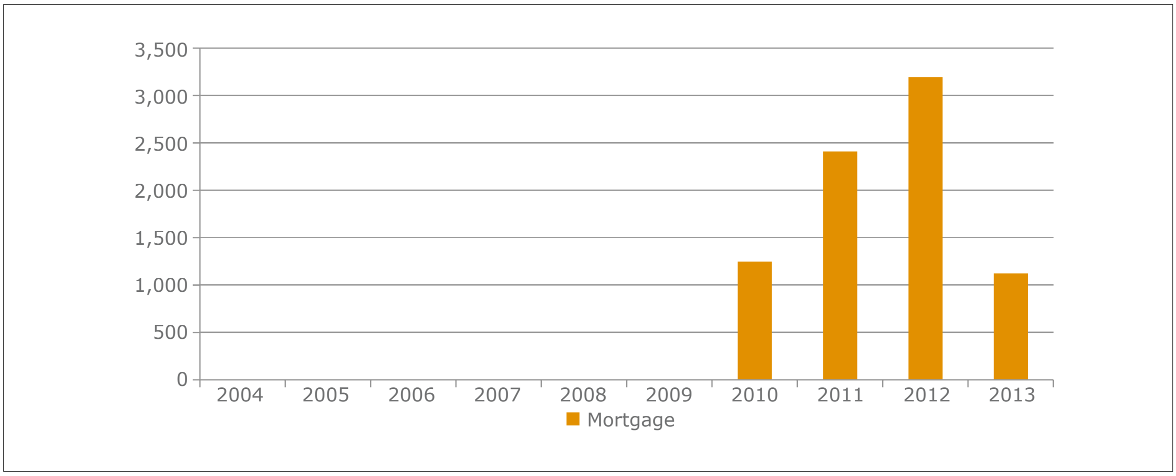
The covered bonds issued directly by financial institutions with registered offices in New Zealand are neither CRR nor UCITS compliant as both frameworks require the issuer to be based in the EU. The New Zealand covered bonds, therefore, do not benefit from the lower risk weighting for bank treasuries in the EU.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2004-2013, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2004-2013, EUR M



Source: EMF/ECBC

Issuers: ANZ, ASB, BNZ, Kiwibank, Westpac Securities NZ

3.22 NORWAY

By Stein Sjølie and Torkil Wiberg, Finance Norway

I. FRAMEWORK

In June 2014 the Norwegian covered bond legislation passed its seventh year milestone. The legislation was a result of a lengthy study and was closely matched corresponding EU directives and regulations, in particular the CRD, which was adopted and implemented in Norway in late 2006. The legislative framework has so far proved to be a solid and sustainable base for the issuers' commercial activity. The law provides investors strong protection from the issuing institution's cover pool, and the Norwegian covered bonds are seen as being among the best in class of European covered bonds. The high quality of Norwegian covered bonds is supported by the Kingdom of Norway's very strong macroeconomic position.

Three specialised institutions were established from the beginning and started issuance of Norwegian covered bonds in international markets during the second half 2007. This activity had thus barely started when the crisis hit the international financial markets the following year. In order to provide liquidity to the Norwegian banking market the authorities opted to swap treasury bills against covered bonds with Norwegian banks and mortgages institutions. This gave an impetus to the fledgling domestic market of covered bonds; a large number of banks established new subsidiaries in order to take advantage of this liquidity window. Today there are 21 Norwegian specialized credit institutions licensed to issue covered bonds. The smallest ones only operate in the domestic market. The largest issuers already have been, and are expected to continue to be, present in the international capital markets on a regular basis.

II. STRUCTURE OF THE ISSUER

The Norwegian covered bond legislation entered into force on 1 June 2007. Relevant amendments were made to the Financial Services Act, hereafter "the Act", and, at the same time, the Ministry of Finance adopted a supplementary regulation, hereafter "the Regulation", to the Act. The legislation permits specialized mortgage credit institution to raise loans by issuing covered bonds. These institutions are licensed credit institutions, supervised by the Financial Supervisory Authority of Norway – Finanstilsynet, hereafter the FSA. They are subject to the same type of regulations as other Norwegian financial institutions, for example capital adequacy requirements, general requirements for liquidity management etc.

A commercial bank or a savings bank will not be allowed to issue such bonds in its own name, but may establish a mortgage credit institution as a subsidiary. Alternatively, a mortgage credit institution may be established as an independent institution with several shareholders.

A licensed mortgage credit institution may raise loans by issuing covered bonds where the object of the institution, as laid down in the articles of association, is (1) to grant or acquire specified types of mortgages and public sector loans and (2) to finance its lending business primarily by issuing covered bonds. The articles of association of the institution shall state which types of loans that shall be granted or acquired by the institution. The scope of the business will therefore be restricted and the institution will have a very narrow mandate. Thus, Norwegian issuers of covered bonds are transparent companies.

III. COVER ASSETS

According to the Act the cover pool may consist of the following assets:

> Residential mortgages

> Commercial mortgages

> Loans secured on other registered assets (subject to further regulations)

> Public sector loans

> Assets in form of derivative agreements (in accordance with the Regulation)

> Substitute assets (in accordance with the Regulation)

The mortgage loans have to be collateralized with real estate or other eligible assets within the EEA or OECD, and the public sector loan borrowers have to be located within the EEA or OECD. The Regulation adds rating requirements on the individual public sector borrowers, if located outside the EEA.

The derivate agreements and the substitute assets are, logically, accessory to the loans. The substitute assets may only amount to 20% of the cover pool (30% for a limited period of time with the consent of the FSA). In addition, the substitute assets ought to be secure and liquid. The Regulation adds requirements necessary in order to comply with the description of covered bonds given in EU Directive 2006/48/EC. Counterparty and rating regulations in accordance with the directive apply to these two asset classes, as well as to the public sector loans.

IV. VALUATION AND LTV CRITERIA

Loan to value ratios (LTV) and monitoring are fixed by the Regulation, in accordance with the EU Capital Requirements Regulation (CRR). For residential mortgages the LTV is 75%. For holiday houses and commercial mortgages the LTV-limit is 60%. The mortgage credit institution shall monitor the development of the LTV of the individual asset as well as the market of the underlying assets, according to the Act, and in accordance with the said directive.

Upon inclusion of loans in the cover pool, a prudent market value shall be set. The market value for a property shall be set individually by an independent and competent person. The valuation shall be documented. However, valuation of residential properties may be based on general price levels.

Predominantly, residential properties in Norway are sold in open auctions in the market. Hence the actual selling price in principle reflects the market value and a recent sales contract may serve as documentation of the market value of a property.

The mortgage institution shall establish systems for monitoring subsequent price developments. Should property prices later fall, that part of a mortgage that exceeds the relevant LTV limit is still part of the cover pool and protects the holders of preferential claims. However, that part of a loan that exceeds the LTV limit is not taken into account when calculating the value of the cover pool to compare it with outstanding covered bonds, please refer to the matching regulations as described below. The same principle applies to loans that are in default, i.e. more than 90 days in arrears.

V. ASSET - LIABILITY MANAGEMENT

The Act establishes a strict balance principle, i.e. the value of the cover pool shall at all times exceed the value of the covered bonds with a preferential claim over the pool. The regulation establishes a strict mark to market principle of both assets and liabilities. Only the value of mortgages within the LTV limits is taken into account in this context. Also, the act caps the maximum exposure to one single borrower at 5% of the cover pool when compliance with the matching requirement is assessed.

There is no requirement in the legislation for a certain percentage of overcollateralization (OC). However, if an issuer chooses to provide voluntary OC, these assets are part of the cover pool, and bankruptcy remote in case of the issuer going into bankruptcy proceedings. The issuing institutions typically declare a certain level of OC, e.g. 5%, to which they are bound. Equally, the mortgage credit institution shall ensure that the payment flows from the cover pool enable the institution to honour its payment obligations.

The mortgage institution may enter into derivative agreements in order to secure the balance principle and payment obligations. If it has a positive market value, a derivative agreement will be part of the cover pool; if negative, the counterparties to derivative agreements will have a preferential claim over the pool, pari passu with the holders of covered bonds. As a corollary to this, the counterparties in the derivative agreements will be subject to same restrictions with respect to declaration of default as the bondholders. In addition to this, the mortgage institution will have to adopt strict internal regulations with respect to liquidity risk, interest rate risk and currency risk.

VI. TRANSPARENCY

Growing investor activism has initiated a work aimed at increasing transparency in the issuing institutions and in particular in the cover pool. At the initiative of an international investor organization, the Covered Bond Investor Council, the Norwegian Covered Bond Council undertook a work to establish a Norwegian template, in accordance with the one from CBIC. The Norwegian template was published on the Norwegian Covered Bond Council's web page early 2012, see Finance Norway's website:http://www.fno.no/en/main/covered-bonds/cbic-european-transparency-standards/, or the Covered Bond Label website: https://www.coveredbondlabel.com/issuers/national-information-detail/17/. As of May 2014 there are three Norwegian issuers labelled (DNB Boligkreditt, Nordea Eiendomskreditt and SpareBank 1 Boligkreditt), with several more issuers expected to apply for the Covered Bond Label.

The template sets transparency standards for the cover pool data that individual issuers want to publish. Links to the different issuers' individual websites, containing the cover pool information, are available on the Norwegian Covered Bond Council's web page: http://www.fno.no/en/main/covered-bonds/. The Norwegian Covered Bond Council will update the template to provide for harmonised reporting in relation to Article 129 (7) CRR in 2014.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Mortgage and other credit institutions are regulated under Chapter 3 of the Act. This chapter sets out the general provisions for a credit institution, i.e. the obligation to obtain a license and to fulfill capital requirements and undertake organizational measures etc.

The issuing of covered bonds is regulated by Chapter 2, Subchapter IV of the Act. The issuance of such bonds is not subject to any further governmental approvals. However the articles of association shall be approved by the FSA. Furthermore, the institution shall notify the FSA no later than 30 days prior to the initial issuance of covered bonds. The FSA has the power to instruct licensed mortgage institutions not to issue covered bonds whenever the financial strength of the institution gives rise to concern.

The mortgage institution shall maintain a register of issued covered bonds and of the cover assets assigned thereto, including derivative agreements. To oversee that the register is correctly maintained an independent inspector shall be appointed by the FSA. The inspector shall also regularly review compliance with the requirements concerning the balance principle, and report to the FSA, yearly or whenever the institution does not comply.

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

The Act gives the bondholders a preferential claim over the cover pool in case of bankruptcy. The term "covered bonds" or literally "bonds with preferential claim" (in Norwegian "obligasjoner med fortrinnsrett") is protected by law. In case of bankruptcy of the mortgage credit institution an administrator shall be appointed by the court. The assets in the pool remain with the estate in case of bankruptcy, but the bondholders have exclusive, equal and proportionate preferential claim over the cover pool, and the administrator is bound to assure timely payment, provided the pool gives full cover to the said claims.

The preferential claim also applies to payments that accrue to the institution from the cover pool. And, as long as they receive timely payments, the creditors have no right to declare default. Details about this may be reflected in the individual agreements between the issuer and (the trustee of) the bondholders. These provisions will also apply to any netting agreements between the institution and its counterparties in derivative transactions.

Bankruptcy or insolvency does not in itself give holders of covered bonds and derivative counterparties right to accelerate their claims. However, should it not be possible to make contractual payments when claims fall due, and an imminent change that will ensure such contractual payments is unlikely, the bankruptcy manager shall introduce a halt to payments. Thereafter further administration of the cover pool shall proceed under the general bankruptcy legislation.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation fulfils and is in compliance with the relevant EU legislation, i.e. the Capital Requirements Regulation (CRR) and in particular Article 52 (4) UCITS.[1] Hence, the Norwegian covered bonds being in compliance with the CRR and the UCITS are eligible for reduced (10%) risk-weighting under the standard method for capital adequacy requirement. The Norwegian covered bonds are also eligible as collateral in ECB.

The issuers are licensed credit institutions under supervision of the Norwegian FSA, and as such bound to comply with all relevant single market directives and regulations applicable to European credit institutions.

X. ADDITIONAL INFORMATION

Legislation supplementing the covered bond legislation

The legal framework regulating the housing market is well developed. This framework provides legal certainty and foreseeability for both consumers as borrowers and owners of housing, and for credit institutions as lenders and creditors. This includes specific consumer protection legislation, a centralized electronic registry system for the ownership of and rights (mortgage, etc.) in real estate, and an effectively and expedient forced sale procedure.

The Financial Contracts Act (Act 1999-06-25 no. 46) regulates the contractual conditions in respect of a loan agreement between financial institutions and their customers, both consumers and corporate clients. The Act applies in principle to all types of loans, whether they are secured or not. This also includes mortgage backed loans included in a cover pool. The act is invariable in respect of consumer contracts, i.e. it cannot be dispensed with by agreement that is detrimental to the customer.

The Mortgage Act (Act of 8 February 1980 no. 2) regulates i.a. mortgages on real estate. Mortgage rights acquire legal protection by registration in the Land Registry/Register of Deeds.

The Forced Sales Act (Act of 26 June 1992 no.86) provides for an effectively and expedient forced sale procedure. A lender may, if a loan is accelerated and the borrower fails to pay any due amount, file an application before the county court for a forced sale of the property that backs the mortgage loan. The registered mortgage contract will itself constitute basis for such application. The court will normally appoint a real estate broker to administer the sale in order to obtain a reasonable price. Normally, nine to twelve months are required to repossess the property and satisfy the holder of a mortgage.

Market overview

The covered bonds are listed. Virtually all active issuers have issues listed on the Norwegian market places offered by Oslo Børs, either on the regulated market or on Oslo ABM, the non-regulated market place run by Oslo Børs. International issues may be listed in a financial centre abroad.

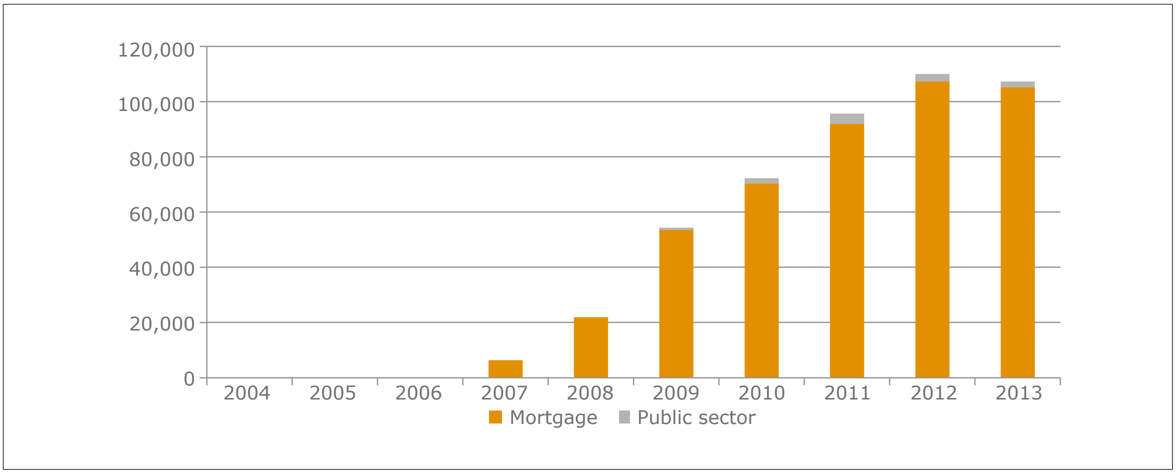
The Norwegian Government's swap program that was introduced to provide extra liquidity to the market at the outbreak of the financial crisis was discontinued by end 2009. Since then, there has been no government spon-

1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

sored program stimulating the market for covered bonds. Of the total amount of NOK 230 bn. (ca. EUR 30 bn.) of Norwegian covered bonds that were lodged in the swap agreements during 2008 and 2009, NOK 32 bn. (ca. EUR 3,9 bn.) still remain in the Treasury (May 2013). The last bonds remaining in the swap agreement will come to maturity in June 2014. The transaction activity and the liquidity in the Norwegian market have showed an increasing trend since the improvement of the capital markets after the financial crisis. The Norwegian market is considered to be very liquid by market participants. As a measure for further improving secondary market liquidity and transparency, the Oslo Stock Exchange will launch a *Norwegian Covered Bond Benchmark List* in June 2014. Bonds listed on the Benchmark list will be subject to continuous indicative quotation, which will contribute to enhanced transparency in the Norwegian covered bond market.

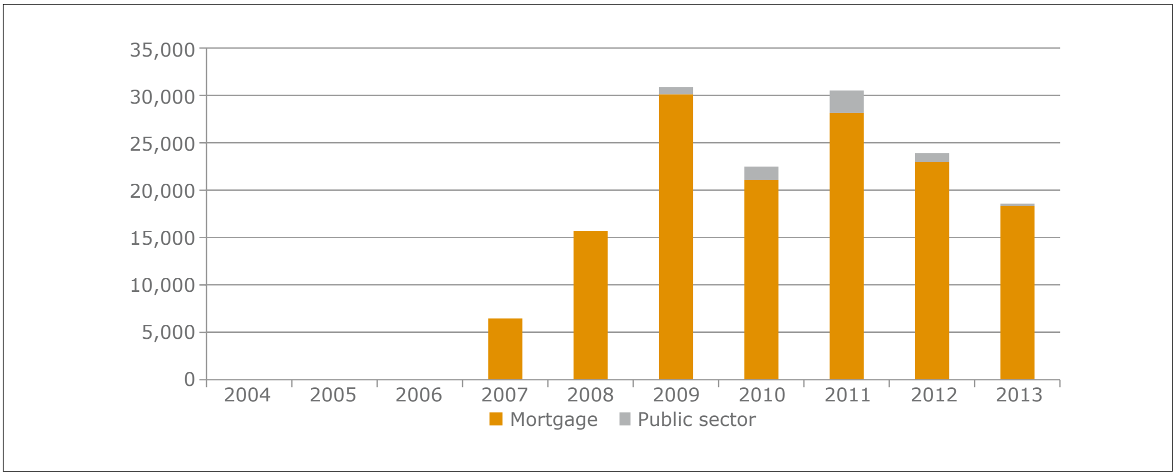
Norwegian covered bond issuers issued a total of EUR 18,5 bn. during 2013. Of this amount approximately 40% was issued in the domestic (NOK) market. Nearly EUR 8,4 bn. was placed in the euro market, while other currency issuance accounted for around EUR 2,6 bn. Although the primary market activity fell slightly through the second half of 2013, the total outstanding volume remains above the EUR 100 bn. mark by the end of the year and exceeds the Norwegian government bond market.

> Figure 1: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2004-2013, EUR m



Source: EMF/ECBC

Issuers: Bustadkreditt Sogn og Fjordane AS, Landkreditt Boligkreditt AS, Møre Boligkreditt AS, Nordea Eiendomskreditt AS, Sør Boligkreditt AS, Gjensidige Bank boligkreditt AS, Fana Sparebank Boligkreditt AS, DNB Boligkreditt AS, DNB Næringskreditt AS, Storebrand Boligkreditt AS, Helgeland Boligkreditt AS, Verd Boligkreditt AS, Sparebanken Vest Boligkreditt AS, Totens Sparebank AS, Sparebanken Øst Boligkreditt AS, Eiendomskreditt AS, Eika Boligkreditt AS, Sparebank 1 Boligkreditt AS, Sparebank 1 Næringskreditt AS, Sandnes Sparebank Boligkreditt AS, KLP Kommunekreditt AS.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/75/Norway

Covered Bond · Label · : DNB Boligkreditt mortgage cover pool; Eika Boligkreditt AS cover pool; Nordea Eiendomskreditt cover pool; SpareBank 1 Boligkreditt (Spabol)

3.23 PANAMA

By Frank Will, HSBC

I. FRAMEWORK

In September 2012, Global Bank became the first issuer of covered bonds out of Panama. It was also Latin America's inaugural covered bond. The USD 200 m deal was issued under Global Bank's USD 500 m Residential Mortgage Loans Covered Bond Programme. In October 2013, the bond was increased by USD 100 m. As of July 2014, we have not seen any new issuance or new covered bond issuers out of Panama.

Panama currently does not have a specific legal framework for covered bonds. Thus, Panamanian covered bonds are based on contractual agreements and the programme characteristics are self-imposed. Similar to the structures used in other markets without a specific covered bond law, many programme features are derived from securitisation techniques. Please note that our country analysis is based on the only available covered bond programme in Panama to date, i.e. the one from Global Bank.

II. STRUCTURE OF THE ISSUER

In the absence of a specific covered bond law in Panama, Global Bank Corp. y Subsidiarias used certain securitisation techniques and contractual law to replicate the key features of specific law based covered bonds and to ensure that the cover pool is isolated in the event of issuer insolvency. The covered bonds represent direct unconditional and unsubordinated obligations of the issuer and rank pari passu among themselves. The covered bond programme has a separate cover pool of Panamanian residential mortgage assets that is transferred to a guaranty trust. The covered bond holders have a priority claim on these assets.

III. COVER ASSETS

Given the lack of other Panamanian covered bond issuers, we focus below on the asset requirements of Global Bank's covered bond programme. Under Global Bank's covered bond programme, the covered bonds are backed by a dynamic pool of first-ranking residential mortgage loans originated in Panama.

The residential mortgage loans are subject to various eligibility criteria:

> The loans must be denominated in USD;

> The mortgage borrowers must be individuals resident in Panama;

> Each loan is secured by a valid and enforceable mortgage or by a guaranty trust, in accordance with Panamanian Law over a fully completed residential property located in Panama;

> With respect to any loan, there are no other loans secured by mortgages or by a guaranty trust ranking pari passu or senior with the mortgage or guaranty trust securing such loan (if there are other loans secured by mortgages or by a guaranty trust and ranking pari passu or senior with the mortgage or guaranty trust securing such loan, such loans have also been originated by the issuer and are included in the portfolio);

> No loan has a current principal balance of more than USD 500,000;

> Each loan has a remaining term of no longer than 30 years; and,

> No loan that has been transferred to the guarantee trust has been more than 90 days in arrears during the calendar year preceding the transfer date.

The aggregate principal amount of substitution assets (and/or authorised investments) may not at any time exceed 20% of the aggregate principal balance of the Guaranty Trust Assets.

IV. VALUATION AND LTV CRITERIA

The maximum permitted LTV is 100% in Global Bank's covered bond programme. For non-preferential first lien mortgages the LTV caps are lower (95% for employed borrowers, 85% for self-employed and 70% for foreign borrowers). The Asset Coverage Test does not give any credit to mortgage loans more than 90 days past due. The maximum asset percentage is set at 84.4%.

V. ASSET - LIABILITY MANAGEMENT

Global Bank's covered bond features several tests including an Asset Coverage Test, an Interest Shortfall Test, a Yield Shortfall Test and an Amortisation Test.

> **Asset Coverage Test:** The Asset Coverage Test is breached if, on any calculation date prior to the occurrence of an issuer event of default and the service of a notice to pay on the guaranty trustee, the adjusted aggregate loan amount is less than the aggregate principal amount outstanding of the covered bonds.

> **Interest Shortfall Test:** The Interest Shortfall Test is breached when, on any calculation date prior to the occurrence of an issuer event of default and service of a notice to pay on the guaranty trustee, the income received with respect to the guaranty trust assets (including interest received or amounts received on hedging instruments) during the calculation period plus other available amounts (representing interest) is less than the interest amounts expected to accrue under the covered bonds during the next succeeding guaranty trust payment period.

> **Yield Shortfall Test:** The Yield Shortfall Test is breached when, on any calculation date following an issuer event of default and service of a notice to pay on the guaranty trustee, interest amounts under the loans and other amounts (representing interest) received by the guaranty trustee in respect of the guaranty trust assets during the calculation period cease to give a yield on the loans at least equal to the weighted average interest rate on the outstanding series of covered bonds.

> **Amortisation Test:** The Amortisation Test is breached if, for so long as any covered bonds remain outstanding upon the occurrence of an issuer event of default and on any calculation date following the occurrence of an issuer event of default and the service of a notice to pay on the guaranty trustee (but prior to the service of a guaranty trust acceleration notice), the amortisation test aggregate loan amount is less than the aggregate principal amount outstanding of the covered bonds as at the determination date.

The issuer can issue covered bonds in hard-bullet or soft-bullet format. In case of soft-bullet bonds, the outstanding covered bonds' maturity will automatically be extended by up to 12 months if the issuer fails to fully redeem a series.

VI. TRANSPARENCY

Global Bank's prospectus requires the bank to prepare a monthly investor report listing selected statistical information in relation to the underlying portfolio and the characteristics of the portfolio as well as confirming compliance with the Asset Coverage Test. The issuer provides comprehensive information on the borrowers (income brackets, employment type, life insurance), delinquency rates, fire & earthquake insurance of the properties, loan-to-value ratios by brackets and charged interest rates.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The asset monitor reports on the arithmetic accuracy of the calculations performed by the cash manager on the calculation date immediately prior to the guaranty trust payment date at the end of each fiscal quarter with a view to confirmation of compliance with the Asset Coverage Test or the Amortisation Test on that calculation date. Following the occurrence of a servicer termination event, the asset monitor will, subject to receipt of the relevant information from the cash manager, be required to report on such arithmetic accuracy following each calculation date and, following a determination by the asset monitor of any errors in the calculations performed by the cash manager such that the Asset Coverage Test has been failed on the applicable calculation date or the adjusted aggregate loan amount or the amortisation test aggregate loan amount is misstated by an amount exceeding one per cent of the adjusted aggregate loan amount or the amortisation test aggregate loan amount, the asset monitor will be required to verify the procedures and calculations made by the cash manager on each calculation date for a period of six months thereafter.

The cash manager will check compliance with the tests on each calculation date. The asset monitor will periodically check compliance. If any of the tests noted above are not satisfied and the breach is continuing, the issuer must take prompt remedial action. The issuer will immediately notify the trustee of the breach of any of the tests. In the event of a breach of either the Asset Coverage Test or the Interest Shortfall Test which is continuing, the issuer will not be permitted to issue.

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

AAs mentioned above, the covered bonds will be direct and unconditional obligations of the issuer but are secured by the guaranty trust assets. The guaranty trustee has no obligation to pay the amounts set out in the guaranty trust priority of payments until the occurrence of an issuer event of default, service by the trustee on the issuer of an issuer acceleration notice and on the guaranty trustee of a notice to pay. There are a number of features of the programme which are intended to enhance the likelihood of timely payments to covered bond holders: (1) the guaranty trust assets secure the obligations of the issuer in respect of the covered bonds; (2) the Asset Coverage Test is intended to test the asset coverage of the guaranty trust assets in relation to the covered bonds prior to the occurrence of an issuer event of default, service of an issuer acceleration notice on the issuer and service of a notice to pay on the guaranty trustee; and last but not least (3) the Amortisation Test is intended to test the asset coverage of the guaranty trust assets in relation to the covered bonds following the occurrence of an issuer event of default, service of an issuer acceleration notice on the issuer and service of a notice to pay on the guaranty trustee.

If an issuer event of default occurs then, for so long as such issuer event of default is continuing, (i) no further covered bonds may be issued and (ii) following service of a notice to pay on the guaranty trustee, the guaranty trust available funds will be dedicated exclusively to the payment of interest and repayment of principal on the covered bonds and to the fulfilment of the obligations of the issuer to the other creditors in accordance with the guaranty trust priority of payments.

All covered bonds issued from time to time will rank pari passu with each other in all respects. If an issuer event of default occurs in respect of a particular series of covered bonds, then, following the service of an issuer acceleration notice, the covered bonds of all series outstanding will accelerate at the same time against the issuer but will be subject to, and have the benefit of, payments made by the guaranty trustee under the Guaranty Trust Agreement (following service of a notice to pay on the guaranty trustee). Payments by the cash manager on behalf of guaranty trustee under the Guaranty Trust Agreement in relation to such covered bonds will continue to be required to be made on their original due for payment date. If a guaranty trust event of default occurs, following service of a Guaranty Trust Acceleration Notice, the covered bonds of all series outstanding will accelerate against the issuer (if not already accelerated following an issuer event of default) and the obligations of the guaranty trustee under the Guaranty Trust Agreement will also accelerate against the guaranty trustee.

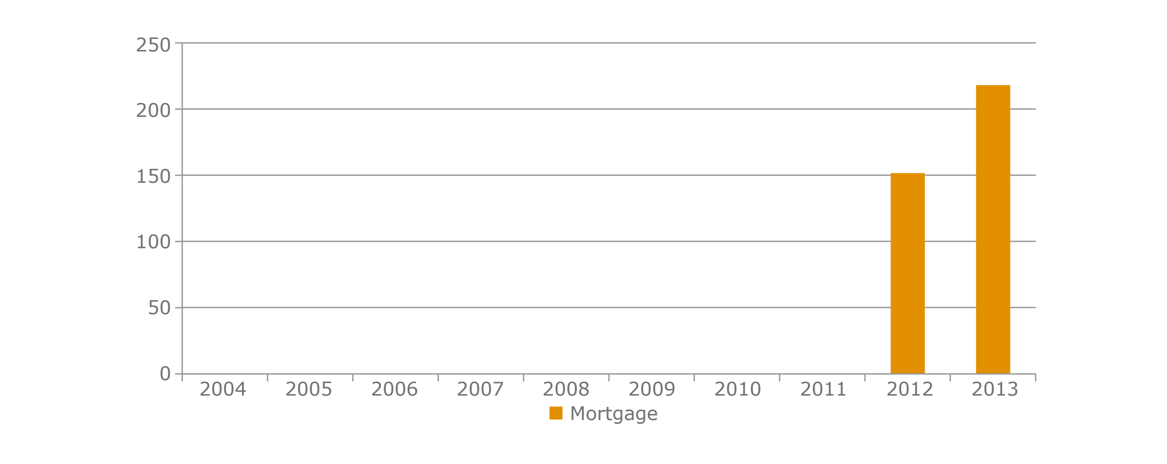
In order to ensure that any further issue of covered bonds under the programme does not adversely affect existing holders of the covered bonds, the Asset Coverage Test will be required to be met both before and after any further issue of covered bonds and, on or prior to the date of issue of any further covered bonds, the issuer will be obliged to obtain written confirmation from the rating agencies that such further issue would not adversely affect the then current ratings of the existing covered bonds. Nevertheless, there can be no assurance that any further issuances will not adversely affect existing holders of the covered bonds.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Global Bank's covered bonds are neither Article 52(4) UCITS-compliant nor Article 129 CRR-compliant as Panama is not a Member State of the European Union (EU). In addition, Panama does not have national covered bond legislation. Therefore, the covered bonds do not benefit from a preferred risk-weighting for regulatory capital purposes under EU rules. Under the Standardised Approach, they are treated similarly to senior unsecured bank debt.

As Panama is neither an European Economic Area (EEA) country nor a G10 country, Panamanian covered bonds are not eligible for the European Central Bank repo operations regardless of their currency and their rating.

> Figure 1: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2004-2013, EUR m

Source: EMF/ECBC

Issuers: Global Bank Corp (Panama)

3.24 POLAND

By Agnieszka Tułodziecka, Polish Mortgage Credit Foundation, and Piotr Cyburt, mBank Hipoteczny

I. FRAMEWORK

The legal basis for covered bond issuance in Poland is "Act on mortgage bonds and mortgage banks" of August 29, 1997; Journal of Laws no. 99, item 919 (List Zastawny Act – hereafter: LZ Act). There is also a special chapter concerning bankruptcy of mortgage banks in the new Bankruptcy Act - *Article 442 – Article450* - Bankruptcy and Reorganisation Law of 28 February 2003.

II. STRUCTURE OF THE ISSUER

The issuer is a specialised mortgage bank, licensed by the National Bank of Poland.

A mortgage bank may only engage in the activities specified in the LZ Act.

According to the Article 12 LZ Act, **the core operations** of mortgage banks include:

> Granting credits secured with mortgages;

> Granting loans not secured by mortgage, only if the borrower, guarantor or underwriter of a loan repayment to its full amount, including the interest due, is the National Bank of Poland, Central European Bank, governments or central banks of the European Union states, Organisation for Economic Cooperation and Development, excluding those countries, which are or have been for the past 5 years restructuring their foreign debt, or by means of a guarantee or security granted by the State Treasury;

> Acquisition of other banks' receivables on account of loans granted by them, secured by a mortgage and receivables on account of credits not secured by a mortgage, granted to the entities of the local self-government;

> The issue of mortgage bonds the base of which constitute the Bank's receivables on account of the granted loans secured by a mortgage or purchased receivables of other banks on account of the loans granted by them secured by mortgage;

> Issuing public mortgage bonds on the basis of:

a) the mortgage bank's receivables arising from its credits not secured by mortgages referred to in the second bullet (above);

b) purchased receivables of other banks arising from their credits not secured by mortgages referred in the second bullet (above).

According to the Article 15 LZ Act, **apart from core operations** referred to in Article 12, mortgage banks may engage in the following activities:

> Accepting term deposits;

> Taking credits and loans;

> Issuing bonds;

> Safekeeping securities;

> Purchasing and taking up shares and stocks of other entities whose legal form limits the liability of a mortgage bank to the sum invested insofar as it helps the performance of activities of a mortgage bank, where the total value of purchased or taken up shares and stocks may not be higher than 10% of the mortgage bank's equity;

- Keeping bank accounts for servicing investment projects financed through credits granted by a mortgage bank;
- Providing consulting and advice with respect to the property market, including help in establishing the mortgage lending value of the property;
- Managing receivables of a mortgage bank and other banks arising from credits referred to in Article 12 LZ Act, as well as granting these credits on behalf of other banks on the basis of relevant cooperation agreements.

All the listed activities may be executed also in foreign currencies upon obtaining relevant authorizations.

Under the LZ Act, the range of activities that can be performed by mortgage banks is specified in a closed catalogue as mentioned above. Particularly, mortgage banks cannot collect deposits of individual saver. The narrowing of activity of mortgage banks facilitates the development of a simplified and clear activity structure (which facilitates supervision, especially external one), the specialization of the loan division and an improvement in methods of credit risk assessment in the field of real (estate) property financing. Due to the above limitations, funds resulting from the issue of mortgage bonds are mainly used towards the financing of the lending activity.

The issuer holds the cover assets on his balance sheet. The covered bonds are direct, unconditional obligations of the issuer.

III. COVER ASSETS

All covered bonds must be fully secured by cover assets. There are two specific classes of the covered bonds: *hipoteczne listy zastawne* (mortgage covered bonds) and *publiczne listy zastawne* (public covered bonds); registered in two separate cover registers.

The cover register for mortgage bonds

The LZ Act provides for a cover register for the mortgage assets, which will be used in the cover pool for the mortgage covered bonds.

There is also a provision for substitute assets, which is limited to 10% of the cover pool and comes from the asset categories below:

- In securities issued or guaranteed by the National Bank of Poland, European Central Bank, governments or central banks of European Union Member States, OECD (with the exclusion of states which are, or were, restructuring their foreign debt in the last 5 years), and the State Treasury;
- In the National Bank of Poland;
- In cash.

In addition, receivables secured by mortgages established on buildings which are in construction phase may not in total exceed 10% of the overall value of mortgage-secured receivables in the cover pool. Within this limit, the receivables secured by mortgages on construction plots in compliance with the land use plan, may not exceed 10% (Article 23 of LZ Act).

The cover register for public covered bonds

A public bond is a registered or bearer security issued on the basis of receivables of a mortgage bank arising from:

- Credits within the secured part with due interest, a guarantee or surety of the National Bank of Poland, the European Central Bank, governments or central banks of the EU Member States, the Organisation for Economic Cooperation and Development, except for states which are currently in the process of restructuring of restructured their foreign debts during the last 5 years, as well as a guarantee or surety of the State Treasury in accordance with provisions of separate laws; or

- Credits granted to entities listed in the point above; or
- Credits in the secured part with due interest, a guarantee or surety of local government units and credits granted to such local government units.

In regard to collateral location, mortgage collateral is restricted to mortgages against the right of perpetual usufruct or the right of ownership to a property situated in Poland are eligible for the cover. For public covered bonds, there is a wider scope and includes the following countries and institutions as eligible for the cover: National Bank of Poland, the European Central Bank, governments or central banks of the EU Member States, the OECD, except for states which are currently in the process of restructuring of restructured their foreign debts during the last 5 years, as well as a guarantee or surety of the State Treasury.

IV. VALUATION AND LTV CRITERIA

The mortgage lending value of real estate is determined under the LZ Act. The mortgage lending value of real property is determined prudently, with due diligence, on the basis of an expert opinion prepared by the mortgage bank or entities with appropriate real estate appraisal qualifications commissioned by the mortgage bank. The mortgage lending value cannot be higher than the market value of the real estate.

There are special banking supervisory regulations, which stipulate in details the assessment of the mortgage lending value and impose on the bank a duty to have a database for real estate prices.

The LTV limits are as follows:

- Single Loan to Value of Security limit: not more than 100% of mortgage lending value (Art 13.2 LZ Act)
- Value of Security limit, relating to the single loan: max. 60% of the mortgage lending value, to fund eligible assets (Art 14 LZ Act: *Funds raised from the issue of mortgage bonds may be used by a mortgage bank for refinancing mortgage-secured credits and purchased receivables of other banks arising from their mortgage-secured credits; the refinancing may not, however, exceed 60% of the mortgage lending value of the property*)
- Absolute portfolio Loan to Value of Security limit: (Art 13.1 LZ Act: *The total amount of receivables from granting credits secured with the mortgages or purchased receivables of other banks arising from their mortgage-secured credits, in the part above 60% of the mortgage lending value of the property, may not exceed 30% of the total sum of the mortgage bank's receivables secured with mortgages*).

V. ASSET-LIABILITY MANAGEMENT

According to the article 18 of the LZ Act:

- The total nominal value of all outstanding mortgage bonds shall not exceed the sum of nominal amounts of the bank's receivables secured with mortgages, which form the basis for the mortgage bond issue.
- The bank's income from interest on its mortgage-secured receivables, referred to in the point above, may not be lower than the amount of the bank's payable interest on outstanding mortgage bonds.

The Act also ensures a suitable monitoring, according to the Article 25: A mortgage bank shall keep a mortgage cover account to ensure compliance, in the long term perspective, with the requirements referred above.

Additionally, according to the internal policy of each mortgage bank, the internal limits are set using management's experience in a development bank as reference.

VI. TRANSPARENCY

The information of the activity of the Polish mortgage banks can be found on the Polish Mortgage Credit Foundation's website: www.ehipoteka.pl.

The range of data published on a yearly basis includes: new issues of covered bonds, outstanding covered bonds (mortgage & public), total assets of mortgage banks and residential & commercial property credits' sale.

So far, none of the Polish issues has joined the Covered Bonds Label Initiative. At the present stage of CB market development , CB investors wouldn't acknowledge this step as an additional value above the detailed law driven requirements and structure of list zastawny.

Detailed information on the covered bonds issues can also be found on the issuers' websites:
mBank Hipoteczny: http://mhipoteczny.pl/oferta/listy-zastawne/
Pekao Bank Hipoteczny: http://www.pekaobh.pl/u235/navi/31467.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

According to the Article 31 LZ Act, the cover pool monitor (powiernik) maintains ongoing supervision of the management of the mortgage cover register.

The cover pool monitor should ensure that:

> Commitments pertaining to the outstanding mortgage bonds are at all times covered by the mortgage bank in compliance with the provisions of LZ Act;

> The mortgage lending value of the property adopted by the mortgage bank has been established in accordance with the regulations referred to in Article 22, paragraph 2; the cover pool monitor shall not be required to investigate whether the mortgage lending value of the property corresponds to its actual value;

> The mortgage bank observes the limits laid down in Article 18 LZ Act; the cover pool monitor shall promptly inform the Banking Supervisory Commission of any cases of non-compliance by the mortgage bank with these limits;

> The manner in which the mortgage bank keeps the mortgage cover register is in compliance with this Act;

> The mortgage bank ensures appropriate cover for planned mortgage bond issues in accordance with the provisions of this Act, and proper control of appropriate entries in the mortgage cover register.

In order to perform tasks referred to in Article 30 LZ Act, the cover pool monitor shall have the right to inspect accounting books, registers and other bank documents at any time.

In matters not regulated by the LZ Act, supervision over mortgage banks shall be exercised in compliance with the Banking Law and the regulations on the National Bank of Poland (NBP). The NBP regularly checks the cover assets.

The Banking Supervisory Commission may commission an independent expert at the expense of the inspected mortgage bank to inspection of the appropriateness of the mortgage bank's entries to the mortgage cover register. This would also including establishing the mortgage lending value of the property was in compliance with the rules referred to in Article 22, paragraph 5 LZ Act.

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

The Act of 28 February 2003 – Bankruptcy and Rehabilitation Law (Journal of Law no. 60 item 535) contains separate chapter: Chapter II - Bankruptcy proceedings for mortgage banks – Articles 442-450.

In case of bankruptcy of the mortgage Bank, the claims, rights and means referred to in Article 18.3 and 18.4 of LZ Act, recorded in the mortgage bonds cover register, shall constitute a separate bankruptcy estate, which shall serve in the first place to satisfy the claims of mortgage bond creditors; after satisfying the mortgage bonds creditors, the surplus of the assets of the separate estate shall be allocated to the bankruptcy estate.

In declaring the bankruptcy, the court appoints a curator (*kurator*) who represents the rights of covered bond holders in the bankruptcy proceedings. Before the appointment of the curator, the court seeks an opinion on the proposed curator of the Banking Supervisory Commission (Article 443.1. of the Bankruptcy and Rehabilitation Law).

The following order shall apply to the satisfaction from the separate bankruptcy estate:

> The costs of liquidation of this estate, including also the remuneration of the curator,

> The amounts due to the mortgage bonds per their nominal value,

> Interest (coupons).

In case that the separate bankruptcy estate does not fully satisfy the mortgage bondholders, the remaining balance shall be satisfied from the whole bankruptcy estate funds; with that sum the curator shall vote when the arrangement is being adopted – according to Article 449 of the Bankruptcy and Rehabilitation Law: *If the separate estate is not sufficient for full satisfaction of covered bond holders, the remaining sum is satisfied from the distribution of the funds of the bankrupt estate; with this sum the curator votes in the signing of the arrangement; he has one vote for each sum resulting from dividing the sum of all other claims of those entitled to vote by the number of creditors representing these claims. The sum earmarked for the satisfaction of covered bond holders is moved from the funds of the bankrupt estate fund to the funds of the separate bankrupt estate.*

In that case, the additional amount for satisfying the mortgage bondholders shall be transferred from the bankruptcy estate funds to the separate bankruptcy estate funds. It means that the covered bond holders get preference over other creditors.

According to the Article 446 Bankruptcy Act – The declaration of bankruptcy of a mortgage bank does not infringe maturity dates of its obligations towards covered bond holders. It means that the covered bonds do not accelerate.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

In order to apply a preferential risk-weighting for covered bonds, the instrument needs to meet the criteria of UCITS Directive and the Capital Requirements Regulation (CRR).

Polish covered bonds (*list zastawny*) already fulfil the criteria of UCITS 52(4) - in December 2008, the Polish list zastawny was notified by the European Commission as an European "eligible bond" – i.e. covered bond – the instrument with a qualified collateral. In that way, the notification procedure, applied by the Polish Ministry of Finance, was finished. Polish *list zastawny* can be found on the EC's website.

The covered bond (*list zastawny*) falls also within the criteria of Article 129(1) CRR.[1]

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 art. 129 (1)(e) CRR (which is 80%).

The previously binding CRD requirements were word–for–word implemented by the Polish Financial Supervision Authority – see Resolution 307/2012. Therefore it is to assume that the Polish covered bonds (*listy zastawne*) apply for the preferential treatment.

1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

Moreover, National Central Bank added covered bonds (*listy zastawne*) to the list of instruments eligible for pawn credit / repo transactions. As of July 2013, the haircut level for repo amounts to 15,0 (3M repo); 20,0 (6 M repo); 25,0 (pawn credit) – ave. maturity of covered bonds – 5 years.

In Poland, the investment regulations pertaining to the limits for covered bonds are as follows:

> Banks – no limits;

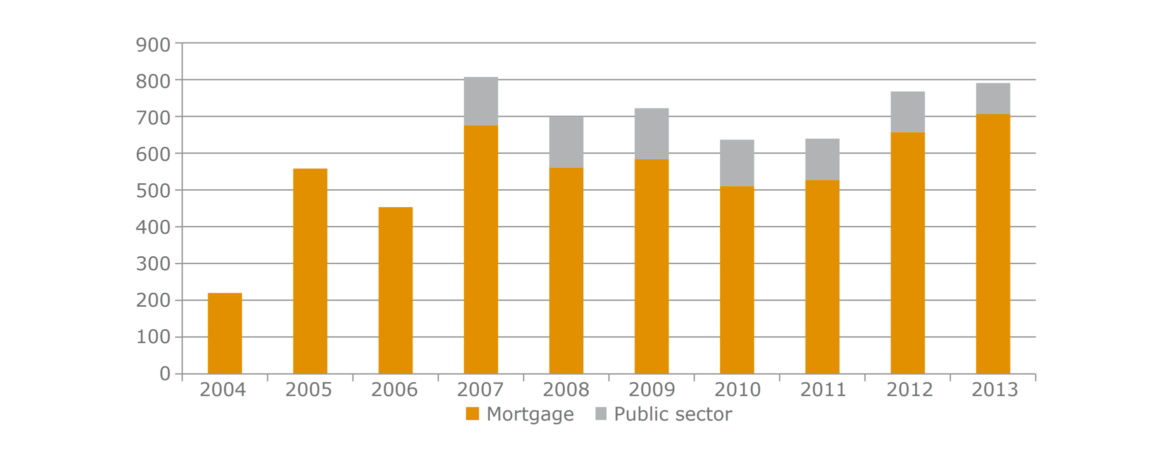
> Insurance companies – up to 40% of technical-insurance reserves – insurance companies (10% in covered bonds which were not allowed to public trading);

> Investment funds – open: 25% of the assets may be invested in covered bonds issued by one mortgage bank; but: total investments in covered bonds may not exceed 80% of the fund's assets and total value of investments in securities or in monetary market instruments, issued by the same mortgage bank, deposits in that entity, as well as the total value of risk connected with the transactions on non-standardised derivatives, which were dealt with that bank, can't exceed 35% of the fund's assets;

> Pension funds up to 40% of the total asset value, 10% per one issuer;

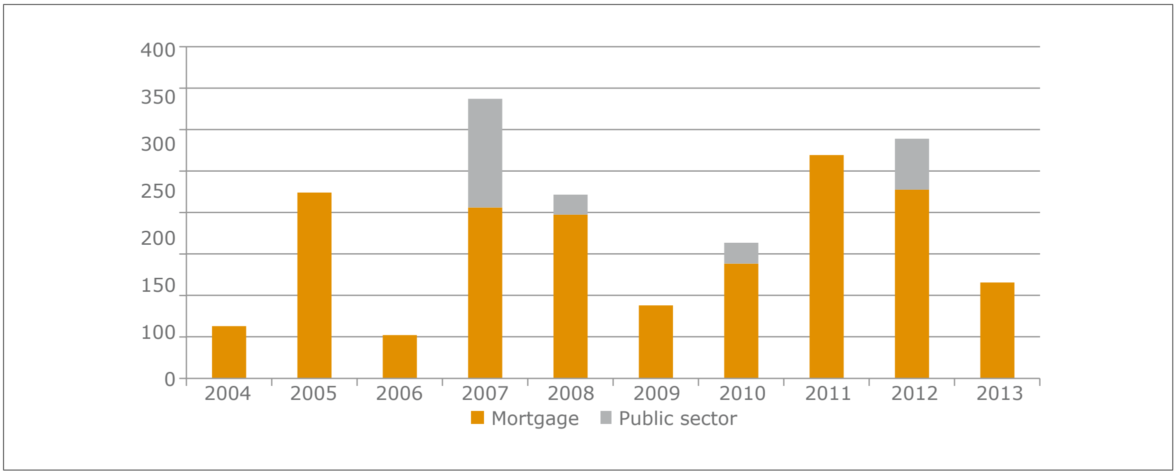
> Only the specialised mortgage banks are entitled to the issue of the *list zastawny* (the Polish covered bond). The current *list zastawny* issuers are: mBank Hipoteczny S.A., and Pekao Bank Hipoteczny S.A.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2004-2013, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2004-2013, EUR M



Source: EMF/ECBC

Issuers: Pekao Bank Hipoteczny S.A. and mBank Hipoteczny S.A.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/77/Polish_Covered_Bonds

3.25 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 20 March 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 (OH) and *Obrigações Sector Público* may be issued by credit institutions legally authorised to grant credits guaranteed by mortgages on real estate and with own funds amounting to no less than EUR 7.5 m. 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) level 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 the Portuguese law allows for substitution assets up to a limit of 20% of the pool, this cannot be considered per se. In fact, Bank of Portugal's regulation establishes that the pool can only trade with credit institutions qualifying for credit quality assessment step 1 and that the aggregate risk positions cannot exceed 15% of the aggregate nominal value of the outstanding covered bonds or public sector covered bonds.

The geographical scope of eligible assets is restricted to loans guaranteed by first lien mortgages on property located in the European Union (EU) or loans granted to the central governments and regional or local authorities located in an EU member state.

Derivative contracts are permitted in the cover pool for hedging purposes, namely to mitigate interest rate, exchange rate and liquidity risks. The transactions involving derivatives, must be executed in a regulated market of a Member State of the European Union, in a legally established exchange of a full member of the OECD, or entered into with a counterparty that must be a credit institution rated "A-" or above. The legal documentation (agreement between the parties) should be standardised, however this will have to safeguard the preferential claim for the counterparty. If the currency of the issue is not in EUR, the use of exchange rate derivative contracts is mandatory in order to hedge the inherent risk of the issue.

The cover pool is dynamic while the originator is solvent and issuers are required to maintain a record of all the assets in the cover pool, including derivatives contracts.

IV. VALUATION AND LTV CRITERIA

The value of the mortgaged asset[2] is the commercial value of the real estate, considering:

> Sustainable characteristics over the long term;

> Pricing under normal market conditions;

> The peculiarities of the local market; and

> The current and alternative uses given to the mortgage asset.

The value of the mortgage asset ascertained by the issuer cannot be superior to its market value, which is the price that the object could be sold at the time the appraisal is made. This assumes that the real estate is placed on sale and that market conditions allow for a regular transmission of the mortgaged asset within an adequate timing.

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;

1 Notice n.º 6/2006

2 Notice n.º 5/2006

> 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 31 December of the previous year, and indicate any changes from the last report. If there are any doubts on the performance of the appraisal specialist, the Bank of Portugal can refuse to accept the valuations, demanding the appointment of another appraisal specialist by the credit institution.

When choosing the appropriate method, the appraisal specialists should consider the specific characteristics of the real estate and its local market. The appraisal of the real estate performed by the specialist should take the form of a written report and include all the elements that allow for an understanding of the analysis carried out and conclusions arrived at.

The maximum loan to value accepted for assets to be eligible into the pool is 80% for residential mortgages and 60% for commercial mortgages loans.

V. ASSET - LIABILITY MANAGEMENT

There are various asset and liability matching requirements established in the decree-law:

> The global nominal value of the outstanding mortgage bonds cannot exceed 95% of the global value of mortgage credits and other assets at any point in time assigned to the bonds (i.e., mandatory overcollateralisation of 5.2632%);

> The average maturity of outstanding mortgage bonds can never exceed the average life of the mortgage credits and substitution assets assigned to the issues;

> The total amount of interest to be paid by the mortgage bonds shall not exceed, at any point in time, the amount of interest to be collected from mortgage credits and other assets assigned to the bonds – cash flows from the cover pool must all be sufficient to meet all scheduled payments due to covered bond holders.

The law also promotes a sound cover pool management by allowing the issuer to apply the funds (for example, funds received from early repayment) to other assets and assign new mortgages to the pool. This option allows issuers to avoid potential cash-flow mismatches. It is also possible for issuers to establish a credit facility to provide for liquidity. This credit facility counterparty is required to have a minimum credit rating of "A-".

Issuers may use derivatives contracts to hedge the interest and exchange rate and liquidity risks. The derivatives are included in the cover pool and derivative counterparties – who also benefit from preferential claim - have to be rated "A-" or above.

If the limits defined in the Decree Law are exceeded, the issuer shall immediately resolve this situation by assigning new mortgage credits, purchasing outstanding bonds in the secondary market and/or assigning other eligible assets. These will, in turn, be exclusively assigned to the debt service of the bond.

Regarding these matters, the secondary legislation[3] determines the application of the following criteria:

> Loans must be accounted according to their outstanding principal, including matured interest;

> Deposits shall be accounted according to their amount including accrued interest;

> 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

3 Notice n.º 6/2006

account any derivative instruments put in place. The ratio established shall be able to comply even when 200 basis points parallel movements of the curve are considered.

Each issuer must deliver in writing the specific and individual policies in written form for risk management, namely exchange risk, liquidity risk, interest rate risk, counterparty risk and operational risk and any other procedures aimed at ensuring compliance with the applicable regulatory regime and with any devised risk limitation policies set by the issuer.

The Bank of Portugal may also make use of its regulatory role to require additional steps by the issuers to meet with all the asset-liability criteria that it sets out.

VI. TRANSPARENCY

In order to provide consistent data and transparency for their issues, Portuguese covered bond issuers have developed a Common National Transparency Template based on the CBIC Template in order to ensure standardisation and comparability of the data provided by its covered bond investor reports. The Template can be found at the Covered Bond Label website.[4]

These investor reports are published on each bank´s website, encompassing specific, relevant and detailed information on the Portuguese covered bonds and the cover pools and are updated on a quarterly basis. Some issuers might not calculate some indicators according to the same criteria (for example LTV), but key concepts explanations are available for a better comprehension.

Should investors require additional financial information they deemed relevant on the Bank`s consolidated accounts or Groups Balance Sheet, they can obtain it on the respective website or directly by contacting the issuers.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The Board of the issuer will appoint an independent auditor who must be registered with the Portuguese Securities Commission, with the task of defending the interests of the bondholders and of 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[5].

In the law, there are no specific rules on the cover pool monitor's responsibility. General rules on civil and contractual responsibility apply. The cover pool monitor will only be liable in case it does not comply with rules applicable to its activity or with its contractual obligations. If the cover pool monitor has complied with all its obligations, it will not be liable in case the issuer has not respected the applicable regulation.

Also, a bondholders' joint representative – common to all mortgages or public bond issues - is to be appointed by the Board of Directors of the issuer in order to represent the interest of the bondholders and supervise the cover pool.

The Bank of Portugal and the Portuguese Securities Commission (CMVM) are responsible for banking and capital markets supervision. The law grants powers to the Bank of Portugal to regulate and supervise the issuers of covered bonds, so they must comply with the requirements of the law and all applicable regulations. Non-compliance by the issuer could imply the application of fines and other sanctions and, ultimately (in a worst case scenario), could determine the revocation of the issuer's licence.

Additionally, the Bank of Portugal has been granted powers to control compliance of the applicable rules for as long as the bonds remain outstanding, namely it may:

4 https://www.coveredbondlabel.com/issuers/national-information-detail/19/

5 Regulatory Instrument n.º 13/2006

> Refuse asset valuations made by a valuation's expert if it has doubts concerning its performance, and demand to the issuer its replacement;

> Require new asset valuations by different experts; and

> Ask for clarifications or additional documents concerning all reports required and received.

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

Preferential status for Portuguese covered bonds holders and bankruptcy remoteness

Holders of covered bonds benefit from special preferential claim over the assets assigned to the issue, with precedence over any other creditors - the covered bond law supersedes the general bankruptcy regulation – for the redemption of principal and payment of interest.

The mortgages that guarantee these credits prevail over any real estate preferential claims. The derivatives contracts are part of the pool and derivatives counterparties rank pari passu with bondholders in terms of preferential claim over the assets in the pool, and consequently, their contracts are not expected to be called in case of insolvency of the originator.

Despite the absence of a direct link between the cover assets and the outstanding covered bond issuance, there is a legal provision that links the cover pool to the payment of capital and interest on the covered bonds thus rendering covered bonds direct, unconditional obligations of the issuer. The issuer of covered bonds holds the claims on the cover assets and these, in turn, will guarantee the covered bonds until all payments due to bondholders have been met.

If the issuer becomes insolvent, cover assets form a separate legal estate - a pool that is to be administered in favour of the covered 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[6].

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.

6 Notice n.º8/2006

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[7] 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.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR). Portuguese covered bonds meet the requirements of Article 129 CRR.

According to secondary legislation, stated in the notice of Bank of Portugal[8], and in compliance with Basel III, 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.[9] 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.

X. ADDITIONAL INFORMATION

Developments in the Portuguese covered bond market

During 2013, the uncertainties related to the European sovereign debt crisis, the high levels of liquidity in the international financial markets and the acceleration of economic activity in the U.S. and Europe starting in the first half of the year were the main factors leading the recovery of investor confidence and other economic agents.

Thus, following the reduction of imbalances in the public accounts, correction of deficits in external accounts and the strengthening of European governance mechanisms and evidence of the end of the recessionary environment, we have observed a fall in yields on sovereign debt of Ireland, Spain, Italy, and Portugal, particularly in the second half of the year. Improving economic and financial situation in Portugal has enabled a reduction of financing costs in capital markets, which together with the improvement of the liquidity of financial institutions was reflected in the reduction of interest rates.

7 Designated Credit Institution

8 Notice n.º7/2006

9 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

In the European periphery, the largest reduction in yields was on 10 year public debt bonds for Spain, down 111 bps. In Portugal, the 10 year rate fell 88.1 bps, closing the year at 6.13%, after having fallen to 5.24% in May 2013, not only the yearly low but the lowest level since August 2010. The reduction of the risk premium on Portuguese sovereign debt took the form of a 149.4 bps narrowing of the spread in comparison to German debt. For 2 year maturities, the falls in yields and spread were 38 bps and 60.5 bps respectively. In 2014, the trend remained downwards. This was accordingly a 2nd consecutive year of narrowing spreads, the first time this has happened since the onset of the financial crisis in 2007, with a return to January 2010 levels.

The primary market remained dynamic during the year with investors' demand for returns being one of the main supporting factors, fuelling significant amounts of debt issues at progressively lower prices. The more optimistic context was also matched by the good performance of the private debt market.

This situation had an effect on Portuguese covered bonds which showed the strongest performance with yields in the 5 years maturity decreasing from 5.298% in the beginning of January 2013 to 3.761% and 2.31% respectively in January and May 2014. The 2 year maturity declined from 5.30% in January 2013 to 1.13% in May 2014.

With the increased stabilization of the market after nearly three years of lack of receptivity to Portuguese issuers, Caixa Geral de Depósitos ("CGD") launched at the beginning of 2013 a €750 million 5 years covered bond issue with a coupon of 3.75%, reopening this segment of the market to Portuguese issuers. The excellent reception of this issue was highlighted by strong demand, which exceeded € 4,000 million, attracting more than 200 foreign investors, notably in the UK, Germany, Austria, France and Switzerland.

In January 2014, CGD returned to the market with another EUR 750 million 5 years issue amounting to EUR 750 million. This issue was very well received by the market, with a final demand exceeding EUR 3.9 billion at a final spread of 188 basis points - corresponding to a reoffer yield of 3.12% (minus 100 basis points when compared to the January 2013 issue), significantly lower than that achieved a year before confirming a growing interest in Portuguese covered bonds and in CGD`s credit and of course an increasingly favorable perception on the respective risk.

In both deals, international demand represented more than 90% of the total, far exceeding supply, and for the later issue there was a greater geographic diversification and including a considerable amount of orders from German investors.

Housing prices are expected to rise slightly in 2014 benefiting from improved economic sentiment but contained by tight credit conditions and still weak demand. The rise in housing prices prior to 2011 - when the adjustment programme was implemented - had been moderate, but ultra-weak demand caused by Portugal's difficult economic situation and exceptionally high unemployment led to a drop nonetheless.

Banks' deleveraging drive over the last three years has led to very limited funding of new mortgages and the construction sector overall. With this, outstanding mortgage loans for the banking sector as a whole have actually decreased a trend that is expected to continue in the next couple of years.

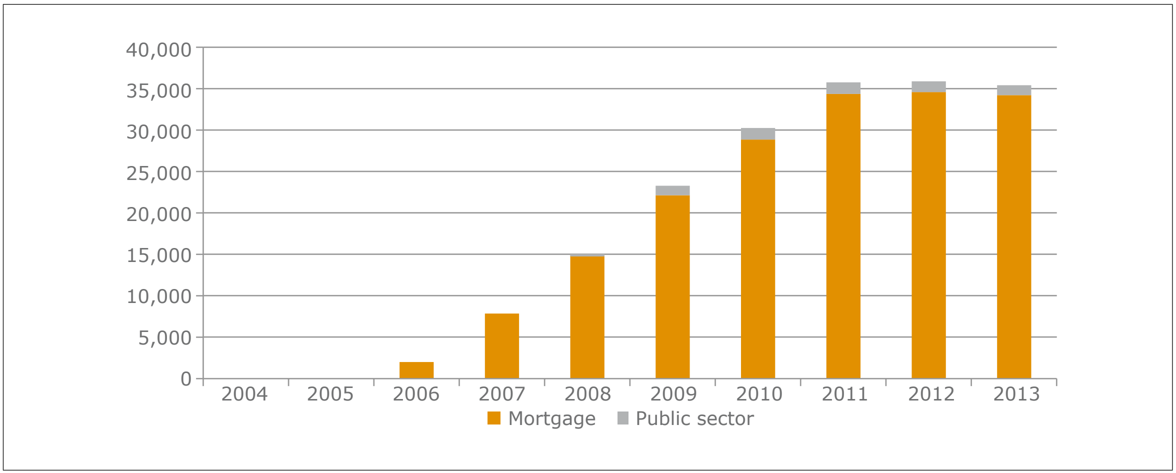
Non-performing mortgage loan levels have risen during the adjustment programme period driven by the recession and the increase in the unemployment level. In 2013, according to statistics from Bank of Portugal, the NPL level peaked at 2.27%, still a very low level compared to other loan categories such as consumer loans where NPL levels have reached 12%. The improved labor market sentiment that has begun to be felt at the beginning of 2014, should lead, at least, to a stabilization of defaults. Just as important for the trend in NPL levels has been the historically low level of interest rates keeping instalments within affordable levels for households even that disposable income has dropped during the period. The ECB's announced low interest rate policy and deflationary concerns should keep Euribor rates low – the most used index rate for variable mortgage loans, representing more than 90% of mortgage loans - and thus lend support to a level of mortgage NPL that banks can easily cope with.

Of equal interest to this matter and the overall strength of Portuguese banks has been the impact of new capital requirements emanating both from the economic adjustment programme and Basel III/CRDIV/CRR, which have improved the quality of banks. Most major issuers now enjoy high levels of capitalization when compared to their European peers and are now in a stronger position to start paying down the CoCo issues bought by the Portuguese State as part of the support measures when markets began to shut down for Portuguese issuers in 2011.

Low level of new loan production partly explains the low level of new covered bond issuance. But as new loan productions begins to raise steadily, so will issuers' appetite to tap the market. Nonetheless, existing issues should benefit from a renewed confidence for Portuguese issuers as demonstrated by a return to the markets by the sovereign and an improved rating outlook at the end of the economic adjustment programme as well as for some of the banks. As yields evolve to more attractive levels, the potential for new issues increases and the Portuguese covered bond market should be as dynamic as in the pre-crisis stage.

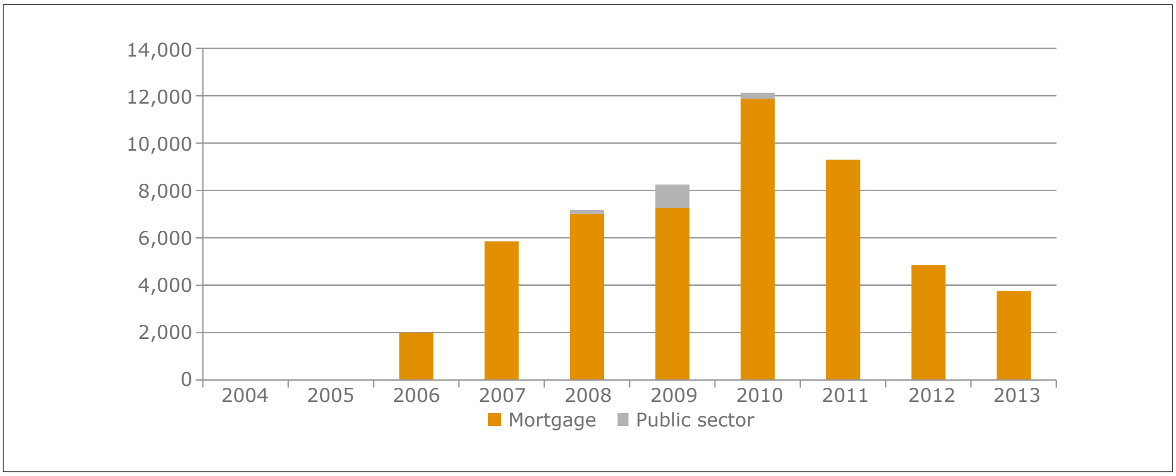
By December 2013, both *Obrigações Hipotecárias* and *Obrigações sobre o Sector Público* combined have achieved an outstanding amount of EUR 35.4 billion of issues with a residual weighted average tenor of 3.2 years.

> Figure 1: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2004-2013, EUR m



Source: EMF/ECBC

Issuers: There are 9 active issuers in Portugal - Banco Comercial Português, Banco Espirito Santo, Banco de Investimento Imobiliário, Banco Português de Investimento, Caixa Económica Montepio Geral, Caixa Geral de Depositos, Banco Santander Totta, Banco Popular Portugal and Banco Internacional do Funchal.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/38/Public_Sector_CB_%28Obriga%C3%A7%C3%B5es_sobre_o_Sector_P%C3%BAblico%29 and http://ecbc.eu/framework/39/Mortgage_CB_%28Obriga%C3%A7%C3%B5es_Hipotec%C3%A1rias%29

Covered Bond · Label · : BPI Mortgage Cover Pool; BCP Residential Mortgages; Banco Espírito Santo Mortgage Cover Pool; Banco Santander Totta, S.A.; Caixa Economica Montepio Geral; Caixa Geral de Depósitos Mortgage Cover Pool

3.26 ROMANIA

By Irina Neacsu, Banca Comerciala Carpatica, in the name of Romanian Banking Association, 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 features which are under discussion with the Romanian supervisory authorities for being amended.

Since the implementation of the existing Mortgage Bonds Law no covered bonds have been issued by a local issuer.

II. STRUCTURE OF THE ISSUER

The issuer can only be a credit institution (as defined by Romanian Banking Law, which is in line with the EU legislation). Therefore, all commercial or mortgage banks may be issuers and no other special covered bond license is required.

According to the proposed Covered Bond law draft, the issuer can be a credit institution as defined in Article 4 para (1) of the EU Regulation 575/2013. The Central Bank is supervising the covered bond issuance activity, for fulfilment of the prudential requirements.

Mortgage banks are credit institutions, but their licensing is limited since this type of credit institutions are not allowed to receive deposits. The National Bank has not yet issued the set of applicable regulations for mortgage banks. Up to date no mortgage bank as such is incorporated under Romanian Law.

Pursuant to the Mortgage Bonds Law, the issuer holds the assets on its balance sheet. The covered bond issuer holds the ownership title over the portfolio. A direct legal link between single cover assets and covered bonds does not exist. All obligations from bonds are obligations of the issuing bank as a whole. However, under the current law there is a legal link between each bond issue and its pool of cover assets. In the event of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved for the claims of holders of the specific bond issue.

Assets servicing may be outsourced, but for covered bonds it is expressly regulated only in case of the issuer's bankruptcy.

The covered bonds are direct and unconditional obligations of the issuer. The claims of the holders of covered bonds are secured by a first rank security interest over the cover assets, which are segregated in bankruptcy. Each bond issue is guaranteed by a distinct pool of assets. In the event of bankruptcy, the bonds holders in a specific issue will have first priority over the pool of assets dedicated to the specific issue.

The proposed Covered Bond law imposes the issuers to obtain the Central Bank approval for covered bond issuance prior to launching such a covered bond issue. Such approval/authorization is valid for one year and it will be withdraw by the Central Bank if the issuer is not launching in one year period any covered bond issue.

This legislative provision regarding separate cover pools for each covered bond issue will be set aside in the amended Romanian covered bond legal framework, which is currently under preparation in Romania.

III. COVER ASSETS

In the case of covered bonds structured under the Mortgage Bonds Law, only mortgage loans (i.e. residential or commercial mortgage loans) can be included in the cover pool. The cover pool could be replenished with other mortgage loans if some of the pledged loans don't fulfil the eligibility criteria anymore. Other eligible assets (besides mortgage loans) will only be used for supplementing the cover pool if the issuer has no other mortgage loans that could be used for such a purpose. The list of these other eligible assets which can be included in a cover pool is to be established by the National Bank.

In terms of derivatives allowed to be included in the cover pool, no special provisions are contained in this respect in the Mortgage Bonds Law. However, the National Bank is entitled to regulate the categories of eligible assets that can be used for supplementing the cover pool in case the issuer has no other mortgage loans. The only restriction in this respect imposed by the Mortgage Bonds Law stipulates that the general maximum ratio allowed for supplementing the portfolio and the substitution of the mortgage loans in a cover pool with eligible assets may not exceed 20% of the portfolio value.

The proposed covered bond law draft stipulates that the mortgage loans must fulfil several eligibility or performance criteria imposed by the Mortgage Bonds Law in order to be included in the cover pool:

> *The pool is homogenous comprising of only one type of mortgage loan according to its investment destination;*

> *The weighted average of the maturities of the mortgage loans included in the cover pool securing an issue is higher than the maturity of the mortgage bonds secured by such a cover pool; the weighted average of maturities shall be calculated by weighting the outstanding life time of the loans included in the cover pool with the nominal value of the loan as of the date of issue;*

> *Net present value of the mortgage receivables must exceed the net present value of covered bond debts, minimum overcollateralization of 2% is required;*

> *Central Bank will issue secondary regulations to set up:*

> *the rules for single debtor exposure limit;*

> *% of the cover pool assets consisting in mortgages on properties without constructions out of the total cover pool value;*

> *asset encumbrances limit.*

> *Only 60% of the mortgage reference value is considered in the cover pool;*

> *Mandatory 180 days coverage of the negative gap between the mortgage cash flow and covered bond cash flow (coverage of such difference with financial assets);*

> *Each mortgage loan in the cover pool meets the general eligibility criteria provided by this law and the performing criteria established through the prospectus;*

> *The nominal value of a mortgage loan does not to exceed, in case of a residential mortgage loan, 80% of the reference value of the immovable asset over which the security interest was created and, in case of a other mortgage loans, 60% of the reference value of the immovable asset over which the security interest was created (exceptions are permitted for special programmes, like "First Housing Programme");*

> *The amount representing the principal granted through a mortgage loan agreement has been fully disbursed to the beneficiary;*

> *The receivables deriving from the mortgage loans are not subject to a security interest in favor of any other person;*

> *The mortgage loan must not register delayed payments exceeding 61 days; and*

> *The real estate over which a security has been created for the reimbursement of the mortgage loan is insured against all risks for an amount equal with the reference value of the immovable established on the date of the mortgage agreement.*

In terms of geographical coverage, the sole restriction imposed under the Mortgage Bonds Law provides that, in order to be included in the cover pool, the mortgage loans should be granted for real estate investments on the territory of Romania or on the territory of member states of the European Union or the European Economic Area.

The current Mortgage Bonds Law generally stipulates that the cover pool is static. The replacement of the mortgage loans included in the cover pool is prescribed as an obligation only when certain mortgage loans no longer comply with the eligibility criteria, have become non-performing in the meaning of this law or determine the reduction of the weighted average of the maturities of the mortgage loans included in the cover pool, of the value of the mortgage loans included in the pool or of the interest amount, according to the limits provided by law.

*In the amended Romanian covered bond legal framework it is intended to have only **one cover pool** (**a mortgage cover pool** – comprising of eligible mortgage and housing loans), 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 residential loans or other mortgage loans at 80% and 60%, respectively. *These are absolute LTVs refer to the loans granted. No provision is made regarding a relative limit.*

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 draft of the amended covered bonds law stipulates a minimum 2% overcollateralization.*

VI. TRANSPARENCY

In the current Romanian legal framework on mortgage covered bonds there are no provisions on transparency.

Under the amended legislation issuers of covered bonds would be obliged to prepare and publish quarterly reports on the total volume of the issued covered bonds and the structure of the cover pool, including the nominal value of the receivables in the pool, their residual value and the structure of maturities of the receivables in the pool.

The supervisory authorities would be entitled to draft regulations regarding the content, the terms and publication of the quarterly reports.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Under the Mortgage Bonds Law, the activity of a mortgage bond issuer is monitored by the Financial Supervisory Authority (ASF) 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 draft of the covered bond law stipulates that the agent is appointed by the issuer from the list of auditors accepted by the NBR and it is approved by NBR. Also, a representative of the covered bond holders must be appointed by the bondholders in the first covered bond holders meeting, his role being to exercise, on its own name, but on the account of bondholders, the bondholders rights, except the voting rights.

The qualification, role and duties of the agent will be clarified in the amended Romanian covered bond legal framework.

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

A cover register allows for the identification of the cover assets for each issue. The issuer has the obligation to keep a cover register for each mortgage bond issue.

Registration in the cover register reflects the structure and dynamic of the portfolio at any time throughout the life of the issue. The cover register contains information with respect to each mortgage loan included in the cover pool (i.e. type: commercial or residential, beneficiary of the loan, immovable asset over which the security for reimbursement of the mortgage loan has been created, land book number, value of the mortgage loan and reference value of the immovable asset, any other collateral and its nominal value) and substitute assets.

Registration in the cover register triggers an obligation for the issuer to have a security interest, which is registered with the Electronic Archive and covers each and all assets registered in the register. These assets are specifically registered in the accounting books of the issuer and segregated from the estate of the issuer in the event of bankruptcy. The cover register is kept by the issuer and subject to checks by the agent and supervision by the National Bank of Romania.

Asset segregation

By registration of the security interest over the pledged cover assets and the entry into the internal cover register of the mortgage loans or other assets included in the cover pool, such assets are segregated from the other assets of the issuer. The segregation of the cover assets from the insolvent estate of the issuer is thus a consequence of a contractual pledge and the operation of the law.

After the launching of the insolvency proceedings, a special portfolio management company carries out the administration of the cover assets. The appointment of the cover pool manager is made by the general meeting of bondholders.

Impact of insolvency proceedings on covered bonds and derivatives

Mortgage bonds do not automatically accelerate when the issuing institution becomes insolvent, but the bondholders could be obliged to accept payments in advance, with the corresponding recalculation of their rights if the cash-flows in the cover pool allow that.

The amended Romanian covered bond legal framework will clarify the asset segregation provisions, set aside the de facto acceleration provision and will also clarify the regime of derivatives registered in the cover register.

Preferential treatment of covered bond holders

Mortgage bond holders enjoy preferential treatment as the law stipulates the separation of the cover assets from the insolvent issuer's estate.

In the event that the cover assets of a specific issue are not sufficient to cover the payments of that issue, the Mortgage Bonds Law provides for a cross-subsidy principle amongst different issues of cover bonds of the respective issuer if there is a surplus after payment of all the obligations towards the bondholders in a specific issue. If the cover assets are not sufficient, the bondholders have an unsecured claim towards the bankrupt estate for the difference.

A moratorium on the insolvent issuer's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of covered bond holders.

A special insolvency procedure could be commenced against the cover pool only by the bondholders.

Access to liquidity in case of insolvency

After bankruptcy proceedings are opened, with the appointment of an asset management company as the cover pool administrator, the right to manage and dispose of the recorded assets is transferred to this company by law. Thus, the cover pool manager first has access to the cover assets and collects the cash flows according to their contractual maturity and pays the amounts due by the issuer to the bondholders.

There are no specific regulations expressly addressing the issue of voluntary overcollateralization in insolvency. It may be argued that voluntary overcollateralization is part of the cover pool with all legal consequences regarding segregation in the event of bankruptcy applicable to the respective pool.

The draft of the amended covered bond law stipulates minimum overcollateralization level of 2%.

Sale and transfer of mortgage assets to other issuers

A bankrupt issuer cannot be liquidated until it has assigned the cover pool to another issuer. The portfolio of assets may be sold to other issuers in a transaction concluded after the launching of the bankruptcy proceedings if the liquidator's report provides the sources from which the insolvent issuer may pay in full the amounts due to the bondholders and if the bondholders in each issue (if more than one) have decided in the general meeting of bondholders to accept payment in advance under the terms provided in the liquidator's report.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR).[1] The covered bonds issued

1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

under the Mortgage Bonds Law comply with Article 129(1) CRR and 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.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/99/Obligatiuni_Ipotecare_-_Mortgage_Covered_Bonds

3.27 RUSSIA

By Tim Lassen[1], PFP Group Ltd., Representative Office, Moscow

I. FRAMEWORK

One of the countries with the largest potential for mortgage securities is without any doubt Russia. The country needs large investments in building of new and renovation of existing housing.

History of the Russian covered bond system

The Russian covered bond system goes back to 1861. From that year on until 1917 in Russia already existed a covered bond system. E. g. in 1914 the share of mortgage securities was nearly 40% (37,7% or 5,3 bn RUB) of all securities on the Russian capital market (in Germany: 29%).

In Russia the mortgage system was formed until the end of the 1880s and included state-owned, joint stock and co-operative banks, funding their mortgage loans by specially secured mortgage bonds ("zakladnyy list").[2]

In 1861 the Saint Petersburg and Moscow Credit Societies (kreditnye obshchestva) were founded, being co-operative institutions and the first mortgage credit banks in Russia. Until 1917 nearly 30 of such city and gubernial credit societies were active. Beginning from 1864, part of the co-operative banks' system was as well the County Bank of the Kherson Governorate (Zemskiy bank Khersonskoy gubernii). These institutions were founded on cross liability of all debtors. On these principles the Society of Reciprocal Land Credit (Obshchestvo vzaimnogo pozemel'nogog kredita) was founded, aiming to perform mortgage credit all over whole Russia. But the Society was not successful in this task and in 1891 it was restructered in a special department (Osobyy otdel) of the Imperial Nobility Land Bank (Gosudarstevennyy dvoryanskiy zevel'nyy bank).[3]

An important role in the development of the Russian mortgage system had the joint stock land banks (aktsionernye zemel'nye banki). Ten land banks existed from the beginning of the 1870s down to the year 1917. These banks had an all-society classes' character and were closely connected with commercial banks.[4]

In the 1880s a system of state mortgage lending was set up. This system included the Imperial Nobility Land Bank and the Peasant Land Bank (Krest'yanskiy zemel'nyy bank). Task of the first was to support nobility land ownership, but in 1915 already 40% of its debtors did not belong to the nobility. Different from the other lenders, the Nobility Land Bank provided its clients with some preferences. The Peasant Land Bank was founded to support peasants (farmers) to obtain land in full ownership. Its activities were closely linked to the government, especially to the Ministry of Finance and the Main Administration of Land Survey and Agriculture (Glavnoe upravlenie zemleustroystva and zemledeliya). Since 1909 the Peasant Land Bank has been partly existing on budget subsidies.[5]

1 Special thanks go to the collegues from AIZhK, DeltaCredit Bank, Sberbank and VTB Capital for proof reading and commenting on this article. An important information source was published earlier this year: Information Agency CBonds/Rusipoteka (publ.): Encyclopedia of Russian Securitization, 2nd ed. Saint Petersburg 2014.

2 Fundamental work on the history of the pre-revolution Russian mortgage system was done by N. A. Proskuryakova, e. g.;
- Ipoteka v Rossii v konce XIX – nachale XX v. i ee rol' v perectrojke ekonomiki (Mortgage in Russia at the end of the 19. – beginning of the 20. Centrury and its role in the restructering of the economy); in: Vinogradov V. A.: Ekonomicheskaya istoriya Rossii XIX – XX vv.; Sovremennyy vzglyad (Economic history of Russia in the 19. – 20. Centrury: Contemporary view); Moscow 2000, pp. 283 – 302.
- Zemel'nye banki Rossiyskoy Federacii (Land banks of the Russian empire); Moscow 202.
- Sankt-Peterburgskoye gorodskoe kreditnoe obshchestvo (1861-1911 gg.) (Saint Petersburg City credit society (1861-1911)); in: Ekonomicheskaya istoriya: Ezhegodnik 2003 (Economic history: Yearbook 2003); Moscow 2004, p 392 – 439.

See as well: Klepikova, Elena / Milyutin, Andrey: Istoria ipoteki v Rossii s 1754g. do nashikh dney (History of mortgage in Russia from 1754 to our days) (2006), http://rusipoteka.ru/istoria_ipoteki/ipoteka_istoriya/ (viewed on 10 April 2014).

3 On the outskirts of the empire (in the Baltics, Poland and South Caucasus) local mortgage institutions continued to exist.

4 For selling bonds of the land banks abroad in 1873 the Central Bank of Russian Land Credit (Tsentralnyy bank russkogo pozevel'nogo kredita) was founded. Already in 1873 it stopped its activities and paid only off existing bonds. In 1893 it was liquidated.

5 Different from the other mortgage banks the obligations of the Peasant Land Bank were not termed as "zakladnoy list", but as "state certificate" (gosudarstvennoe svidtel'stvo).

In 1913 for communal finance („public finance") at the Ministry of Finance, the Caisse of City and County Credit (Kassa gorodskogo i zemskogo kredita) was founded. The Caisse was entitled to issue bonds to fund its granted loans.

After 1917 all these institutions have been liquidated.

Current legal framework

This article will give an overview over the current legal framework for mortgage obligations. Legal basis is the Law on Mortgage Securities[6]. This law is supported by rules in the Mortgage Law, the Bankruptcy Law, the Credit Organisations Bankruptcy Law and the Securities Market Law.[7]

In addition the Central Bank of the Russian Federation (CBRF) issued the Mortgage Cover Mandatory Requirements Instruction[8]. The Federal Financial Markets Service (FSFR) released[9]:

> The Mortgage Cover Determination Order[10],

> A joint order containing (i) the Special Depositor Decree and (ii) the Register Maintenance Rules[11] and

> The Mortgage Cover Administrator/Special Depositor Data Reporting Decree[12].

Further rules are in general regulations of the CBRF and the FSFR[13].

Aside from some changes to the Law on Mortgage Securities, which will be discussed here, the Russian covered bond market saw a breakthrough in 2013: The second Russian covered bond issue was rated (issuer: Delta Credit Bank, rated by Moody's) with a rating of two notches above the issuer's rating: Baa1 to Baa3 negative[14].

II. STRUCTURE OF THE ISSUER

The Russian Law on Mortgage Securities foresees two types of "mortgage obligations"[15] (Art. 7, sec. 1[16]): obligations[17] issued (i) by a credit organisation (covered bonds) or (ii) by a SPV ("mortgage agent") (MBS)[18].

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6 Federal law dated 11 November 2003 No 152-FZ "On Mortgage Securities". Changes since last year: (1) Federal law dated 23 July 2013 No 251-FZ (published: SZ, 2013, No 3 (part I), item 4084), (2) Federal law dated 21 December 2013 No 379-FZ (SZ, 2013, No 51, item 6699). A list of the legal framework is attached to the country report in ECBC Fact Book 2010, pp. 274 – 276.

7 Again – as in former years with pessimistic economic expectations – a discussion on improving the covered bond regulation has started. See Chernykh, Andrey: Mnenie yurista: Ob osnovnykh napravleniyakh razvitiya zakonodatel'stva ob ipotechnykh obligatsiyakh bankov (Lawyer's opinion: On principle directions of development of the legislation on bank mortgage securities); Legal Capital Partners, Obzor zakonodatel'stva, 31.03.2014, pp. 2 - 4. See as well (both articles published in OOO "Cbonds.ru"/OOORusipoteka: Entsiklopediya rossiyskoy sek'yuritizatsii 2014, Saint Petersburg 2014, following: ERS): (1) Pervova, Ekaterina: Yuridicheskoe regulirovanie i riski balansovykh ipotechnykh sdelok (Legal regulation and risks of on-balance mortgage transactions), pp. 166 – 170; (2) Lassen, Tim: Preimushchestvennoe pravo investorov pri bankrotstve banka-emitenta ipotechnykh tsennykh bumag (Privilege right of investors in case of bankruptcy of the bank, issuing mortgage securities), pp. 176 – 183. For the last draft law to improve the regulation see: Lassen, Tim: Country Report Russia; in: ECBC FB 2009, pp. 253 – 259.

8 Instruction of the CBRF dated 31 March 2004, No 112-I "On mandatory requirements for credit organisations, issuing securities with mortgage cover".

9 Regarding the merger of the FSFR into the CBRF: See below chapter VII.

10 Order dated 01 November 2005 No 05-59/pz-n "On confirmation of the Decree on the method of determination of the mortgage cover".

11 Order dated 01 November 2005 No 05-60/pz-n "On confirmation of the Decree on the activity of the special depositar for the mortgage cover and the Rules of the maintenance of the register of the mortgage cover".

12 Order dated 15 December 2009 No 09-57/pz-n "On confirmation of the Decree on data reporting of the administrator of the mortgage cover and the Decree on data reporting of the specialised depositor of the mortgage cover".

13 > Order FSFR dated 04 October 2011 No 11-46/pz-n "On confirmation of the Decree on disclosure of information of issuers of issuing securities"; here following: Order FSFR No 11-46/pz-n/2011.
> Instruction of the CBRF dated 03 December 2012 No 139-I „On mandatory requirements for banks"; here following: Instruction CBRF No 139-I/2012.

14 Moody's Investors Service: (i) Rating Action: Moody's assignes definitive Baa1 rating to Series 12 of DeltaCredit Bank mortgage covered bond, 05 September 2013; (ii) Pre-Sale Report: DeltaCredit Bank Mortgage Covered Bonds, 19 July 2013. The rating is linked to DeltaCredit's credit strength.

15 Language of the Law: "Obligations with mortgage cover".

16 Law citations without link are citations of the Law on Mortgage Securities.

17 "Housing mortgage obligations" are a special type of 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).

18 Another mortgage security under the Law is the "mortgage participation certificate" (Art. 17 – 31), an instrument similar to investment fund certificates. Due to their different structure in this article we will not look after them.

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.

For new issues (new series of issues) are new cover pools set up. The cover pools itself are dynamic (as defined by the ECB[19]): The cover pool for every issue can be modified in cases, stipulated by the law, to ensure that there is always enough cover for the outstanding mortgage securities.

Credit organisations (Art. 7, sec. 2)

A credit organisation has to comply with the Banking Law and the rules, set up by the Central Bank for credit organisations. If the credit organisation does not fulfil the statutory requirements, the licence can be revoked (Art. 20, sent. 1, no 10 of the Banking Law).

By pt. 1.1 and 2.4 of the Mortgage Cover Mandatory Requirements Instruction, the CBRF has set up a special regulation[20] for the minimal ratio between the volume of the cover pool and the volume of the issued mortgage obligations (N18): 100 % (pt. 1.1, sec. 3 and 2.4 of the Mortgage Cover Mandatory Requirements Instruction).

For credit organisation the excess amount of the cover pool shall not be more than 20% (Art. 13, para. 3, sec. 2).

The Central Bank has not used its right to set a special limit for mortgage obligation issuers for the interest rate and foreign exchange risk[21].

SPVs (mortgage agents, Art. 8)

The mortgage agents are described in detail in the ECBC Fact Book 2011, p. 413. Here we will look on some changes that will come into force on 1 July 2014, introduced by the so-called "Securitization Law"[22].

In the charter of the mortgage agent has to be stipulated the maximum number of mortgage securities' issues, this agent is founded for (Art. 8, sec. 1, para. 6).

Due to Art. 8, sec. 1, para. 3, mortgage agents may borrow money under loan/credit agreements for the purposes stated in its charter (i.e. bridge financing). The more a volunteer liquidation of a mortgage agent is only allowed after repayment of all outstanding mortgage obligations (Art. 8, sec. 4).

The Securitization Law widens the rights of the mortgage agents under Art. 8, sec. 1, para. 3: It will be clearly stated - among others - that mortgage agents are able to have civil rights and obligations and will have the right to insure their default risk. Furthermore, it will become possible to set up mortgage agents as limited liability companies (Art. 8, sec. 1, para. 4). New Art. 8, sec. 5 and Art. 12, sec. 4 define which rules for non-mortgage SPVs and pledge secured securities in the Securities Market Law and which rules in the laws on joint stock companies and limited liability companies are applicable to mortgage agents.

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 ("ipotechnoe pokrytie"), mortgage agent ("ipotechnyj agent") and "mortgage specialized organisation" ("ipotechnaya spezializirovannaya organisatsiya")[23] may be used only for the purposes of the Law on Mortgage Securities.

19 European Central Bank: Mortgage obligations in the EU Financial System, December 2008, p. 7.

20 On the bases of Art. 7, sec. 2, para. 2 – 4. After 1 July 2014 Art. 7, sec. 2 and 3 will be formulated more generell. The Central Bank will be entitled to set up special rules for disclosure of information by the issuing banks and forbiding issues, if the requirements of the Central Bank are not fulfilled.

21 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).

22 Federal law dated 21 December 2013 No 379-FZ (SZ, 2013, No 51, item 6699). Basically this Law aims to ease requirements for off-balance securitization of non-mortgage assets. The Law contains rules for (non-mortgage) SPVs; securities, secured by a pledge over non-mortgage assets; individual investment, nominal and escrow accounts; tasks for the Central Bank to supervise the securitization market.

23 "Mortgage specialized organization" is another allowed name for "mortgage agent" (Art. 8, sec. 1, para. 5).

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).

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; Art. 13 sec. 1, para. 3[24]).

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).

> In the moment of distribution (razmeshcheniye) or delivery (vydacha) of the mortgage obligations the cover cannot sustain of mortgage secured claims, pledged to secure other obligations (Art. 3, sec. 3, para. 1).

One asset may only be used for one cover pool (Art. 3, sec. 5)[25].

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%[26] of the market value (Art. 3, sec. 3, para. 2). In both cases, the valuation has to be made by an independent valuer[27].

The Law does not contain special regulations on valuation for the purpose of mortgage securities.

V. ASSET-LIABILITY MANAGEMENT

The Asset-liability management is described in detail in the ECBC Fact Book 2012, pp. 415 - 416.

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 following claims shall not be encountered 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; and,

24 And for not longer than two years since the acquisition (pt. 7.8.1.3 CBRF Order No 13-55/pz-n/2013).

25 The cover pool itself is defined in legal literature as "specific type of property", sustaining of different elements but used as unitary "other property" according to Art. 128 of the Civil Code, see Efimova, Olga V.: Ipotechnoe pokrytie kak osobyy vid imushchestva, Yurist No 24/2011, pp. 19 – 22 (p 22).

26 Including the first ranking mortgage.

27 The valuers' profession and independence of the valuer is regulated in the Valuation law.

> No insurance of the mortgage object for more than 6 month.

> 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[28]; Art. 3, sec. 4).

For proper performance of the obligations under the mortgage obligations[29] the amount of the cover pool for the whole maturity of the bonds shall not be lower than the aggregate outstanding nominal value of the bonds (Art. 13, sec. 2, para. 2, sent. 1). This is further defined in the Instruction 128-I/2006 of the CBRF, which foresees that the cover pool has to secure completeness of payment and timely payment[30] (pt. 6.4.2, sent. 8, Instruction 128-I/2006)[31].

One cover pool can secure two or more tranches of mortgage obligations (Art. 11, sec. 2, para. 1; Art. 13, sec. 2). In this case the rules on calculation of the necessary cover for one tranche apply similarly (Art. 11, sec. 2, para. 1). If mortgage securities are issued in several tranches on the bases of one cover pool, the volume of the cover pool has to be not less than the nominal value of each tranche together with other tranches with similar or foregoing ranks (Art. 13, sec. 2, para. 3). Among the two or more tranches the issuer may define an order of priorities: The performance of claims of one tranche is only allowed after proper performance of the claims of the higher ranking tranche(s) (Art. 11, sec. 2, para. 2[32] and 3). The rule, that for all tranches at any time the cover rules are fulfilled, can be excluded for the junior tranche by the decision on the issue (Art. 11, sec. 2, para. 1; Art. 13, sec. 6).

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 former rule that at least 80% of the cover pool have to be mortgage secured claims (Art. 13, sec. 1, para. 2 / old) has been abolished[33]: Under the new regulation only at the moment of formation of the cover pool, it has to sustain for 100% of mortgage loans. After issuing the bonds, due to amortisation of the cover pool, this share will reduce. To avoid the consequence of necessary prepayment of the issue, and the risk that potential new cover mortgage loans will not fit to the parameters, the money from regular repayments of the mortgages has to be included into the cover pool.[34]

The mortgage securities' holders have the right to claim for prepayment of the mortgage obligations in the following cases (Art. 16, sec. 1): Breach of the rules regarding:

> Volume of the cover pool;

> Replacement of cover assets;

> Proper fulfilment of obligations under the mortgage obligations;

> The issuer is active in fields not allowed for it; and,

> Other reasons stipulated by the decision on issuing mortgage obligations.

28 The Securitzation law adds the possibility to replace assets, if this is forseen in the decision on the issue and consented by the "bond holders' representative" (in Russian: Predstavitel' vladeltsev obligatsiy). The representative was introduced by the Federal law dated 23 July 2013 No 210-FZ (SZ, 2013, No 30 (part I), item 4043) into Art. 29.1 – 29.11 of the Securities' market law (changes comig into force on 1 July 2014). In principle the appointment of a representative is voluntary, obligatory only under certain defined circumstances. The representative has to secure the interest of the bond holders in front of the issuer, a security provider, as well as state institutions, including courts.

29 In Russian "nadlezhashchoe ispolnenie obyazatel'stv po obligatsiyam s ipotechnym pokrytiem".

30 In Russian "polnota i svoevremenost' ispolneniya obyazatel'stv po obligatsiyam s ipotechnym pokrytiem".

31 Moody's assigned a timely payment indicator (TPI) of "Very Improbable", as covered bonds under Russian law accelerate, if the issuer becomes insolvent. Due to Moody's the Law on Mortgage Securities offers limited support for timely payment to the covered bond holders, after issuer default. (Moody's Investors Service: Pre-Sale Report: DeltaCredit Bank Mortgage Covered Bonds, 20 November 2012 and 19 July 2013, in both reports p. 2).

32 The Securitization Law clearifies this rule regarding interest.

33 Federal Law dated 29 December 2012 No 281-FZ.

34 See pt. 5 Explanatory Memorandum of the authors of the draft dated 19 August 2011.

A time frame to claim for prepayment has to be set up in the decision of the issue and shall not be less than 30 days from discovery or disclosure by the issuer of the prepayment right to the mortgage securities' holders (Art. 16, sec. 3, sent. 1). After this term the right to claim for prepayment ends (Art. 16, sec. 1, sent. 2). If the prepayment right arose in connection with a breach of the rules for the volume of the cover pool and/or the proper fulfilment of obligations under the mortgage securities as described in Art. 13, the right to claim a prepayment ends on the date of discovery or disclosure of information by the issuer of elimination of the breaches (Art. 16, sec. 3, sent. 2).

The issuer has to inform the mortgage securities' holders, that the right to claim for prepayment has arisen, the value of the securities, the procedure of prepayment and the termination of this right (Art. 16, sec. 2).

VI. TRANSPARENCY

The Law on Mortgage Securities stipulates a wide range of publishing information on the mortgage obligations by the issuer (Art. 37 – 41). In addition to the main rules according to the Securities Market Law (Art. 37, para. 1; Art. 40, sec. 1), important information is an account report on performance of the cover assets (Art. 40, sec. 4, para. 2). Credit organisations issuing mortgage obligations have special reporting duties to the Central Bank (Art. 7, sec. 1, para. 3; pt. 3.1 – 3.5 of the Mortgage Cover Mandatory Requirements Instruction).

Main points for publishing information are:

> If the mortgage obligations are rated by a rating agency, this rating has to be published (Art. 37, para. 2).

> Interested persons have the right to get knowledge of the cover register (Art. 39, para. 1)[35].

> The regulators set up further special rules for mortgage obligation issuers in the general regulations on disclosure of information[36].

The transparency rules are described in detail in the ECBC Fact Book 2012, pp. 417 - 418.

VII. COVER POOL MONITOR, COVER REGISTER AND BANKING SUPERVISION

Cover pool monitor

The cover pool is controlled by a cover monitor (the "specialized depositor of the mortgage cover"[37]), Art. 33, sec. 1. The cover monitor has to be a commercial organisation[38], licensed for (i) activity as special depositor for investment funds, share investment funds and non-state pension funds as well as for (ii) performance of depositary activities on the securities' market (Art. 32, para. 2). The FSFR has published the Special Depositor Decree.

The duties and tasks of the cover pool monitor are described in the ECBC Fact Book 2012, pp. 418 - 419.

Cover register

Cover assets have to be registered in a "register of mortgage cover"[39] (Art. 5). The FSFR has adopted Register Maintenance Rules[40].

Details are described in the ECBC Fact Book 2012, pp. 419 - 420.

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35 The cover register contains information on the mortgage claims on the loan-level basis (Art. 5).

36 FSFR: Order No 11-46/pz-n/2011 and Order dated 04.07.2013 N 13-55/pz-n "On confirming Standards for issuing securities and registration of securities' prospectus' (registered Ministry of Justice 30.08.2013, published Rossiyskaya Gazeta-special issue, N 244/1, 30.10.2013, following: Order N 13-55/pz-n/2013; replacing Order No 07-4/pz-n/2007).
Central Bank: Instruction No 128-I/2006.

37 In Russian "spetsializirovannyj depozitariy ipotechnogo pokrytiya".

38 Not affiliated with the issuer (Art. 33, sec. 3, para. 2).

39 In Russian "reestr ipotechnogo pokrytiya".

40 The "register" contains information on loan-level basis.

Supervision

Since 2013 the financial sector and banking system is supervised by the Central Bank of the Russian Federation as so-called "mega regulator". This was realized by incorporation of the FSFR into the Central Bank.[41]

Concerning mortgage securities the state regulation of issuing mortgage securities (Art. 42 - 46) as well as the supervision of banks, issuing mortgage securities, is done by the Central Bank (Art. 7, sec. 2).

Issuing of mortgage obligations

For details of this process see ECBC Fact Book 2012, pp. 420 - 421.

For issuing securities, Russian law foresees a four step process[42]: (i) decision on issue[43], (ii) state registration of issue[44], (iii) placement of securities and (iv) state registration of the report or notification on results of the issue[45]. For these general steps, the FSFR and the CBRF set up special requirements for the issue of mortgage securities.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF MORTGAGE OBLIGATIONS

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 of the Law on Mortgage Securities; Art. 131, sec. 2, para. 3 of the Bankruptcy Law; Art 50.35, sec. 2 and 4 of the Credit Organizations Bankruptcy Law).

The insolvency administrator is obliged to open two special bank accounts for the cover pool to collect the money paid on the mortgage secured claims or from realization of these claims and to make payments to the mortgage obligations' holders (Art. 133, sec. 4 of the Bankruptcy Law). A special administrator of the cover pool, different from the insolvency administrator of the general bankruptcy estate is not foreseen.

Impact of insolvency proceedings on mortgage obligations

The Law on Mortgage Securities stipulates two possibilities of realization of the cover pool in case of bankruptcy of the issuer (Art 16.1, para. 2):

> Change of the issuer ("zamena ėmitenta obligaciy s ipotechnym pokrytiem"): The cover pool will be sold with the obligation for the buyer to fulfil all conditions of the decision on issuing the mortgage obligations. Details have to be stipulated by a federal law. This federal law has not been enacted yet.

> Selling of the cover pool ("prodazha ipotechnogo pokrytiya"): The cover pool assets will be sold and the money received will be distributed among the mortgage obligations' holders. The mortgage obligations accelerate.[46]

41 Federal law dated 23 July 2013 No 251-FZ (SZ, 2013, No 30 (part I), item 4084). Regulations of the FSFR remain in force until replacement by regulation of the CBRF (Art. 49, sec. 1 of the named law).

42 Pt. 2.1.1 Order FSFR No 13-55/pz-n/2013.

43 The decision sustains of two parts: Taking the decision and approval of the decision.

44 Based on the Decision and the prospectus.

45 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".

46 The federal law dated 21 December 2013 No 379-FZ adds new provisions (Art. 16.2, sec. 3, para. 3 and 4), that in case if one (or severeal) bond holders' representatives are appointed for the covered bonds secured by one cover pool (for several tranches secured by one cover pool) the bankrupcy receiver will transfer the money to special account of the representative. The representative will distribute the mony among the the bond holders.

Preferential treatment of mortgage obligations' holders

Mortgage obligations' holders enjoy preferential treatment as the Russian law stipulates the separation of the cover pool from the general insolvency estate of the issuer (Art. 16.1, para. 1).

In case they are not satisfied in the realization of the cover pool, the mortgage obligations' holders may ask for satisfaction from the general bankruptcy estate of the issuer (Art. 16.1, sec. 1 para. 3).

They are also enjoying a preferential treatment against deposit holders, as the cover pool – securing mortgage obligations – is excluded from the general bankruptcy estate, which in turn secures depositors on preferential bases[47].

For details to access to liquidity in case of insolvency and sale and transfer of mortgage assets to other issuers, see ECBC Fact Book 2012, p. 423.

Enforcement into the cover pool

Russian Covered Bond Law allows for enforcement of the covered bond holders into the cover pool (Art. 15). The earlier existing special rules for this enforcement have[48] been deleted by federal law dated 21 December 2013 No 379-FZ and will lose force on 1 July 2014. Only the general realization rules of the Mortgage Law will apply after this date. The rule, that in case of different issues with different ranking, the ranking has to be kept in distribution of the receipts, remains in force (Art. 15, sec. 3).

In addition a new rule is introduced, that in case, if an issue sustains of several tranches, the foreclosure in one tranche is only allowed upon an application of the bond holders' representative (Art. 15, sec. 1, para. 3).

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION; ECBC LABEL CONVENTION

Russian mortgage obligations (mortgage obligations, issued by credit organisations) comply with the requirements of Art. 52, sec. 4 UCITS and the ECBC Label Convention (see ECBC Fact Book 2012, pp. 424 - 426). Mortgage obligations still enjoy a privileged risk weighting compared to other non-public securities: Mortgage obligations are weighted with 100% instead of 150%[49].

Implementation of Basel III into Russian law

Earlier this year the Central Bank published the Draft of a Regulation "On Terms of Settlement of Short-Term Liquidity (Basel III)", where the approach to the LCR (Liquidity Coverage Ratio) of mortgage securities is defined. After adoption the new regulation will be discussed in detail.

Capital Requirements Regulation (CRR)[50]

The CRR is **fulfilled** for mortgage obligations, issued by banks, where the cover pool sustains only of housing mortgage loans (e.g. housing mortgage obligations). For mortgage obligations, secured by commercial mortgage loans, the CRR requirements (Art. 129, sec. 1, lit. f) are **not fulfilled**, as a loan to value up to 80% of the market value is allowed under Russian law as cover asset.

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47 See the Explanatory Memorandum of the authors dated 01 February 2011, the Official Opinion of the Government of the Russian Federation dated 6 July 2011 and the Conclusions of the Financial Markets' Committee of the State Duma as of 20 September 2011 and 24 January 2012 to draft law no 495103-5 (enacted as Federal law dated 25 June 2012 No 83-FZ).

48 See ECBC Fact Book 2011, pp. 342-343 and FB 2012, p. 423.

49 See also ECBC Fact Book 2012, p. 426. This privilege is also based on pt. 2.3.4., Schedule 1 Designation code "8815" of the new Instruction CBRF No 139-I/2012.

50 Regulation (EU) No 575/2013 of the European Parliament and the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, Official Journal of the European Union L 176, 27 June 2013, pp. 1 – 337.

Article 129

Exposures in the form of covered bonds

1. To be eligible for the preferential treatment set out in paragraphs 4 and 5, bonds as referred to in Article 52(4) of Directive 2009/65/EC (covered bonds) shall meet the requirements set out in paragraph 7 and shall be collateralized by any of the following eligible assets:

(a) exposures to or guaranteed by central governments, ESCB central banks, public sector entities, regional governments or local authorities in the Union;[51]

Fulfilled. Art. 3, sec. 1: State bonds, issued by the Russian Federation and Russian regions.

(b) exposures to or guaranteed by third country central governments, […];

Not applicable.

(c) exposures to institutions that qualify for the credit quality step 1 […];

Not applicable.

(d) loans secured by:

(i) residential property up to the lesser of the principal amount of the liens that are combined with any prior liens and 80 % of the value of the pledged properties; or

Fulfilled. Art. 3, sec. 2, para. 1: Eligible are mortgage secured loans up to 80% of the market value. The Law allows for "housing mortgage obligations", covered only by loans, secured by residential real estate (Art. 2, para. 5).

(ii) senior units issued by […].

Not applicable.

(e) residential loans fully guaranteed […];

Not applicable

(f) loans secured by:

(i) commercial immovable property up to the lesser of the principal amount of the liens that are combined with any prior liens and 60 % of the value of the pledged properties; or

***Not fulfilled**. Art. 3, sec. 2, para. 1; sec. 3, para. 2: Eligible are mortgage secured loans up to **80%** of the market value or second ranking mortgages up to **70%** of the market value.*

(ii) senior units […].

Not applicable.

Loans secured by commercial immovable property are eligible where the Loan to Value ratio of 60 % is exceeded up to a maximum level of 70 % if the value of the total assets pledged as collateral for the covered bonds exceed the nominal amount outstanding on the covered bond by at least 10 %, and the bondholders' claim meets the legal certainty requirements set out in Chapter 4. The bondholders' claim shall take priority over all other claims on the collateral;

***Not fulfilled**. Under Russian law this is only a theoretical possibility, combining second ranking cover mortgage loans and allowed overcollateralization.*

51 „EU" is here understood as „national": Russian bonds instead of EU bonds.

(g) loans secured by maritime liens […].

Not applicable.

For the purposes of points (c), (d)(ii) and (f)(ii) […].

Not applicable.

The competent authorities may, after consulting EBA, partly waive the application of point (c) […].

Not applicable.

2. The situations referred to in points (a) to (f) of paragraph 1 shall also include collateral that is exclusively restricted by legislation to the protection of the bond-holders against losses.

   Fullfiled: Art. 16.1; Art. 16.2 of the Law on Mortgage Securities; Art. 131, sec. 2 para. 3 of the Bankruptcy Law; Art. 50.35, sec. 2 and 4 of the Credit Institutions Bankruptcy Law.

3. Institutions shall for immovable property collateralising covered bonds meet the requirements set out in Article 208 and the valuation rules set out in Article 229(1).

4. Not applicable.

5. Not applicable.

6. Covered bonds issued before 31 December 2007 […].

Not applicable.

7. Exposures in the form of covered bonds are eligible for preferential treatment, provided that the institution investing in the covered bonds can demonstrate to the competent authorities that:

   (a) it receives portfolio information at least on:

   In addition to the wide range of transparency rules (see above VI) in the Order FSFR 11-46/pz-n/2011 are also contained special rules. Legal basis is Art. 39 of the Mortgage Securities Act.

   (i) the value of the cover pool and outstanding covered bonds;

   Fullfilled: In the prospectus the issuer has to publish detailed information on the content, structure and volume of the cover pool (pt. 9.1.5.5, Annex 2, Order FSFR 11-46/pz-n/2011):

   > *volume of the mortgage cover and its ratio to the volume of mortgage securities, in RUB and foreign currency (lit. b),*

   > *volume and content of the cover pool (including e. g. amount of outstanding mortgage loans in RUB and foreign currency, LTVs, average interest, average duration)(lit. v).*

   > *In addition information has to be given on the fulfillment of the requirements, set up by the CBRF (pt. 5.2, para. 7, Annex 2, Order FSFR 11-46/pz-n/2011)[52].*

   This information has to be given again on placement of the securities (pt. 10.4.1, lit. g, no 2, 2.1, Annex 2, Order FSFR 11-46/pz-n/2011).

   Information, having a significant influence on the value of the mortgage securities has to be published (pt. 10.2, Order FSFR 11-46/pz-n/2011)[53], as well as information of the exchange of cover assets (pt. 6.2.34.2, Order FSFR 11-46/pz-n/2011).

52 The same information has to be given in the quarterly reports (pt. 4.2, para. 7, Annex 3, Order FSFR 11-46/pz-n/2011.

53 In the prospectus and the quaterly report the issuing credit organisation is obliged to give an overview on the real estate and mortgage market (pt. 4.2.6.3, last para., Annex 2 and pt. 3.2.6.3, last para., Annex 3, Order FSFR 11-46/pz-n/2011).

(ii) the geographical distribution and type of cover assets, loan size, interest rate and currency risks;

Fullfilled: In the prospectus the issuer has to publish detailed information on the content, structure and volume of the cover pool (pt. 9.1.5.5, Annex 2, Order FSFR 11-46/pz-n/2011):

> *structure of the cover pool regarding types of mortgaged properties as well as cash money and securities in the cover (lit. g, no 1 – 3),*

> *the regional distribution of the cover assets (lit. e).*

> *The information, contained in the cover register has to be made available to all interested persons (pt. 10.3.1 – 10.3.5, Order FSFR 11-46/pz-n/2011).*

This information has to be given again on placement of the securities (pt. 10.4.1, lit. g, no 2.2.1 - 2.2.3; 4, Annex 2, Order FSFR 11-46/pz-n/2011).

(iii) the maturity structure of cover assets and covered bonds; and

Fullfilled: In the prospectus the issuer has to publish detailed information on the content, structure and volume of the cover pool (pt. 9.1.5.5, Annex 2, Order FSFR 11-46/pz-n/2011):

> *Volume and content of the cover pool (including e. g. amount of outstanding mortgage loans in RUB and foreign currency, LTVs, average interest, average duration)(lit. v).*

This information has to be given again on placement of the securities (pt. 10.4.1, lit. g, no 2, Annex 2, Order FSFR 11-46/pz-n/2011).

(iv) the percentage of loans more than ninety days past due;

Fullfilled: In the prospectus the issuer has to publish detailed information on the content, structure and volume of the cover pool (pt. 9.1.5.5, Annex 2, Order FSFR 11-46/pz-n/2011):

> *Breakdown for up to 30, 30 – 60, 60 – 90, 90 - 180 and over 180 days (lit. z, h).*

This information has to be given again on placement of the securities (pt. 10.4.1, lit. g, no 5, Annex 2, Order FSFR 11-46/pz-n/2011).

(b) the issuer makes the information referred to in point (a) available to the institution at least semi-annually.

Fulfilled: This information has to be given also in the quarterly report of the issuer (pt. 8.4.1, lit. g, no 2 - 8, Annex 3, Order FSFR 11-46/pz-n/2011). Such reports have to be published in the internet (pt. 1.8, 1.9 Order FSFR 11-46/pz-n/2011).

Article 208

Requirements for immovable property collateral

1. Immovable property shall qualify as eligible collateral only where all the requirements laid down in paragraphs 2 to 5 are met.
2. The following requirements on legal certainty shall be met:

(a) a mortgage or charge is enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement and shall be properly filed on a timely basis;

(b) all legal requirements for establishing the pledge have been fulfilled;

(c) the protection agreement and the legal process underpinning it enable the institution to realise the value of the protection within a reasonable timeframe.

Fulfilled. Art. 3, sec. 6, para. 1, subsec. 2: The mortgage has to be registered – to be a perfected lien. Realisation of the value: See Stöcker/Stürner[54], pp. 60 – 81 (esp. pp. 80 f.; no 25 and 26).

3. The following requirements on monitoring of property values and on property valuation shall be met:

   (a) institutions monitor the value of the property on a frequent basis and at a minimum once every year for commercial immovable property and once every three years for residential real estate. Institutions carry out more frequent monitoring where the market is subject to significant changes in conditions;

   (b) the property valuation is reviewed when information available to institutions indicates that the value of the property may have declined materially relative to general market prices and that review is carried out by a valuer who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process. For loans exceeding EUR 3 million or 5 % of the own funds of an institution, the property valuation shall be reviewed by such valuer at least every three years.

   Institutions may use statistical methods to monitor the value of the property and to identify property that needs revaluation.

   Fulfilled. For a privileged weighting of mortgage secured housing credits to individuals – among others – an annual re-valuation is obligatory: Instruction CBRF No 134-I/2012, Annex 1, designation code "8806".

4. Institutions shall clearly document the types of residential and commercial immovable property they accept and their lending policies in this regard.

   Fulfilled. Art. 3, sec. 6, para. 1, subsec. 1 – Necessary are excerpts from the land register regarding the property.

   The cover register itself has to contain information on the different types of cover assets (pt. 3.2 of the Register Maintenance Rules).

5. Institutions shall have in place procedures to monitor that the property taken as credit protection is adequately insured against the risk of damage.

   Fulfilled. 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).

Article 229

Valuation principles for other eligible collateral under the IRB Approach

1. For immovable property collateral, the collateral shall be valued by an independent valuer at or at less than the market value. An institution shall require the independent valuer to document the market value in a transparent and clear manner.

   Fulfilled. Art. 3, sec. 2, subsec. 1. The valuation has to be done by an independent appraiser. Independence is defined in Art. 16 of the Valuation Law.

   Art. 3, sec. 2, para. 1; sec. 3, para. 2: Eligible are mortgage secured loans up to 80% for first or up to 70% of the market value for second ranking mortgages.

54 Stöcker, Otmar M. / Stürne, Rolf: Flexibility, Security and Efficiency of Security Rights over Real Property in Europe – Volume III (Results of the Workshops of the Round Table "Security Rights over Real Property" held in Berlin 2009), 2nd revised and extended edition Berlin 2010 (vdp's - Association of German Pfandbrief-Banks - publication series, vol. 44).

In those Member States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions the property may instead be valued by an independent valuer at or at less than the mortgage lending value. Institutions shall require the independent valuer not to take into account speculative elements in the assessment of the mortgage lending value and to document that value in a transparent and clear manner.

Not applicable.

The value of the collateral shall be the market value or mortgage lending value reduced as appropriate to reflect the results of the monitoring required under Article 208(3) and to take account of any prior claims on the property.

Fulfilled. Art. 3, sec. 2, para. 1; sec. 3, para 2.: Eligible are mortgage secured loans up to 80% of the market value of first ranking or up to 70% of the market value of second ranking mortgages.

Article 4

Definitions

1. For the purposes of this Regulation, the following definitions shall apply:

(76) 'market value' means, for the purposes of immovable property, the estimated amount for which the property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without being under compulsion;

Fulfilled. Pt. 6 FSO, No 2[55]: In determining the market value, the most likely price is, for which the object can be exchanged on an open market under conditions of competition, when the parties of the transaction are acting prudently, posses the necessary information and the amount of the price of the transaction is not affected by extraordinary circumstances.

X. ADDITIONAL INFORMATION

Investment regulations

The EU investment regulations for mortgage obligations are not transferred into Russian law. Nevertheless, different investment rules and privileges for mortgage securities do exist. In any case the investment rules are always including further requirements for mortgage securities to be eligible for investment[56] and the CBRF's Lombard list[57]. For taxation and purchase programs for mortgage obligations, see ECBC Fact Book 2012, pp. 426 - 429.

55 Order by the Ministry of Economic Development and Trade dated 20 July 2007 No 255 "On confirmation of the Federal valuation standard "Objective of valuation and types of value (FSO No 2)""; Rossiyskaya gazeta dated 04.09.2007 No 194, Reg No 10045 (23.08.2007).

56 For details, see ECBC Fact Book 2010, pp. 269 – 271 (regarding pension funds, investment funds, insurance companies and other institutional investors).

57 For details, see ECBC Fact Book 2011, pp. 343- 344.

> Figure 1: Overview over the issues of bank mortgage obligations (covered bonds)[58]

	Date	Issuer	Tranches	Volume		Interest	Remarks	Maturity
				mRUB	mEUR[59]			
1	11.10.07	Moscow Mortgage Agency		2,000.0	56.7	9.00% 12.5%	1-8 coupon 9-12 coupon 13-32 coupon by issuer	01.10.2015
2	16.12.09	VTB 24		15,000.0	341.3	9.70%		10.12.2014
3	14.09.11	Unicredit-bank		5,000.0	121.3	8.20%		07.09.2016
4	21.09.11	VTB 24	 A B	5,000.0 3,333.3 1,666.7	116.5 77.7 38.8	 9.00% 3.00%		26.11.2043
5	9.11.11	Delta-Credit		5,000.0	119.2	8.33%	1-6 coupon 7-10 coupon by issuer	02.11.2016
6	14.09.12	VTB 24	 A B	6,000.0 4,000.0 2,000.0	148.0 96.6 49.3	 9.00% 3.00%		15.09.2044
7	11.12.12	Delta-Credit		5,000.0	125.5	9.15%	1-6 coupon	05.12.2017
8	2.04.13	Delta-Credit		5,000.0	125.5	8.50%	1-12 coupon	02.04.2016
9	23.05.13	VTB 24	 A B	6,000.0 4,000.0 2,000.0	148.8 99.2 49.6	 9.00% 3.00%		01.09.2044
10	10.07.13	Delta Credit		5,000.0	117.3	8.65%	1-6 coupon	04.07.2018
11	5.09.13	Delta-Credit		5,000.0	113.5	8,45%	1-6 coupon	30.08.2018
12	18.12.13	VTB 24	 A B	12,300.0 8,200.0 4,100.0	271.7 181.2 90.6	 9.00% 3.00%	 1-132 coupon 1-132 coupon	18.06.2046
13	27.03.14	Delta-Credit		5,000.0	102.1	12%	1-40 coupon	27.03.2024
Total				81.300,0	1,907.4			

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/41/Mortgage_Obligations_

58 Details of the issues can be found on www.cbonds.info.
59 CBRF exchange rate as of date of issue.

3.28 SINGAPORE

By Colin YS Chen, DBS Bank, and Franz Rudolf, UniCredit Bank

I. FRAMEWORK

On 31 December 2013, the Monetary Authority of Singapore (MAS) published its regulations regarding the issuance of covered bonds by banks incorporated in Singapore (MAS Notice 648). The regulations became effective on 31 December 2013, and the requirements set out in the notice are mandatory for Singapore's banks as MAS Notice 648 is part of The Banking Act in Singapore. The regulation outlines MAS' rules relating to the issuance of covered bonds by banks incorporated in Singapore and will enable Singapore's banks to gain access to longer term, stable funding options as well as to facilitate the diversification of funding sources for the banking and financial markets in Singapore. As of the time of writing, there were no Singapore covered bonds outstanding.

Singapore's covered bonds will be based on contractual agreements and will be governed by the law of contracts under common law, which applies to all elements of the covered bond structure. This – together with the implemented specific covered bond regulations – creates a framework comparable with that of other European jurisdictions, e.g. in the UK, via a more prescriptive regulatory framework.

Singapore's legal system is similar to the legal system in the UK in that the covered bond structure is fundamentally based on statutes or acts, which have been formally enacted by the legislative authority of the Republic of Singapore. It is considered a primary authority and source of law and determines the applicable legislation. The MAS guidelines arising from the MAS Notice 648 provide clarity on the characteristics of a Singapore covered bond.

Singapore covered bonds will be a direct and unconditional obligation of the issuer, and in the event of a default or insolvency of the issuer, investors in the covered bond will have dual recourse: first, an exclusive senior secured claim on the pool of cover assets and second, a senior unsecured claim on the issuer. The cover pool assets will be held in a special purpose entity, which, in turn, will provide a guarantee in respect of the principal and interest payments under the covered bonds' outstanding. A bond/security trustee is appointed to hold the security over the cover pool for the benefit of the covered bond investors.

II. STRUCTURE OF THE ISSUER

In the MAS Notice 648 covered bonds are defined as "bonds, notes or other debentures issued by a bank or an SPV (Special Purpose Vehicle) where the liabilities to the holders of such covered bonds and any liabilities arising from the enforcement of the rights of the holders of the covered bonds are: (a) secured by a cover pool; and (b) recoverable from the bank where the cover pool is insufficient to pay off such liabilities." This implies the dual recourse nature of covered bonds with a claim of covered bond holders against the cover pool as well as the issuing bank. The cover pool, in this context, comprises the eligible assets beneficially owned by the bank or an SPV for the purpose of securing the liabilities to the holders of the covered bonds only. MAS Notice 648 is applicable to all banks incorporated in Singapore. In order to issue covered bonds, the bank has to notify MAS at least one month prior to the issuance of covered bonds. In addition, issuers will have to submit to the MAS a Memorandum of Compliance, confirming that the guidelines with respect to the program and issuances for covered bonds have been adhered to and complied with.

III. COVER ASSETS

The cover pool may consist of the following assets, according to Paragraph 6 of MAS Notice 648:

> Mortgage loans secured by residential property ("residential mortgage loans"), whether in Singapore or elsewhere (no geographic limitation to mortgage loans); the loan-to-value (LTV) limit is set at 80%, taking into account the current market value of the residential property

- Any other loans secured by the same residential property as the residential mortgage loans
- Assets, including intangible properties, that form part of all the security provided for the residential mortgage loans, such as guarantees and indemnities
- Derivatives held for the purpose of hedging risks arising from the particular issuance of covered bonds
- Cash (including foreign currency)
- Singapore Government Securities
- MAS Bills

The aggregate value of substitute collateral (cash, treasuries and MAS Bills) is limited to 15% of the cover pool.

MAS imposed to limit the amount of collateral in the cover pool at 4% of total assets of an issuer. Total assets of the bank includes assets of the branches but does not include assets of the subsidiaries of the bank. For the purpose of determining the total assets of a bank, the bank shall exclude assets it uses to meet regulatory requirements under sections 38, 39 and 40 of the Banking Act, section 8 of the Deposit Insurance and Policy Owners' Protection Schemes Act and other regulatory requirements as may be prescribed or specified by MAS. Commercial mortgage loans or public sector loans are not eligible.

IV. VALUATION AND LTV CRITERIA

The legal framework sets an 80% loan-to-value (LTV) limit for the eligibility of residential mortgage loans. The LTV limit is a soft limit, meaning that in case a mortgage loan exceeds 80%, the loan can still be included in the cover pool, but only the value up to 80% is given credit to when determining the value of the cover pool. The value of the underlying collateral is determined by the current market valuation of the residential property that is used to secure the residential mortgage loan. A valuation of residential properties used to secure the loans shall be conducted on an annual basis.

V. ASSET - LIABILITY MANAGEMENT

Paragraph 6(h) of MAS Notice 648 stipulates a mandatory minimum overcollateralization (OC) of 3% on a nominal basis as "... the value of assets in a cover pool shall be at least 103% of the face value of the covered bonds secured by the assets at all times." Covered bond issuers shall, in accordance with Paragraph 8(a) of MAS Notice 648, perform regular asset coverage tests (ACTs) to ensure collateral quality and the proper level of overcollateralization. In addition, regular stress tests on risks related to default, prepayment, currency, interest rate, counterparty and liquidity have to be performed. Details regarding these tests will be addressed in the respective covered bond programs of Singapore issuers.

VI. TRANSPARENCY

Covered bond issuers shall disclose to the covered bond holders the results of asset coverage tests (ACTs) performed and cover pool characteristics on a regular basis and in any event, at least every quarter, according to Paragraph 8(e) of MAS Notice 648.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

According to Paragraph 8(b) of MAS Notice 648, a cover pool monitor shall be appointed. The cover pool monitor, who has to be an external third party qualified to be an auditor under the Companies Act (Cap 50), has to verify the compliance of the covered bond issuer with MAS Notice 648 regulations and report these to MAS. A certified report has to be submitted to the Authority annually in the first quarter following the end of the bank's financial year. The duties of the cover pool monitor explicitly include to: 1. verify annually that the bank complies with covered bond-specific regulations (asset cap, eligible assets, LTV limits, overcollateralization, et al as defined in Paragraph 6(a) to (h) of MAS Notice 648); 2. verify annually that the bank keeps an accurate register of the assets in the cover pool; 3. assess the adequacy of the bank's risk management process and internal controls relating to the covered bond program annually; 4. submit a certified report to MAS annually on compliance with covered bond regulations; and 5. report to MAS immediately if it becomes aware that the bank has breached any of the conditions imposed.

Singapore's covered bond regulations stipulate that the issuing bank shall ensure adequate risk management processes and that internal controls are in place to manage the risks arising from the issuance of covered bonds, including appropriate governance arrangements and regular stress tests on risks arising from issuing covered bonds such as default, pre-payment, currency, interest rate, counterparty and liquidity risks. This also includes having governance processes in place with respect to the authority to approve any issuance of the covered bond. Finally, regulations state that the board and senior management of the issuer are responsible for conducting due diligence in assessing the risks associated with issuing covered bonds and ensuring that risk management processes that are put in place for covered bonds are adhered to.

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

Given that Singapore's legal system is based on Commonwealth common law, a similar structure applies as used for the issuance of covered bonds in the UK, Canada, Australia, or New Zealand. Thus, covered bonds will be issued by a bank, with the cover pool collateral sold by way of an equitable assignment to a Special Purpose Vehicle (SPV). The covered bond will benefit from dual recourse on the issuer and the cover pool. This structure ensures the segregation of the cover assets from the insolvency estate of the issuer in the case of an issuer default. The contractual agreements for the issuance of covered bonds are structured within the general legislation in Singapore.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Singapore covered bonds are neither Article 52(4) UCITS nor Article 129 CRR compliant given that Singapore is not a member state of the European Union.[1] As such, it is unlikely that Singapore covered bonds will benefit from preferential risk-weighting for regulatory capital purposes. However, regulations constitute a covered bond framework that broadly complies with European standards. Once issuance of covered bonds has started in Singapore, covered bonds are expected to be LCR eligible in Singapore.

X. ADDITIONAL INFORMATION

The mortgage loan-to-GDP ratio in Singapore was 45% in 2013, up from 44% in 2012. Home ownership is relatively high and is dominated by the public home ownership sector (Housing & Development Board; HDB). According to data from MAS, approximately 90% of the total housing stock is owner occupied with 76% being public housing and the remainder, private housing. Landed housing comprises approximately 6% of the total housing stock. Housing loans granted rose 2% to SGD203 bn from SGD199bn in the previous year. Owner-occupied housing loans amounted to SGD 182.5 bn up from SGD 142.5 bn in 2013. The average loan-to-value ratio was 47% and the total non-performing loan ratio was 0.3% as of end-2013.

ECBC Covered Bonds Comparative Database: http://www.ecbc.eu/framework/111/Singapore_Covered_Bonds

1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position

3.29 SLOVAKIA

By Jaroslav Sobolič and Viktória Múčková, CSOB

I. FRAMEWORK

According to Articles 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 (Article 16, paragraph 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) (Article 16, paragraph 5). In order to become a mortgage bond issuing institution, the respective bank has to apply for a license. The minimum amount of cash contribution to the bank's equity capital necessary to establish a mortgage bond issuing institution is SKK 1,000,000,000 (EUR 33 m) or an equivalent amount in fully convertible foreign currency, which is twice the amount necessary to establish a non-mortgage bond issuing bank. Furthermore, the licence application has to contain details on the minimum requirements, as outlined in Section II.:

> Article 16
>
> (4) The total par value of issued mortgage bonds must be covered at least in the same amount and at least with the same yield as the par value of the mortgage bank's receivables from mortgage loans, and this shall represent due (ordinary) coverage.
>
> (5) Due coverage of issued mortgage bonds may be replaced by substitute coverage at most up to the level of 10% of the total par value of issued mortgage bonds.

- > The methods of keeping a mortgage register;
- > The proposal for appointment of the mortgage controller (trustee) and his/her deputy;
- > The real estate assessment methods (valuation); and
- > The method of keeping a separate analytical record of mortgage activities within the bank's accounting system.

As the criteria indicated in the criteria above, in order to be distinguishable from the insolvency estate of the bank, the mortgage loans serving as due (ordinary) coverage for mortgage covered bonds, just as all other items serving as substitute collateral, have to be recorded in separate mortgage (coverage) register by the issuing bank.

With respect to the general approach to covered bonds the model, applied by Slovak 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 Slovak covered bond law defines the conception of temporary mortgage bonds.

Within eighteen months following the effective date of mortgage business license, a bank may issue, upon a decision taken by its general meeting, temporary mortgage bonds in form of bearer securities with a total nominal value not exceeding 50% of the bank's basic capital. The bank is obliged to exchange such temporary mortgage bonds for mortgage bonds covered in accordance with Article 16, paragraphs 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 Slovak 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 Slovak 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 Article 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 Slovakia;

> Deposits in branches of foreign banks in the Slovakia;

> 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(2), a mortgage bank shall lower the value of the real estate by the amount of claims guaranteed by such lien or transfer restrictions. A mortgage bank shall only be bound by its own valuation of real estate, in accordance with Article 73(2).

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 of experience in economics or law in the banking sector, shall be deemed professionally competent. A person shall be deemed to have the necessary integrity if he has not been lawfully sentenced for a criminal offence committed in the discharge of a management office or any intentional criminal offence.

Article 80, Act on Banks:

1) A mortgage controller shall supervise the issuance of mortgage bonds and municipal bonds with regard to their particulars and coverage pursuant to a separate regulation.
2) Prior to each issue of mortgage bonds or municipal bonds, a mortgage controller shall be obligated to issue a written certificate testifying that they are covered in accordance with a separate regulation, and that an entry was made in the register of mortgages.
3) A mortgage controller shall check whether a mortgage bank provides mortgage and municipal loans, including their securing through mortgage and whether a mortgage bank meets its obligations in respect of the mortgage register in accordance with this Act and other generally binding regulations.
4) If requested by a mortgage bank, a mortgage controller shall be obligated to assist in activities related to the performance of mortgage operations, which could not be completed by the mortgage bank without his assistance.

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

A cover register permits the identification of the cover assets. The register records the cover assets being used to cover HZL. A list of mortgage and municipal loans and their amounts, liens and claims of a mortgage bank under mortgage and municipal loans that serve to cover mortgage and municipal bonds, or other assets serving as substitute coverage, must be kept separately by a mortgage bank in its *register of mortgages* (Article

76(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(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(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 (Article 8, Article 28 (2), Article 50, Article 67), also Article 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(2), Articles 69 and 176 to 196 of Act No. 7/2005 Coll. on bankruptcy as amended – shall secure secured receivables of mortgage (municipal) bonds owners against the mortgage bank for the payment of the nominal value and yields upon mortgage (municipal) bonds".

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR). Slovak "*Hypotekárny záložný list*" fully comply with the requirements of Article 52(4) UCITS and Article 129(1) CRR.[1]

Article 45 (7) and (11) of Collective Investment Act

Article 45(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.

1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

Article 45(11): Bonds which are issued in the Slovakia and meet the criteria laid down in paragraph 7 shall be deemed to include **mortgage bonds** and **municipal bonds** (municipal debt) issued by a bank which, with the funds raised from their sale, provides a municipal loan to a municipality or higher territorial fund share, and provided that these municipal bonds are guaranteed in accordance with the conditions stipulated by a separate law (Act on Bonds).

With regard to the bonds mentioned in paragraph 7 that are issued in a Member State, the management company shall take into account the similar list of bonds compiled in accordance with the law of this Member State, provided that such a list exists.

Finally, Slovak institutional investors investment legislation allows:

> Mutual funds to invest up to 25% of their assets in HZL;

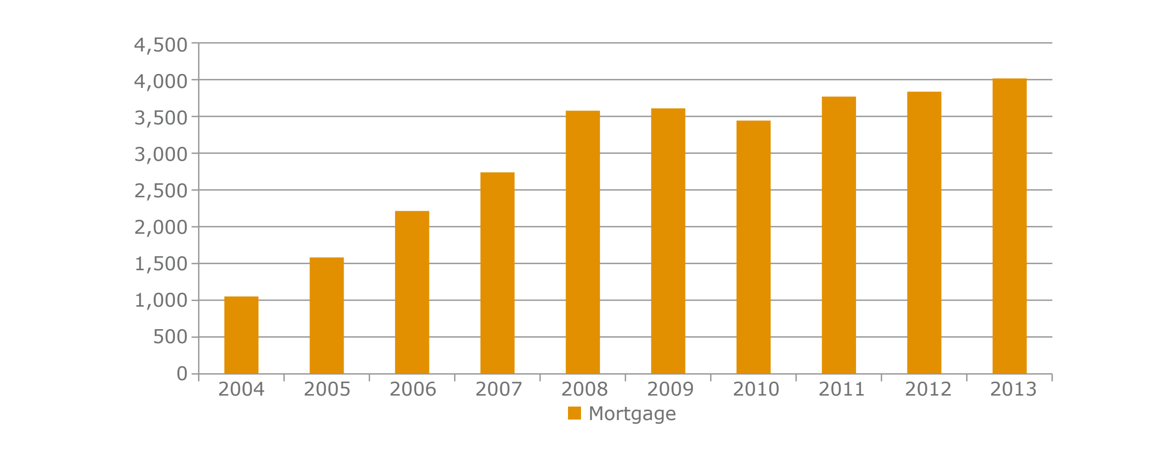
> Insurance companies up to 20 % of their technical reserves in HZL, and

> Pension funds up to 15 % of their assets in HZL.

IX. ADDITIONAL INFORMATION

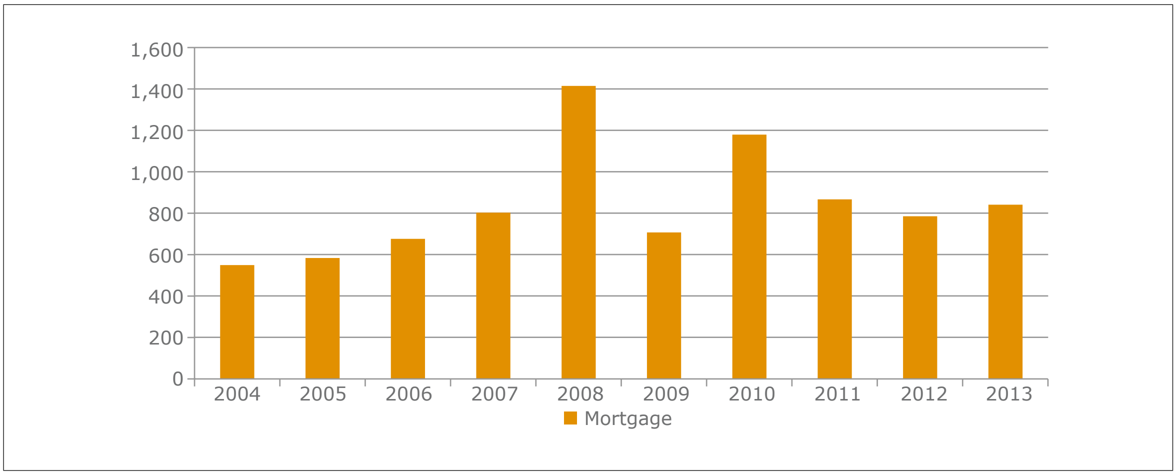
Irrespective to the mortgage bond, the new cover private placement bond was issued during the year 2013. Company TMR issued the cover bond not according to special regulation and law mentioned above. The bond issue was prepared as bullet bond which is covered by a lien on properties. The coverage and legal framework was technically defined in terms and conditions.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2004-2013, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2004-2013, EUR M



Source: EMF/ECBC

Issuers: There were nine issuers of covered bonds: one issuer of cover bond TMR and eight issuers of mortgage bonds in Slovakia as of the end of 2013: CSOB, Dexia Banka, Istrobanka, Volksbank, OTP Banka Slovensko, Slovenská sporitelna, Tatra Banka, UniCredit Bank (Slovakia) and Všeobecná úverová Banka.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/42/Slovakian_Covered_Bonds

3.30 SLOVENIA

By Damjana Lavrič, Matjaž Grčar, Maja Koritnik; Nova Ljubljanska banka d.d., Ljubljana

I. FRAMEWORK

The legal basis for covered bond issuance in Slovenia is the **Mortgage Bond and Municipal Bond Act** (Official Gazette of the Republic of Slovenia, No. 10/12 and No. 47/12, hereinafter "Covered Bond Act"). Together with the secondary legislation (the regulations of the Bank of Slovenia[1]) outlined below, it represents the legislative framework for mortgage and municipal bonds.

> **Regulation on the conditions for obtaining an authorisation for issuing mortgage and municipal bonds** (Official Gazette of the Republic of Slovenia, No. 17/2012) which regulates in detail the requirements for obtaining an authorisation to issue mortgage and/or municipal bonds;

> **Regulation on matching the cover pool with the outstanding mortgage and municipal bonds** (Official Gazette of Republic of the Slovenia, No. 17/12) which determines detailed rules for matching cover assets and liabilities from issued mortgage or municipal bonds based on the net present value principle, and 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 conditions for inclusion of derivative instruments in the cover pool of mortgage and municipal bonds** (Official Gazette of the Republic of Slovenia, No. 17/12) sets out the maximum level of derivative instruments for inclusion into the cover pool, the form of derivative instruments, the type of counterparties and other detailed criteria;

> **Regulation on the documentation for proving the fulfilment of conditions for the cover register administrator appointment** (Official Gazette of the Republic of Slovenia, No. 17/12) regulates the conditions for appointing the cover register administrator[2] of a cover register and for acquiring a Bank of Slovenia's authorisation to act as the cover register administrator of a cover register.

In addition the Bank of Slovenia adopted **Guidelines for managing the records of the cover register** (Governing Board of the Bank of Slovenia, dated 28.2.2012) which set out the guidelines regarding the content, the form and the way of management of the cover register's records.

II. STRUCTURE OF THE ISSUER

The issuer of covered bonds under the Covered Bond Act can be a bank holding a valid banking license issued in accordance with the Banking Act. Further, the issuer must have obtained a license from the Bank of Slovenia for issuing the relevant type of covered bonds (i.e. mortgage bonds, municipal bonds, or both).

In order to obtain the Bank of Slovenia's license for issuing covered bonds, the issuer must prove to the satisfaction of the Bank of Slovenia that it complies with the requirements set out in Article 9 of the Covered Bond Act (detailed provisions set out in Regulation on the conditions for obtaining an authorisation for issuing mortgage and municipal bonds) as outlined below:

> The issuer must have in place systems for managing risks associated with the issuance of the mortgage and municipal bonds, as well as risks associated with cover assets;

1 The central bank.

2 Cover register administrator is entitled to verify the accuracy and completeness of the information on the cover assets and covered bonds, measuring compliance with the statutory tests on an on-going basis and approving the entries in and removals of cover assets from the cover register.

> The issuer must ensure an adequate number of qualified employees, be organizationally and technically qualified for issuing mortgage and municipal bonds and to grant mortgage loans, public loans and other financing to legal entities;

> The issuer must ensure that the activities concerning granting mortgage loans and loans to public sector entities and issuing mortgage and municipal bonds are conducted separately from its other business activities;

> The issuer must have in place rules for maintaining the cover register;

> The issuer must have in place the rules for property valuation and must either employ for indefinite period and on full-time basis or engage contractually at least one independent property valuator.

Covered Bond Act envisages the on-balance sheet structure of covered bonds. The cover assets remain the property of the issuer until the insolvency of the issuer or withdrawal of the issuer's license to issue covered bonds. Upon the said events, the cover assets are segregated from the general assets of the issuer and used for repayment of the obligations under the covered bonds in priority to any other assets of the issuer (Covered Bond Act, Articles 15(1) and 45(1)).

III. COVER ASSETS

The cover assets can only be included in the cover pool of covered bonds to the extent that they satisfy the criteria set out in the Covered Bond Act and are free and clear of any lien or other encumbrance.

The cover pool of mortgage bonds may consist of receivables arising from (i) the loans secured by a mortgage on residential property located in the EEA or Switzerland, (ii) the loans secured by mortgage on commercial property located in the EEA or Switzerland (up to 20% of cover assets), (iii) the complementary cover assets (up to 20% of cover assets) and (iv) the derivative instruments (up to 12% of cover assets).

Cover pool of municipal bonds may consist of receivables arising from (i) the loan granted to, or debt securities issued by, an eligible state[3] or eligible local community[4], (ii) the loans granted to, or debt securities issued by, another legal entity provided that the obligations in respect to such loans or securities are guaranteed by an eligible state under an eligible guarantee, (iii) the complementary cover assets (up to 20% of cover assets) and (iv) the derivative instruments (up to 12% of cover assets).

The complementary cover assets may comprise of (i) cash on the account maintained at the Bank of Slovenia, (ii) marketable debt securities issued by an EEA member state and Switzerland (to the extent that its credit rating is equal to or higher than the Eurosystem's credit rating threshold) or its central bank or ECB, or other debt securities issued by EIB, EBRD or other bank according to criterion of ECB.

Issuer can also include the derivative instruments in the cover pool if they reduce risks associated with the cover assets, interest and/or currency mismatches applicable to cover assets and covered bonds.

There are certain other limits concerning the cover assets which comprise the cover pool (Covered Bond Act, Articles 25 and 38(4)):

> Up to 5% of the cover pool may consist of mortgage loans secured by a mortgage on residential property under construction;

3 Eligible state is an EEA member state and Switzerland, to the extent that its credit rating is equal to or higher than the Eurosystem's credit rating threshold.

4 Eligible local community is a local community in EEA and Switzerland, to the extent that its credit rating is equal to or higher than the Eurosystem's credit rating threshold.

> Up to 10% of the cover pool may consist of mortgage loans secured by a mortgage the registration of which is still pending, provided that the process of registration is completed within 12 months from the date of filing of the application;

> Up to 20% of the cover pool may consist of mortgage loans to the same person or a group of legal entities which qualifies as a group of affiliated persons in accordance with the Banking Act, without prejudice to the rules on largest exposure applicable under the Banking Act.

IV. VALUATION AND LTV CRITERIA

The level of receivables from mortgage loans that can be taken into consideration for the cover assets must not exceed: (i) 80% of the mortgage lending value of the mortgaged property or, if the issuer decides to use the general market value, 50% of the general market value of property for loans secured by mortgage on residential properties; (ii) 60% of the mortgage lending value of the mortgaged property for loans secured by mortgage on commercial properties. When the level of receivables from mortgage loans exceeds the above restrictions, only an appropriate portion of the loan may be considered as cover assets (Covered Bond Act, Article 28).

The value of the residential and commercial properties can be estimated as the mortgage lending value[5] or market value[6]. Both, the mortgage lending value or market value, are determined by an independent property appraiser in compliance with the international property standards (Covered Bond Act, Article 26(4)). Residential properties can alternatively be estimated also by the use of a general market value appraised by the mass appraisal methods (Covered Bond Act, Article 27). The value of a property is determined individually for each real property (Covered Bond Act, Article 30(1)).

During the property mortgage loan term, the issuer must regularly monitor the value of the mortgaged property and re-assess this value at least once a year for commercial property and at least once every three years for residential property. Issuers may use statistical methods to monitor the value and identify the real property that requires revaluation. Further need for revaluation arises should the value of the real property and the general market prices of the real property in the area where the real property is situated have dropped by more than 20% in the period from the last valuation, or if a borrower is late in meeting his obligations for mortgage loans by more than 90 days (Covered Bond Act, Article 30(4)).

V. ASSET - LIABILITY MANAGEMENT

The issuer may issue mortgage or municipal bonds only to the extent that is necessary to ensure the coverage for liabilities from bonds in circulation and derivative instruments at all times by means of cover assets in at least the same nominal amount (Covered Bond Act, Article 22(1)).

Notwithstanding the provision regarding the nominal amount coverage, the matching of the cover assets with the liabilities from mortgage or municipal bonds and the derivative instruments is ensured at all times according to the present value principle; in this case, the cover assets' present value must exceed the present value of liabilities for mortgage or municipal bonds by at least 2% (Covered Bond Act, Article 22(2)).

The maturities, interest rates and currencies of the cover assets included in the cover register are adjusted to the maturities, interest rates and currency of the liabilities under the covered bonds and the derivative instruments (Covered Bond Act, Article 22(3)).

5 The mortgage lending value of real property shall be the value of real property as determined on the basis of prudential analysis of the possibilities of selling the property in the future carried out by an independent property appraiser by taking into consideration the long-term sustainability aspects of such property, the usual and the local market conditions, and its current and alternative proper uses without consideration of the speculative elements.

6 The market value of property is the price determined by an independent appraiser, at which the property could be sold by the seller to the buyer on the basis of a purely commercial relationship, without coercion.

The compliance with the conditions referred to in previous paragraphs must be verified at least once a month.

In addition, stress tests (test of the impact of the change in interest rates and foreign exchange rates) must be performed at least once a month. The issuer must initiate the procedure to increase the cover pool assets should the stressed present value of covered assets not exceed the stressed present value of liabilities of covered bonds by at least 2%.

The issuer must keep cover assets reserves by comparing the amount of matured receivables from cover assets entered in the cover register with the amount of matured liabilities from the issued mortgage or municipal bonds and the matured liabilities from the derivative instruments entered into, on a daily basis over the next 180-day period. Following the comparison of the largest calculated difference between the matured liabilities and the matured receivables, the issuer must provide coverage in the form of complementary assets (Covered Bond Act, Article 23).

VI. TRANSPARENCY

The Slovenian banking sector closely follows the developments regarding the ECBC's and its members' initiatives and trends on transparency. It should be noted that there have been no covered bond issuances from the Slovenian market yet. However, the market initiative on the subject and, in particular, on the national transparency templates is currently being contemplated.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Obligation to keep a cover register

Issuer must keep a cover register and cannot transfer this task to other persons. The cover register includes the individual entries which represent cover assets for the issued mortgage or municipal bonds. The cover register also includes a record of all the mortgage or municipal bonds issued. The cover register reveals at all times the nominal value of cover assets and mortgage or municipal bonds in circulation (Covered Bond Act, Article 37). Only assets approved by the cover register administrator may be recorded in the cover register or struck off the cover register (Covered Bond Act, Article 38(3)).

When issuing mortgage and municipal bonds, the issuer must keep separate cover registers (Covered Bond Act, Article 51(2)).

Cover register administrator

Every issuer must have a cover register administrator[7] who is independent from the issuer and ensures that the cover register is maintained in accordance with Covered Bond Act, as well as the regulations issued on the basis thereof and performs the other tasks provided for by Covered Bond Act. The cover register administrator is appointed by the issuer (Covered Bond Act, Article 39).

The duties of the cover register administrator are: (i) to ensure that the cover assets provide coverage or the total value of the mortgage or municipal bonds in circulation and liabilities from the derivative instruments; (ii) to ensures the assets are registered in this register; (iii) prior to the issuance of mortgage or municipal bonds, the cover register administrator must confirm that the cover assets provide sufficient and adequate coverage for the bonds; (iii) to consider the issuer's requests for a cancellation of a mortgage as a security for the claims entered as coverage in the cover register; (iv) to forthwith notify the Bank of Slovenia when the cover register administrator determines that the cover assets do not sufficiently cover the mortgage or municipal bonds and liabilities from the derivative instruments, or that they are otherwise contrary to the provisions of

7 The cover register administrators shall be a person: (i) a certified public accountant who meets the requirements of the act governing auditing or persons with other professional qualifications; (ii) having previously obtained a licence from the Bank of Slovenia to perform the activities of cover register administrator; (iii) whose previous activity raises no doubt as to that person's suitability for the role of administrator (Covered Bond Act, Article 40).

the Covered Bond Act; (v) to regularly notify the Bank of Slovenia of its findings pursuant to the Covered Bond Act (Covered Bond Act, Article 41).

The responsibilities of the cover register administrator are: (i) to examine the books of account and other documents of the issuer that are in any way associated with the mortgage or municipal bonds and cover assets; (ii) to require from the issuer to keep the cover register administrator regularly informed of the performance of the cover asset-related repayments and any other changes associated with these assets (Covered Bond Act, Article 42).

Replacement of inadequate assets

The cover register administrator must require from the issuer to replace the inadequate mortgage loans if: (i) during the term of the mortgage loan, the value of real property declines to such an extent that the value of the outstanding mortgage loan exceeds the mortgage lending value or the real property's general market value level; or (ii) the borrower falls behind in meeting its payment obligations under the loan agreement for over 90 days; or (iii) the issuer receives the cover register administrator's written request related to the expiration of the time limit for entering the mortgage in the land register. In case of a decline in the real property value referred to in item (i), the issuer may supplement the existing receivables from mortgage loans by receivables from other mortgage loans or other suitable assets to the extent of the deficit in the cover assets resulting from a decline in the real property value (Covered Bond Act, Article 31).

Role of the Bank of Slovenia

The Bank of Slovenia supervises the implementation of the Covered Bond Act, grants authorisation to the bank prior to the issuance of the covered bond and grants license to the cover register administrator. In case of the issuer's insolvency, the Bank of Slovenia proposes to the court a cover assets trustee and is authorised to file a request to institute separate bankruptcy proceedings against the cover assets. The issuer and covered bond administrator have to regularly report to the Bank of Slovenia.

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

Segregation of cover assets

The cover assets that comprise the cover pool are evidenced by way of entry in the cover register; while they remain the property of the issuer, they are intended primarily for the payment of obligations under the covered bonds and the derivative instruments that are included in the cover pool (Covered Bond Act, Article 3(1)). Cover assets and complementary assets may not be used or pledged for any other purpose (Covered Bond Act, Articles 19(4) and 20(4)).

The issuer must ensure that the activities in connection with the covered bonds and cover assets are conducted separately from its other business activities (Covered Bond Act, Article 10).

Only the obligations of the issuer under the covered bonds and the derivative instruments can be enforced against the cover assets (Covered Bond Act, Article 37(5)). The law also sets limitations to the set-off rights of the debtors whose liabilities are included in the cover pool (Covered Bond Act, Article 37(6)).

Impact of the issuer's insolvency proceedings and the preferential treatment of the covered bond holders

Upon the issuer's insolvency, the cover pool is separated from the issuer's insolvency estate and the payment of obligations under the covered bonds and the derivative instruments, including the costs, from the cover assets is given priority over all other claims against the issuer (Covered Bond Act, Articles 45(1) and 44(1)). The consequences of the insolvency proceedings do not affect the issuer's obligations under the covered bonds and the derivative instruments (Covered Bond Act, Article 45(2)).

The court designates a cover assets trustee (who is not the same person as the issuer's insolvency administrator) entrusted with the management and disposal of cover assets to the extent necessary for the continuous payment of obligations under the covered bonds and the derivative instruments, for which no approval of the court is required (Covered Bond Act, Articles 46 and 47(1)). The court approval is required for the cover asset trustee's disposal of the cover pool and redemption of the covered bonds prior to their maturity, which is granted if such redemption increases the possibility of repayment of the issuer's obligations under the covered bonds and the derivative instruments (Covered Bond Act, Article 47(3)) – this is the only possible means of acceleration before the maturity of the covered bonds, they do not automatically accelerate in case of insolvency of the issuer nor can they be accelerated at the option of the holders (Covered Bond Act, Article 18).

The issuer's insolvency administrator may request the cover asset trustee to transfer to the issuer's insolvency estate such part of the cover assets that will, beyond any doubt, not be required for the payment of obligations under the covered bonds and the derivative instruments included in the cover pool; the decision on transfer vests with the court (Covered Bond Act, Articles 47(5) and (6). Once all the obligations under the covered bonds and the derivative instruments have been paid, the cover asset trustee transfers the remaining cover assets to the issuer's insolvency estate (Covered Bond Act, Article 47(7)).

Should the cover assets prove insufficient to ensure the continuous payment of obligations under the covered bonds and the derivative instruments, a separate insolvency proceedings are initiated against the cover assets at the request of the Bank of Slovenia; the cover asset trustee can give the initiative to the Bank of Slovenia (Covered Bond Act, Articles 49(1) and (2)). If such separate insolvency proceedings still do not result in full payment of the obligations under the covered bonds and the derivative instruments, the holders of the covered bonds and the creditors under the derivative instruments are entitled to file a claim for the outstanding part of their receivables in the issuer's general insolvency proceedings (Covered Bond Act, Article 49(3)).

Access to liquidity in case of insolvency

The cover asset trustee is entitled to borrow money if this is required to ensure continuous compliance with the payment obligations under the covered bonds and the derivative instruments (Covered Bond Act, Article 47(2)).

Sale and transfer of cover assets to other issuers

Once appointed, the cover asset trustee may transfer the entire cover pool and all obligations arising under the issued covered bonds to a substitute issuer who is willing to assume such rights and liabilities, subject to the prior approval of the Bank of Slovenia (Covered Bond Act, Article 48).

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk-weighting of covered bonds is regulated by two regulations adopted by the Bank of Slovenia, (Regulation on the calculation of capital requirements for credit risk under the standardised approach for banks and savings banks and the Regulation on the calculation of capital requirements for credit risk under the internal ratings based approach for banks and savings banks, both published in the Official Gazette of the Republic of Slovenia, No. 135/06, as amended). The banks using the standardised approach assign the risk-weightings to their covered bond exposures based on the risk weighting of the issuer (e.g. covered bonds of the credit institution with a 20% risk-weighting are assigned a 10% risk-weighting). Under the internal ratings based approach the loss given default (LGD) for covered bonds is set at 11.25%.

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR). The provisions of the Covered Bond Act fall within the criteria of Article 129(1) CRR as well as the criteria of Article 52(4) of the UCITS Directive.[8]

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/110/Slovenian_Covered_Bonds

8 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

3.31 SOUTH KOREA

By Hoin Lee, Kim & Chang and Frank Will, HSBC

I. FRAMEWORK

Efforts to create a covered bond market in Korea

Korea did not have legislation for covered bonds until recently when the Covered Bond Act ("Covered Bond Act") was passed by the National Assembly on December 19, 2013 and came into effect on April 15, 2014. Until now, domestic banks in Korea had been looking at covered bonds as an alternative source of funding and the Korea Federation of Banks, a major association of banks in Korea, set up a task force team in 2008 to pursue the introduction of covered bonds in Korea, including by way of a dedicated covered bond statute. Even prior to the Korea Federation of Banks task force team, market participants were looking into alternative structured covered bond structures utilizing Korea's Act on Asset-Backed Securitization (the "ABS Act").

Such efforts eventually led to Kookmin Bank's offshore covered bond issuance in May 2009 (the "KB Covered Bonds"). Kookmin Bank developed a structure on the basis of the securitization techniques under the ABS Act and the Trust Act that enabled the relevant asset pool to be "ring fenced" and effectively granted dual-recourse to its investors through contractual arrangements. The KB Covered Bonds were the first covered bonds issued out of Korea and the Asia-Pacific region.

Many Korean banks looked into possible issuance of similar structured covered bonds after Kookmin Bank's inaugural transaction. Due to the complex structure and favorable market conditions allowing banks to procure funding at acceptable rates, Korean banks did not follow through with covered bond issuance under the Kookmin Bank structured covered bond model.

Separately, in July 2010, the Korea Housing Finance Corporation ("KHFC") issued the second covered bond out of Korea and the first statutory covered bond transaction out of Asia. KHFC utilized the "mortgaged-backed bonds" (the "KHFC Covered Bonds") under the Korea Housing Corporation Act (the "KHFC Act") in issuing the covered bonds. The KHFC Act contemplates various financing options for KHFC and to issue mortgage-backed bonds is one of these options. Mortgaged-backed bonds are economically similar to covered bonds because the bond holders have a statutory priority right over a pool of assets segregated from the other assets of KHFC.

The successful issuance of the KHFC Covered Bonds in 2010 stimulated new interest for covered bonds in Korea, with KHFC Covered Bonds being considered as a potential alternative to traditional residential mortgage backed securities (RMBS) transactions as a funding source for Korean mortgage lenders. Several follow-on transactions have been completed that utilize KHFC as the issuer and the dual recourse feature of mortgage-backed bonds under the KHFC Act.

II. STRUCTURE OF THE ISSUER

1. KHFC Act

Eligible issuer

KHFC, which is wholly owned by the Korean government and the Bank of Korea, is the only eligible issuer of KHFC Covered Bonds. Pursuant to Article 31 of the KHFC Act, the holders of KHFC Covered Bonds have a statutory priority right of payment from a separately managed pool of mortgage loans designated as the underlying collateral for KHFC Covered Bonds (the "KHFC Cover Pool"). In addition, if principal and interest on a KHFC Covered Bond are not fully paid out of the KHFC Cover Pool, it can be paid from the general assets of KHFC. KHFC issues these bonds without transferring the cover assets to a separate legal entity and the bankruptcy remote cover assets are left on KHFC's balance sheet.

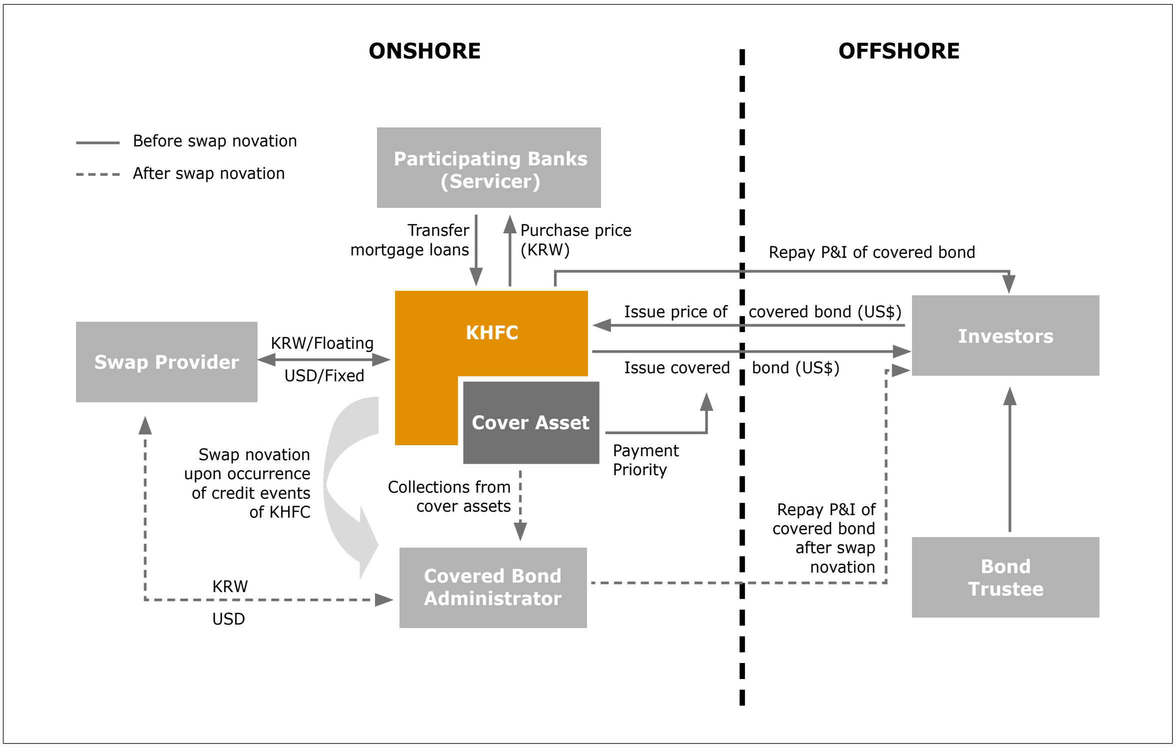
A bond trustee is typically appointed to act on behalf of the investors and an onshore covered bond administrator is appointed for the purpose of the automatic swap novation described below. The investors have dual recourse in respect of the KHFC Covered Bonds: (a) a senior unsecured claim to KHFC upon the occurrence of an issuer event of default or at maturity; and (b) a statutory priority right of payment over the KHFC Cover Pool.

In the case of KHFC Covered Bonds issued offshore, KHFC enters into a cross currency swap agreement and an interest rate swap agreement with the swap providers, pursuant to which KHFC will deliver KRW interest periodically and principal at maturity to the swap providers in exchange for U.S. dollar currency payments. The swap providers pay U.S. dollar interest periodically and principal at maturity. The swap agreement is subject to an automatic swap novation mechanism (the "Swap Novation") in which the swap providers, KHFC, and the covered bond administrator entered into a tripartite automatic novation agreement, which states that the swap agreement will be automatically terminated with KHFC and novated to the covered bond administrator upon the occurrence of certain events of default regarding KHFC, and that the mark-to-market valuation of the swap agreement as of the novation date will not be exchanged between KHFC and the swap providers or between KHFC and the covered bond administrator.

Subsequent to such events of default, the covered bond administrator will pay KRW generated from the KHFC Cover Pool to the swap providers in exchange for the U.S. dollar denominated payments, and the swap providers will pay the U.S. dollar denominated interest periodically and principal at maturity.

The following diagram illustrates the structure of the KHFC Covered Bonds transaction.

FIGURE 1: KHFC COVERED BONDS TRANSACTION STRUCTURE



Source: Kim & Chang

Issuance limit

KHFC may issue KHFC Covered Bonds up to 50 times of its paid-in equity capital.

2. Covered Bond Act

Eligible issuer

Eligible issuers of covered bonds under the Covered Bond Act (the "Covered Bonds") include (i) banks licensed and established under the Bank Act of Korea, (ii) the Korea Development Bank under the Korea Development Bank Act, (iii) the Export-Import Bank of Korea under the Export-Import Bank of Korea Act, (iv) the Industrial Bank of Korea under the Industrial Bank of Korea Act, (v) NH Bank under the Agricultural Cooperatives Act, (vi) the credit business division of National Federation of Fisheries Cooperatives under the Fisheries Cooperatives Act, (vii) KHFC under the KHFC Act, (viii) the Korea Finance Corporation under the Korea Finance Corporation Act, or (ix) any other company engaging in finance business pursuant to other laws as prescribed by the Presidential Decree of the Covered Bond Act (the "Presidential Decree"). The Presidential Decree came into effect on April 15, 2014 and does not stipulate any additional eligible issuers other than those already set out in the Covered Bond Act. Eligible issuers of Covered Bonds, however, must have equity capital of not less than KRW 100 billion, Bank for International Settlements (BIS) ratio of not less than 10%, and appropriate funding and operation structures and risk management procedures, etc.

Issuance limit

The Covered Bond Act prescribes that eligible issuers may issue Covered Bonds up to the ceiling set by the Presidential Decree which shall not exceed 8% of its total assets as of the end of the fiscal year immediately preceding the scheduled date of issuance and the Presidential Decree limits this to 4% of its total assets as of the end of the fiscal year immediately preceding the scheduled date of issuance. The Financial Services Commission (the "FSC"), which is the main financial regulator in Korea, reserves the right to restrict this further to 2% of its total assets taking into consideration various factors, such as collateralization ratio and financial condition including liquidity position.

III. COVER ASSETS

1. KHFC Act

The mortgage loans in the KHFC Cover Pool are acquired from certain Korean financial institutions that function as the originating banks. The individual mortgage loans included in the KHFC Cover Pool may change from time to time as a result of substitutions by KHFC, and KHFC is responsible for ensuring that the mortgage loans are properly serviced and will delegate its servicing responsibility to the originating banks, with each originating bank servicing those mortgage loans originated and sold by it to KHFC.

2. Covered Bond Act

The cover pool (the "Cover Pool") shall comprise of (1) the Underlying Assets, (2) the Liquid Assets and (3) Other Assets. The "Underlying Assets" shall include (i) residential mortgage loans with 70% or lower loan-to-value (LTV) ratio and first priority mortgage, obligors of which are not subject to insolvency proceedings, (ii) loan receivables against the government, a local government or a corporation incorporated under the special laws, (iii) Korean Treasury bonds, municipal bonds or bonds issued by a corporation incorporated under the special laws, (iv) mortgage loans secured by ships or aircraft with 70% or lower LTV ratio and is insured for an amount in excess of a prescribed minimum level (which is currently 110% of the sum of (a) the aggregate outstanding balance of the relevant loan and (b) any other outstanding debt of the issuer that are at least pari passu with such loan) and (v) asset backed securities issued under the ABS Act and KHFC Covered Bonds and residential mortgage backed securities issued pursuant to the KHFC Act. The following limitations are applicable to the residential mortgage loans comprising the Underlying Assets: (x) at least 20% must have a debt-to-income (DTI) ratio of 70% or less, (y) at least 30% must be fixed rate loans, and (z) if there are residential mortgage loans of which 50% or more of their outstanding principal balance may be set off against the relevant issuer, such residential mortgage loans should comprise 10% or less of all residential mortgage loans. The "Liquid Assets" shall comprise of cash, certificates of deposit with a maturity of no more than 100 days issued by financial companies other than the issuer of the Covered Bonds, bonds issued by any government as prescribed by the FSC, financial instruments issued by foreign financial companies as prescribed by the FSC similar to the certificates of deposit referred to above and deposits and term deposits at either domestic or foreign financial companies with maturity of 3 months or less. Finally, "Other Assets" shall comprise of collections and other property rights acquired from the Underlying Assets and the Liquid Assets and the claims acquired from derivatives transactions executed in order to hedge foreign exchange rate or interest rate risks and other risks associated with the cover pool pursuant to the Covered Bond issuance plan.

IV. VALUATION AND LTV CRITERIA

1. KHFC Act

KHFC's detailed rules for the purchase of residential mortgage loans stipulates the requirements of such loans that it can acquire from financial institutions, prescribing that if the DTI ratio is in excess of 44% but no higher than 100%, LTV shall not exceed 60%, while if DTI ratio is 44% or lower, LTV shall be 70% or lower for apartments or 65% or lower for general houses. However, if (i) the grace period is in excess of 1 year; (ii) the interest rate is floating rate; (iii) the credit rating is at or below a certain grade; or (iv) in the case of newly constructed apartments whose collateral valuation is based on their initial sale price, LTV shall be 60% or lower.

There is no statutory standard for valuation of residential mortgage loans that are included in KHFC Cover Pool. Instead, the valuation methods are set forth in individual transaction documents for the KHFC Covered Bonds which value residential mortgage loans between 100% and 0%, depending on the length of delinquency.

2. Covered Bond Act

LTVs for residential mortgage loans as well as loans secured by ships or aircrafts in the Cover Pool shall be 70% or lower. Valuation shall be carried out by reference to the closing market price of the relevant day on the securities exchange. Where no reliable market prices are available on the relevant day, book value, par value, purchase price, transaction price and price provided by an entity which satisfies statutory requirements shall be taken into account, alongside the prevailing exchange rate at the time of valuation. Where derivative transactions have been entered into for the purpose of hedging exposure to movements in foreign currency exchange rates, the exchange rates as specified in such derivative transactions themselves shall be used and non-eligible assets and derivative transactions shall be valued at "0".

V. HEDGING AND ASSET – LIABILITY MANAGEMENT

1. KHFC Act

In the case of KHFC Covered Bonds issued offshore, the underlying residential mortgage loans are denominated in KRW but the KHFC Covered Bonds are issued in foreign currency and KHFC entered into swap agreements to hedge the resulting currency risk. This swap agreement is subject to the Swap Novation described above.

There are no statutory regulations on overcollateralisation or excess yield of collateralized assets. However, the transaction documents in previous KHFC Covered Bonds have required the KHFC Cover Pool to satisfy an asset coverage test and portfolio yield test and the failure for the KHFC Cover Pool to satisfy the foregoing tests for a certain period of time becomes an issuer event of default which in turn triggers the management of the KHFC Cover Pool to be transferred to a separately appointed covered bond administrator, in addition to the above-mentioned Swap Novation.

2. Covered Bond Act

The total value of the Cover Pool shall be equal to or more than 105% (the"Required Overcollateralisation Ratio") of the total value of the covered bonds and the liquid assets shall not exceed 10% of the total value of the Cover Pool. The details of the valuation standard and method, etc. for each type of assets comprising the cover pool are prescribed by the Presidential Decree. The issuer shall prepare and maintain separate books for the management of the Cover Pool. If the total value of the Cover Pool is likely to fall below the Required Overcollateralisation Ratio or cover assets fail to satisfy the Cover Pool eligibility criteria set forth in the Covered Bond Act (the "Cover Asset Eligibility"), the issuer shall add or substitute the Underlying Assets and Liquid Assets without delay in order to comply with the Required Overcollateralisation Ratio and the Cover Asset Eligibility. In this case, the relevant assets shall be deemed to form part of the Cover Pool until the relevant assets are substituted.

Unlike the KHFC Act, the claims acquired from derivatives transactions executed in order to hedge foreign exchange rate or interest rate risks and other risks associated with the Cover Pool pursuant to the Covered Bond issuance plan are included in the Cover Pool as described above and the swap provider also has a priority right of payment from the Cover Pool under the Covered Bond Act. As such, we do not expect there to be a particular need to novate the relevant swap agreement to a third party.

VI. TRANSPARENCY

1. KHFC

To issue KHFC Covered Bonds, KHFC must register a securitization plan with the FSC and this securitization plan is available to the public on the FSS website. Amendments to the securitization plan after issuance must also be registered with the FSC.

The securitization plan should include (i) name of KHFC and location of its office, (ii) term of the securitization plan, (iii) the details, total sum and appraisal value of the residential mortgage loans as cover assets, (iv) types, total sum and issuance conditions of the KHFC Covered Bonds to be issued, (v) matters concerning management, operation and disposition of the residential mortgage loans as cover assets, and (vi) matters concerning the covered bond administrator.

2. Covered Bond Act

Any eligible issuer that intends to issue Covered Bonds must register the Covered Bond issuance plan and details of the Cover Pool with the FSC. The issuer must also register amendments to the issuance plan or the matters concerning the Cover Pool, while minor changes shall be reported to the FSC within seven days from the date of such change. The issuance plan should include (i) the terms and conditions of the Covered Bonds, (ii) qualification requirements of the issuer pursuant to the Covered Bond Act such as equity capital, balance sheet, etc., (iii) the details of the Cover Pool, (iv) total valuation amount and details of such valuation of the Cover Pool, (v) the Required Overcollateralisation Ratio, (vi) details of the Cover Pool monitor and (vii) information relating to protection of debtors, details of further issuance of Covered Bonds if relevant, funding plans for redemption of Covered Bonds and other matters relating to issuance, distribution and redemption of Covered Bonds as prescribed by the FSC.

The issuer is required to establish and monitor at least on a quarterly basis separate risk management standards and procedures relating to the issuance and redemption of the Covered Bonds. The issuer is also obligated to disclose on its website on a quarterly basis the result of risk management monitoring, the report prepared by the Cover Pool monitor and other information necessary. The FSC may request data concerning business or properties of the issuer and its administrator and the Cover Pool monitor, or investigate such business and properties if necessary for protecting the Covered Bond investors.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

1. KHFC Act

There are no explicit provisions in the KHFC Act on the KHFC Cover Pool monitor but independent third parties are appointed to supervise and monitor KHFC's management of the KHFC Cover Pool. For example, an accounting firm has been appointed as the cover pool monitor in previous KHFC Covered Bond issuances to be responsible for confirming whether the KHFC Cover Pool minimum maintenance requirements have been satisfied. In addition, the KHFC Covered Bond administrator is appointed in advance for the management of the Cover Pool in order to protect the KHFC Covered Bond holders upon occurrence of any issuer event of default including a bankruptcy event of KHFC.

2. Covered Bond Act

The issuer shall appoint with the approval from the FSC a Cover Pool monitor to monitor the eligibility of the Cover Pool independently. The Cover Pool monitor shall be (i) a person who qualifies as a bond administrator under the Korean Commercial Code, (ii) KHFC (excluding the case where the issuer is KHFC) or (iii) a corporation with equity capital of KRW 1 billion or more that has five or more administration personnel necessary for the performance of duties as a Cover Pool monitor including two or more experts such as lawyers, certified public accountants or certified public appraisers and one or more persons with experience in business related to Covered Bonds.

The Cover Pool monitor is authorized to take any actions in court or otherwise necessary for the management, maintenance and disposition of the Cover Pool. The Cover Pool monitor is obligated to submit on a quarterly basis a report to the FSC within 30 days of the end of each quarter on the performance of its duty as a Cover Pool monitor and provide it to the issuer and, upon request, the Covered Bond investors and other parties, as described below, who have a priority right of payment from the registered Cover Pool.

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

1. KHFC Act

Articles 30 and 31 of the KHFC Act state that (i) KHFC may issue the KHFC Covered Bonds with a statutory priority right of payment over the mortgage loans separately managed in accordance with the applicable KHFC Act securitization plan, and (ii) if mortgage loans in the KHFC Cover Pool are separately managed according to the applicable KHFC Act securitization plan, the investors will have a priority right of payment against such mortgage loans unless otherwise prescribed in other laws. Considering the legislative intent and history of these provisions, the statutory priority right of payment over the mortgage loans owned by KHFC was considered as having been granted to the investors through the registration with the FSC of the applicable KHFC Act securitization plan without taking any other actions necessary for the establishment or perfection of the statutory priority right.

KHFC is required to separately manage the mortgage loans included in the Cover Pool from its other assets on the basis of the applicable KHFC Act securitization plan.

2. Covered Bond Act

Article 13 of the Covered Bond Act states that (i) holders of Covered Bonds, (ii) swap providers, (iii) claimholders relating to the redemption/maintenance and management of the Covered Bonds and management/disposal and execution of the Cover Pool, and (iv) the Cover Pool monitor have a priority right of payment on the registered Cover Pool over third parties. Article 12 of the Covered Bond Act states that, in case of an issuer's insolvency, the Cover Pool shall not be subject to the issuer's insolvency proceedings, including compulsory execution, preservative measures and stay orders. If the principal of the Covered Bonds is not fully repaid, Covered Bond holders have the right to payment from other assets of the issuer in addition to the Cover Pool.

With the consent of the holders of at least 75% of the aggregate outstanding principal amount of the Covered Bonds, FSC may issue an order to transfer relevant contracts to another eligible issuer.

The issuer is required to separately manage the mortgage loans included in a Cover Pool from its other assets on the basis of the applicable issuance plan. The books for the Cover Pool must also be separately maintained and any violation may be subject to criminal sanctions.

IX. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN REGULATION

The Covered Bonds under the Covered Bond Act and the KHFC Covered Bonds under the KHFC Act are not compliant with Article 52(4) UCITS, in which case they may not benefit from the higher investment limits because neither KHFC nor any of the potential South Korean issuers of the covered bonds is a credit institution with its registered office in a EU member state. These covered bonds cannot be CRD compliant without meeting the requirements of Article 52(4) UCITS.[1] Thus, the covered bonds cannot benefit from special treatment in terms of risk weighting.

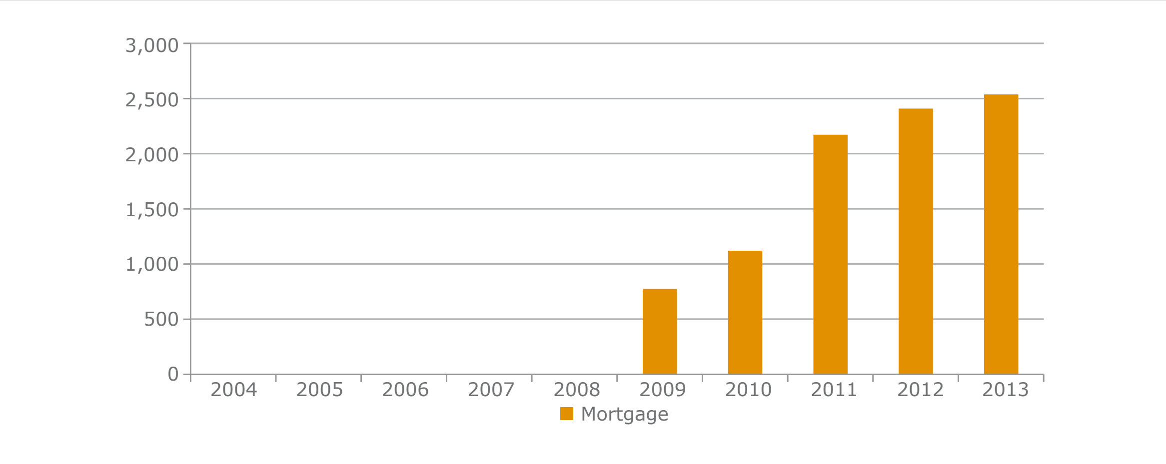
X. ADDITIONAL INFORMATION

There have been 10 covered bond issuances by Korean issuers, four of which were foreign currency denominated covered bonds issued offshore. Apart from the KB Covered Bonds, all the others were KHFC Covered Bond issuances.

Issuer	Issue Date	Face Amount	Credit Rating	Market
Kookmin Bank	May 14, 2009	US$ 1 billion	AA/Aa2 (S&P/Moody's)	Offshore
KHFC	July 15, 2010	US$ 500 million	Aa3 (Moody's)	Offshore
	April 28, 2011	US$ 200 million	AAA (NICE/KIS)	Onshore
	June 17, 2011	KRW 250 billion	AAA (KR)	Onshore
	July 25, 2011	US$ 500 million	Aa3 (Moody's)	Offshore
	December 8, 2011	KRW 290 billion	AAA (KR)	Onshore
	December 29, 2011	KRW 250 billion	AAA (KR)	Onshore
	March 30, 2012	KRW 250 billion	AAA (KIS)	Onshore
	March 7, 2013	US$ 500 million	Aa1 (Moody's)	Offshore
	March 7, 2013	KRW 150 billion	AAA (KIS)	Onshore

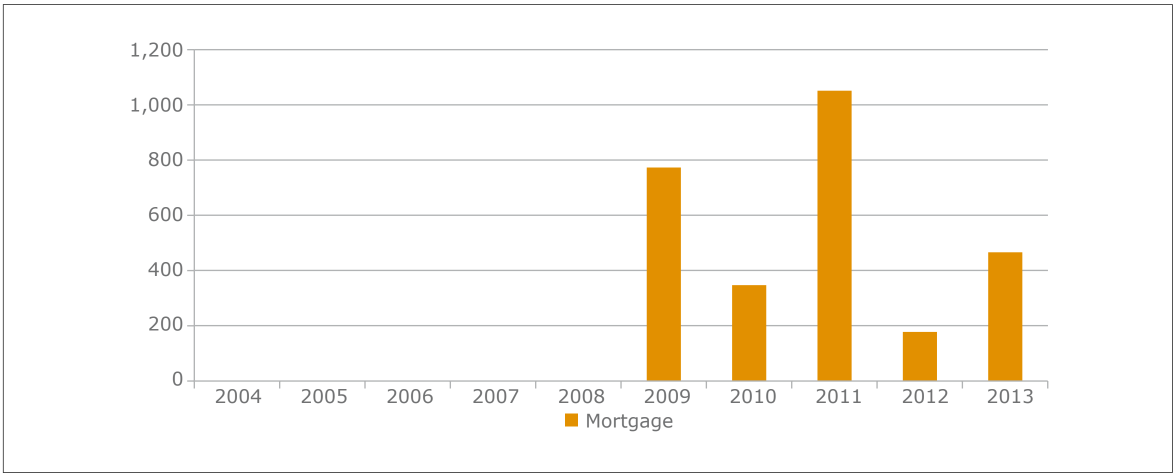
1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 2: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

> Figure 3: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

Issuers: Korea Housing Finance Corporation and Kookmin Bank.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/107/South_Korean_Covered_Bonds

3.32 SPAIN

By Gregorio Arranz, Spanish Mortgage Association

I. FRAMEWORK

The legal framework for Spanish covered bonds – "Cédulas Hipotecarias" (CHs) – is determined by the Law 2/1981 of 25 March on the regulation of the mortgage market (hereinafter, "Law 2/1981"), Law 41/2007 of 7 December, by which Law 2/1981 of 25 March, regulating the mortgage market and other rules of the mortgage and financial system are modified, reverse mortgages and long-term care insurance are regulated and certain tax regulations are established (hereinafter Law "41/2007") and the Royal Decree 716/2009 of 24 April, which develops certain aspects of Act 2/1981 and other rules of the mortgage and financial system (hereinafter "RD 716/2009"). In May 2013, a new Law on protection of mortgage debtors, restructuring of mortgage debt and rented social housing was approved and partially affected mortgage and procedural laws and some very specific points of Law 2/81 referred below.

Regarding bankruptcy regulation, Article 14 of Law 2/1981 (modified by the 19th final provision of Law 22/2003 of 9 July, hereinafter the "Insolvency Law", and by Law 41/2007) provides for a special treatment for the holders of the CHs in case of insolvency of the issuer. According to this article, CH holders have special privileged claims (*créditos con privilegio especial*) as established in Article 90 of the Insolvency Law.

Article 12 of Law 2/1981 defines that the capital and interests of the CH are secured by the entire mortgage loan book registered in favour of the CH issuer (excl. loans used in securitisations or loans securing mortgage bonds).

Moreover, Article 14 of Law 2/1981 determines that in case of issuer insolvency claims of CH holders shall be treated as privileged claims against the insolvency estate (*créditos contra la masa*). It shall be considered as credits against the mass: all the payments which correspond to the repayment of the capital and interest of the issued cédulas hipotecarias and, if any, to the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to the issues (Article of 14 Law 2/1981). Pursuant to Article 84(2)(7), in combination with Article 154 of the Insolvency Law, claims against the insolvency estate have to be paid on their respective due dates without delay of payment, regardless of the status of the bankruptcy proceedings.

In addition, the second additional provision of the Insolvency Law, modified by Royal Decree – Law 3/2009 of 27 March, establishes that in case of insolvency of credit institutions, their specific legislation, specifically Article 10, Article 14 and Article 15 of Law 2/1981 of the 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%. Later on, the Law 14/2013 of 27 September on support for and the internationalisation of entrepreneurs created the so-called "Cédulas de Internacionalización" and "bonos de internacionalización" which are covered bonds very similar to *cédulas hipotecarias* and *bonos hipotecarios* (see below) where the cover asset pool consists of loans and credits associated with the financing of export agreements. For the time being, secondary legislation is pending and no issuance has taken place. The total amount cannot exceed70% of the eligible amounts. Last but not least, a last type of covered bonds is the Bonos Hipotecarios that, although contemplated in Law 2/1981, have not been used for the time being. These bonds have specific mortgages as collateral and not the whole portfolio.

III. COVER ASSETS

A distinction shall be made between cover assets and eligible assets.

Cover assets consists of the entire mortgage loan book registered in favour of the issuer. The special privileged claims of the holders of CHs are guaranteed by the cover asset pool and if any, by the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to each issue.

The Law 2/1981 does not establish specific requirements for mortgage loans that constitute the cover asset pool.

For issuance purposes and their limits, it shall be considered as eligible assets in order to determine the maximum amount of CH issued and outstanding for a particular issuer.

All mortgage loans which comply with the following criteria are taken into account for the calculation of the maximum amount of CH issued and outstanding:

> The object of the loan or credit must be the financing of the construction, reconstruction, or acquisition of residential premises, zoning works and social equipment, construction of agrarian buildings, tourist, industrial and commercial and any other activity or work and any other loan, regardless its purpose.

> The mortgage that guarantees the loan or credit must be a first-ranked mortgage.

- The loan or credit guaranteed may not exceed 60% (Article 5 of 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 (Article 5 of RD 716/2009). Although the latter is a theoretical possibility as a matter of fact Spanish issuers have never utilized it. Any possible usage should be under the stringent control of Bank of Spain.

  Notwithstanding, mortgaged loans or credits that initially exceed these percentages can be used as cover assets for the issuance of CHs when, as a consequence of the repayment of their principal amount or the modification of the market value of the mortgaged properties the values do not exceed said LTV, in relation to the initial or revised valuation of the mortgaged asset.

  The mortgaged properties must have been valued previously by the so-called "Sociedades de Tasación" or by the valuation services of the issuer.
- The mortgaged assets must be insured against damages.
- Residential mortgage loan cannot exceed 30 years.

  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 has been a common 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 (Article 12 of Law 2/1981, Article 21 of 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*.

As said before, for eligible assets, the loan or credit guaranteed may not exceed 60% (Article 5 of 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 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. The last legal reform as of May 2013 prevents credit institutions from owning more than a 10% of appraisal companies' capital. Moreover, those entities are supervised and subject to inspection by the Bank of Spain. These rules were developed by the Ministerial Order of 27 March of 2003 in relation to the appraisal of real estate goods.

V. ASSET - LIABILITY MANAGEMENT

The volume of CHs issued and outstanding by a particular Issuer cannot exceed 80% (Article 16 of Law 2/81) of the sum of the unpaid principal amounts corresponding to all the mortgage credits or loans included in the Issuer's portfolio that comply with the requirements mentioned above under section III on cover assets. The issuer cannot issue CHs beyond these percentages at any time.

The cédulas hipotecarias can be backed up to a limit of 5% of the issued capital by substitution assets (fixed income securities issued by the State and other EU Member States, cédulas hipotecarias, mortgage bonds, securities issued by Mortgage Securitisation Funds or Asset Securitisation Funds and other fixed-income securities listed on an official secondary market or on a regulated market, with a credit rating equivalent to that of the Kingdom of Spain – Article 15 and Article 17 of Law 2/1981)

Notwithstanding this general statement, if the limit is surpassed due to increases in the redemption of the Eligible Assets or any other event whatsoever, the Issuer shall re-establish due balance by means of any of the following actions:

> Cash deposit or deposit of government paper in the Central Bank of Spain.

> Acquisition of CHs in the relevant marketplace.

> Execution of new mortgage loans or acquisition of mortgage participations provided that they are eligible to cover CHs.

> Redemption of CHs by the pertinent amount until balance has been reinstated, which, if necessary, can be executed through early redemption and drawing the number of securities to be redeemed by lot.

As a general remark it should be noted that it has been a common practice for the issuer to hedge interest rate risk.

Moreover, regulation provides for some particular rules in this respect that can be summarised as follows: Issuers shall adopt the necessary measures to avoid inappropriate imbalances between the flows from the cover portfolio and those derived from the payments due for the cédulas that they issue (Article 17(6) of RD 716/2009).

Concerning foreign exchange risks, there is no legal provision in relation to the following areas

> The currency of the covered bonds

> Limiting FX risks between cover assets and the CHs

> Limiting, managing or hedging the exchange risk as in the case of the interest rate risk. Notwithstanding, it is universal market practice to denominate the CHs in Euro if the currency of the cover assets is Euro.

Other risks such as early repayment, reinvestment, etc. are also mitigated by the 25% overcollateralisation as well as by the dynamic nature and structure of the cover pool.

VI. TRANSPARENCY

As mentioned above (Section III, Cover Assets) Spanish legislation obliges Spanish issuers of covered bonds to keep a special and very complete register of their loans and credits. The annual accounts have to contain additionally the essential details of said register.

On top of that, main Spanish issuers of CH, coordinated by the Spanish Mortgage Association, and since the end of 2011, have created a transparency template, consistent with the guidelines of the ECBC Label Initiative. This last version meets the requirements of Article 129(7) of the Capital Requirements Regulation (CRR).

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The institution issuing the cédulas will keep a special accounting register. Please refer to Section III on cover assets. The Spanish legislation does not require a special pool monitor other than the 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 beyond its regular prudential supervision is responsible for specifically 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 Law 26/1988 of 29 July.

The issuer is also responsible and liable for cover and eligible assets pool monitoring. The quantitative mandatory limits have to be maintained at all times, thus the monitoring is carried out continuously by the issuer as a part of the risk management and auditing of its activity.

The "special" supervision - as per reference to Article 52(4) UCITS - is also carried out by the *Comisión Nacional del Mercado de Valores* (hereinafter, "*CNMV*"). The CNMV may also monitor and supervise compliance with statutory requirements and limits upon approval of the issuance and clearly supervise the placing process

The role of the rating agencies shall be decided by the issuer on a case-by-case basis, either for commercial or market reasons, although as matter of fact most issues are rated.

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

Identification of the cover assets

Any mortgage that is originated in Spain must be registered in the Land Registry. Consequently, the Land Registry is the cover registry which records all the mortgages serving as the collateral for the CHs. The institution issuing the cédulas will keep a special accounting register.

Asset segregation from the insolvency's estate

Article 14 of 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. 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. (Article 14 of 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 (Article 157(2) of the Insolvency Law).

A judicial stay (moratorium) on the insolvency's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of interest and the principle on CHs.

In case of insolvency of the issuer, liquidity is ensured by the means discussed above, by the flows derived from the cover assets.

In order to comply with the payment obligations to the holders of the cédulas hipotecarias in the event of a temporary gap in the revenue received by the debtor, payments shall be made by means of liquidating the substitution assets serving as collateral of the issue. If this was insufficient, payments shall be made by means of funding operations via subrogation of the debtor in the position of the holder of the cédulas (Article 14 of 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") normally comprising a single person.

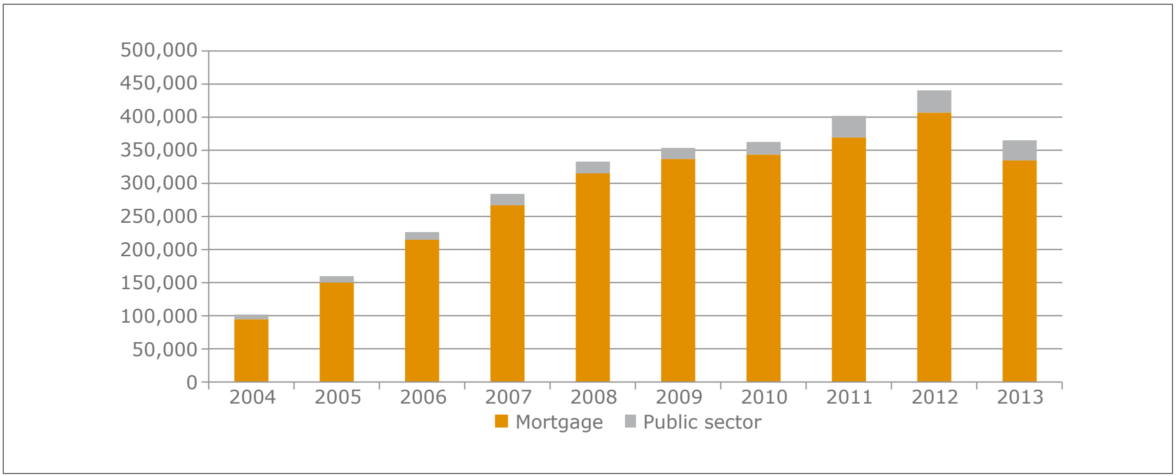
IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR). The Spanish covered bonds fulfil the criteria of Article 52(4) UCITS and Article 129 CRR.[1]

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.

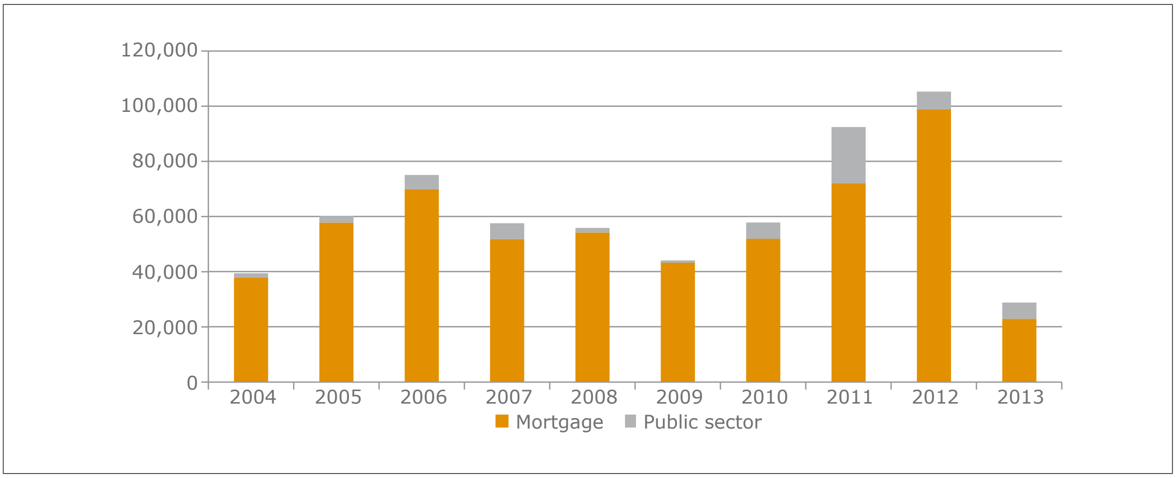
1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2004-2013, EUR m



Source: EMF/ECBC

Issuers: Banca March, Banco Caja Castilla La Mancha, Banco Caminos, Banco de Sabadell S.A., Banco Mare Nostrum, Banco Popular, Banco Popular e.com, Banco Santander S.A., Banesto, Bankia, Bankinter, Bankoa, Barclays Bank, BBVA, BES SA, C. Pollença, CaixaBank SA, Caja Laboral, Caja Rural de Granada, Caja Rural Navarra, Caja Tres, Cajas Rurales Unidas, Cajasur, Catalunya Bank, CEISS, Deutsche Bank SAE, Ibercaja, Kutxabank S.A., Liberbank, NCG Banco, Santander Consumer Finance, Unicaja Banco.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/45/C%C3%A9dulas_Hipotecarias

Covered Bond Label: Banco de Sabadell, S.A.; Banco Popular Español; Santander Mortgage Covered Bonds; Bankia Mortgage; Bankinter, S.A.; BBVA Covered Bond Programme; BBVA Public Sector Covered Bond Programme; Mortgages Loans Caixabank S.A.; Public Loans CaixaBank S.A.; Kutxabank S.A.; Unicaja Banco Mortgage Covered Bonds.

3.33 SWEDEN

By Jonny Sylvén, Association of Swedish Covered Bond Issuers (ASCB)

I. FRAMEWORK

In Sweden, the issuance of covered bonds is governed by the Swedish Covered Bonds Issuance Act, which came into force on 1 July 2004 (Lag 2003:1223 *om utgivning av säkerställda obligationer*, hereinafter the 'CBIA')[1]. The CBIA supersedes the general bankruptcy regulation and grants covered bond investors a priority claim on eligible cover assets (CBIA: Chapter 4, Section 1). A new regulatory provisions (FFFS 2013:01, 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 (Figure 1). If the SFSA withdraws a licence, the authority may determine a plan to wind down the operation.

> Figure 1: Licence needed to issue covered bonds

Requirements for issuance licence:

- The institution's articles of association, by laws or regulations must comply with the CBIA.
- The issuer must conduct the covered bonds business according to the CBIA and related regulatory provisions.
- Outstanding mortgage bonds to finance loans that may be included in the covered pool must be converted into covered bonds or 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 it is sufficiently stable so that the interest of other creditors is not jeopardised when it issues covered bonds. The report must be substantiated by auditors.
- The issuers must submit an operational plan that calls for sound management and supervision of the covered bond business (including information of the IT business).

The SFSA may withdraw a licence if:

- The institution is in material breach of its obligations pursuant to the CBIA; and/or
- The institution has failed to issue a covered bond within one year of receiving the licence.

Source: Lag 2003:1223, FFFS 2013:01

1 Lag 2003:1223 om utgivning av säkerställda obligationer [Covered Bonds Issuance Act].
2 FFFS 2013:01 Finansinspektionen's Regulations and Guidelines regarding 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

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 is on mortgage covered bonds (more than 90 percent of cover pools).

Eligible assets are mortgages:

> on real estate intended for residential, agricultural, office or commercial use;

> on site-leasehold rights intended for residential, office or commercial use;

> pledged against tenant-owner rights; and

> against similar foreign collateral.

The CBIA restricts mortgages against offices and commercial property to 10% of the total cover pool. Mortgage loans can be secured only with collateral comprising property located in Sweden and the European Economic Area (EEA)[3]. Neither asset-backed securities nor mortgage-backed securities are permissible as cover assets. The mortgage loans must meet valuation procedures and certain loan-to-value ratios defined by the CBIA and the CBR (see section IV).

Eligible public-sector assets are defined as securities and other claims:

> issued by or guaranteed by the Swedish state, Swedish municipality or comparable public body;

> issued by or guaranteed by a foreign state or central bank, where the investment is in the foreign state's currency and is refinanced by the same currency[4];

> issued by or guaranteed by the European Communities, or any of the foreign states, or central banks as prescribed by the Swedish government; or guaranteed by a foreign municipality or public body that has the authority to collect taxes.

The cover pool is a dynamic pool, and non-performing 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).

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.

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) at the time the agreement is entered into. The law stipulates asymmetrical collateralisation, in that it requires collateral, a guarantee or replacement language in the event that the counterparty's rating falls below the minimum rating level. There is no reciprocal requirement by the covered bond issuer, given that derivative counterparties have a priority claim on the cover pool (CBR: Chapter 4, Sections 5 to 7). The use of derivatives is not limited to a maximum percentage of the cover pool since they are not included in the nominal matching calculation. Their use is limited to serve the balance between cover assets and outstanding covered bonds when creating a balance in respect of net present value of assets and liabilities.

Substitute assets

Highly liquid assets can serve as substitute assets for up to 20% of the mortgage cover pool. The SFSA can temporarily raise the limit to 30%. Eligible substitute assets include eligible public sector assets plus cash, cheques and postal money orders. These assets qualify for a 0% risk weighting. The SFSA has the discretion to extend the universe to eligible substitute assets (CBIA: Chapter 3, Section 2).

IV. VALUATION AND LTV CRITERIA

The CBIA defines valuation principles for properties that act as collateral for mortgages in the cover pool (CBIA: Chapter 3, Section 4). The valuation relating to residential properties may be based on general price levels. The valuation of any other eligible property class must be based on the market price, which must be determined by individual appraisal by qualified professionals. The market value should reflect the price achievable through a commercial sale, without time pressure and excluding any speculative or temporary elements. Issuers must monitor the market value of the property regularly, and in the case of serious decline must review the valuation, and ensure that the loan to value (LTV) of the related mortgage loan remains within the defined maximum limit (CBR: Chapter 3, Section 7, Chapter 5, Section 4). The valuer is normally an employee of the issuer, but external valuers are also used.

For the various mortgage types eligible as cover, the following maximum LTV ratios apply (CBIA: Chapter 3, Section 3):

> 75% of the value for real estate, site-leasehold rights and tenant-owner rights where the property is intended for residential use;

> 70% of the value for real estate intended for agricultural use;

> 60% of the value for real estate, site-leasehold rights and tenant-owner rights where the property is intended for office or commercial use.

These LTV limits are relative, not absolute, limits. A loan with a higher LTV ratio can be included in the cover pool up to the legal threshold. The balance must be refinanced with other funding instruments (e.g., senior unsecured funding) (CBR: Chapter 5, Section 3).

An issuing institution shall test and analyse how changes in property values may affect LTV ratios and the value of the cover pool. These tests shall at least be performed once a year. The tests should be based on conservative assumptions.

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 in an unfavourable direction, 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 3-5). The CBIA does not require a mandatory level of minimum overcollateralization (OC). However, the issuer can adhere to a self-imposed OC level for structural enhancement, as the CBIA protects any OC in the cover pool in the event of issuer insolvency.

Finally, the issuing institution shall ensure that the cash flow with respect to the assets in the cover pool, derivatives agreements and the covered bonds are such that the institution is always able to meet its payment obligations towards holders of covered bonds and counterparties in derivatives agreements (CBIA: Chapter 3, Section 9). The issuer should be able to account for these funds separately.

VI. TRANSPARENCY

The issuers are presenting information regarding their cover pool and outstanding covered bond every quarter in line with the national transparency template. The information is today on every issuers' websites. Some of the issuer report more frequent then quarterly. The content of the national transparency template (posted on the Covered Bond Label website[5]) will be expanded if there are requests for it. Adaptations have been made to the requirements in the Capital Requirements Regulation (CRR). The information in the national transparency template will at least be what is required in CRR. Most of the issuers in Sweden have a special company that issue bonds. Those companies present quarterly or semi-annual reports. Those reports have information regarding the company and its business. The issuer is required to feed the independent inspector with all kinds of information with a rather tight frequency. According to the new regulation from the Swedish FSA this year that information will be more detailed.

VII. COVER POOL MONITORING AND BANKING SUPERVISION

The covered bond issuers fall under the special supervision of the SFSA. The financial regulator monitors the institutions' compliance with the CBIA and other related regulatory provisions (e.g., CBR). If the covered bond issuer is in material breach of its obligations under the legal framework, the SFSA can issue a warning or revoke the issue license altogether. The SFSA may also revoke a license if the institution has declared that it waives the license or if the institution has not made use of the license within a year from the date of receiving the license. The revocation may be combined with an injunction against continuing the operations and with the imposition of a conditional fine. In any case, the SFSA must determine how the operations should be wound up (CBIA: Chapter 5, Sections 2 to 6).

For each issuing institution, the SFSA must appoint an independent and suitably qualified cover pool inspector (cover pool trustee), who is paid by the covered bond issuer. The duties of the cover pool inspector are to monitor the register and verify that covered bonds, derivatives agreements and the cover assets are correctly recorded. The inspector also ensures compliance with matching and market risk limits in accordance with the CBIA. The inspector must also, nowadays, review the revaluations of underlying collateral that has been conducted during the year. The institution is obliged to provide the covered bond inspector with any information requested relating

5 https://www.coveredbondlabel.com/issuers/national-information-detail/24/.

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).

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

Cover register

The issuer must keep a register of eligible cover assets, substitute assets, derivative contracts, and outstanding covered bonds (CBIA: Chapter 3, Section 10). The law specifies the form and content of such a register, which must be easily accessible for the SFSA and the cover pool inspector. The registration legally secures covered 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).[6] 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.[7]

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.

6 According to preparatory works to the Act, this would be, for example, "temporary liquidity constraints".

7 There are no means in the Act that could disrupt or delay payment to covered bondholders. However, the Act does not explicitly derogate from the general provision of the Code of Procedures 1948 or the Bankruptcy Act 1987, of which neither explicitly ensures the integrity of payments on covered bonds.

The law does not provide for the appointment of a special cover pool administrator. The receiver-in-bankruptcy represents the interests of both the covered bond investors and the unsecured investors. The receiver has the right to use OC to pay advance dividends to other creditors of the bankrupt issuer, if the pool contains more assets than necessary.[8] If the cover assets later prove to be insufficient, these advance dividend payments can be reclaimed.

Access to liquidity in case of insolvency

In the cases of issuer insolvency, the law does not enable the receiver-in-bankruptcy to refinance maturing covered bonds of the issuing institution by issuing new covered bonds against the cover pool. Likewise, the receiver is not able to substitute ordinary cover assets for alternative assets. However, the receiver can use available liquid substitute assets included in the pool. In addition, the receiver can sell part of the cover pool in the market to create the necessary liquidity without raising debt.

The receiver-in-bankruptcy has – as of 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.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 CRR. Swedish covered bonds comply with the criteria of article UCITS 52 (4) UCITS and with the covered bond criteria defined in article 129 in CRR.[9] Because of the bonds compliance with article 129 in CRR, the risk- weight for the Swedish covered bonds will be as is stated in article 129 for banks that use the standard method. 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 CRR does not. However, general opinion of the parties involved is that the EU CRR'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 the CRR. 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.[10]

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 According to legal opinion, the receiver-in-bankruptcy would have to 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.

9 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

10 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. 552 (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.

X. ADDITIONAL INFORMATION

Issuing and trading of Swedish domestic covered bonds

In order to issue covered bonds mortgage companies and banks need an authorisation by the Swedish Financial Supervisory Authority (SFSA). Normally the bonds are registered at the Nordic Exchange Stockholm (NASDAQ OMX Group), although no actual bond trading takes place there. Offering circulars with the detailed issue conditions are following a standard based on the Prospectus Directive with acceptance from the SFSA, OMX and the market makers. The normally used technique for issues is "on tap".

The Swedish bond market investors appreciate liquidity. Because of these "requirements" the large issuers issue their bonds as benchmarks which mean that large amounts (SEK 3 billion and more) are issued and that a number of dealers, under normal circumstances, show both bid and offer prices. Also, only benchmarks are deliverable in the future contracts. When a new benchmark-loan is issued, the issuers make sure that the amount issued meets the requirements for a benchmark sized deal. After the initial day of issuance the issuer can, without further notice, issue "on tap" the size he requires to match the lending.

The bonds are sold into the primary market through banks acting as agents for the issuer. These banks also act as market makers in the secondary market. Currently, there are six banks that act as market makers in covered bonds: Danske Bank, Nordea, Nykredit, SEB, Svenska Handelsbanken and Swedbank. The market for government and domestic covered bonds, as well as treasury bills, is a telephone and screen-based over-the-counter market. Market makers display indicative two-way prices on an electronic information system which is instantaneously relayed by Reuters. Fixed prices are quoted on request and most deals are concluded via telephone. Trading in the secondary market takes place on all business days between 09.00 and 16.15 (local time). The number of bonds 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. The Swedish Debt Office offers a repo-facility in government bonds and treasury bills and mortgage companies offer their market makers a repo-facility in their own bonds. The repo transaction is viewed as a 'sell-buy back' or 'buy-sell back' deal and the ownership of the security has to be transferred. There are no standard conditions for a repo transaction and the counterparties have to agree on maturity, settlement day and delivery for each deal. Most often, though, repos are settled two banking days after the trading day. Repo rates are quoted as a spread vs the Riksbank repo rate.

Almost all public listed securities in Sweden are registered at the Euroclear Sweden. In general, Swedish bonds are domestically settled via the Euroclear. Domestic settlement requires a custodian account with one of the Swedish banks or securities firms. Foreign investors can either have a custodian service with a Swedish bank or securities firm or settle via Euroclear or Cedel.

Accrued interest is calculated from the previous coupon date to the settlement day. The interest rate is calculated by using ISMA's 30E/360 day count - "End-of-month" convention.

Swedish government and covered bonds have five ex-coupon days which means that there is negative interest when settlement occurs within five business days before the coupon date.

Most Swedish bonds pay coupon annually. There are, however, bonds that pay coupon semi-annually. All domestic banks act as paying agents.

Swedish krona bonds redeem at par upon maturity.

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.

Further information concerning the road show, the LTV-method as well as the Swedish covered bond market is accessible at the website of ASCB (www.ascb.se).

Essential Terms and conditions of a typical Swedish market maker agreement

The market maker has a duty to:

> Help the issuer sell bonds via taps of the benchmark loans in the market;

> Actively support trading of these bonds in the secondary market; and

> Continuously quote indicative rates in the information systems used.

These obligations apply to a limited number of the issuer's loans – the benchmark-loans. Typically 5 to 8 loans of a big issuer have this status with respect to outstanding volume. Using the on-tap issuing technique a loan typically reaches bench-mark status when the outstanding loan amount is SEK 3-5 bn. (At the peak of the life of the bond it typically has a volume of SEK 50 to 70 bn. After that the volume falls due to active repurchase operations by the issuer. With one year to go to maturity a loan is no longer of benchmark status. This paves the way for a controlled redemption of the remaining part of the loan.)

The bid ask spread shall be in line with present market conditions and the trading lots shall typically exceed SEK 500 million.

The obligations of a market maker are conditional upon a number of things of which the following could be mentioned:

> that no change in the economic, financial or political conditions have occurred which in the reasonable opinion of the market maker would create a major obstacle to the fulfilment of the obligations;

> that the bonds, in the reasonable opinion of the market maker, cannot be placed in the primary or secondary market on normal market conditions.

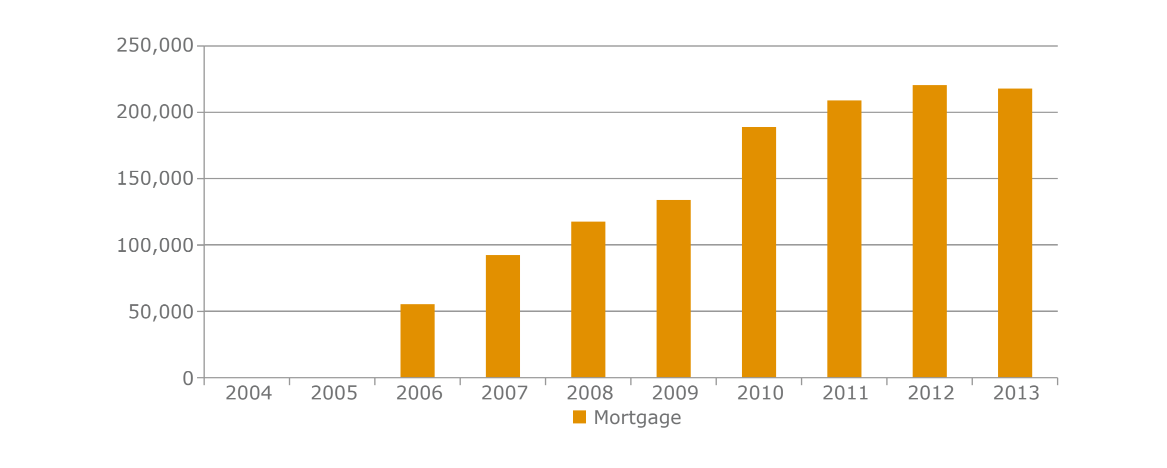
If so, the market marker shall notify the issuer and may withdraw from the duties wholly or in part for a shorter or longer time.

The market maker also has an obligation to trade two futures (2 and 5 year) of the issuer in a similar way as that of the benchmark bonds..

The issuer on his side has an obligation to (under normal market conditions) supply the market maker with a repo facility in the outstanding benchmark bonds. (This facility used to be unlimited. Today, however, the limit is set by the available cover in the cover pool of the issuer.)

With respect to transparency, the issuer shall make public at the end of each week figures on outstanding benchmark loans as of the last day of the previous week.

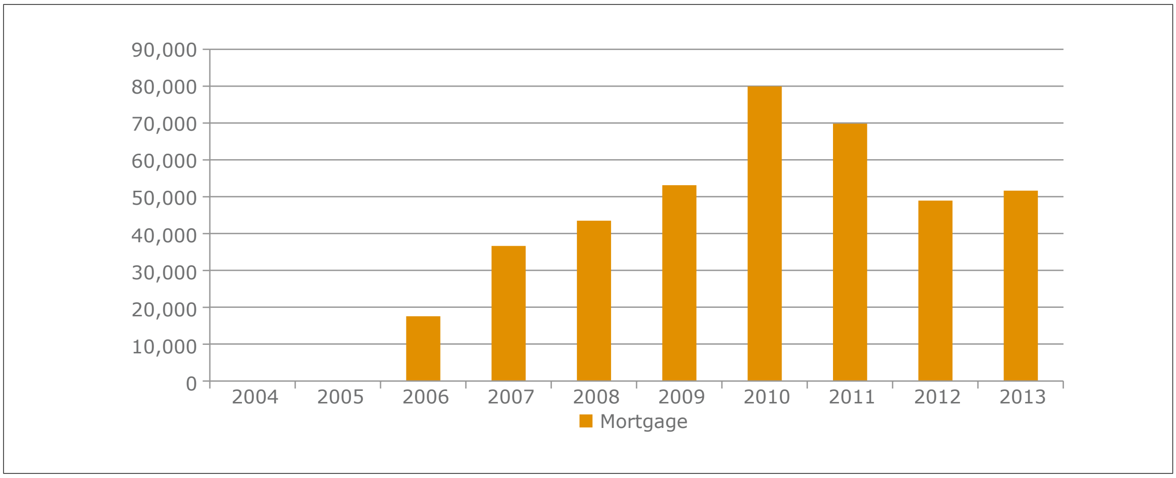
> Figure 1: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

Notes: The first covered bonds were issued in 2006 with the application of the Covered Bond s 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. In the graph only covered bonds are present.

> Figure 2: Covered Bonds Issuance, 2004-2013, EUR m



Source: EMF/ECBC

Issuers: The Swedish covered bonds market in 2011 consists of seven issuers: Stadshypotek, Swedbank Mortgage, Nordea Hypotek, Swedish Covered Bond Corporation (SCBC), SEB, Länsförsäkringar Hypotek and Landshypotek. The market is dominated by the first five of them and the majority of their exposure is to domestic residential mortgages, with the remainder consisting of commercial property loans and public sector loans.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/47/Swedish_Covered_Bonds

Covered Bond Label: Länsförsäkringar Hypotek AB; Nordea Hypotek cover pool; SEB Cover Pool; Stadshypotek Swedish Pool; Stadshypotek Norwegian Pool; Swedbank Mortgage cover pool; The Swedish Covered Bond Corporation

3.34.1 SWITZERLAND – SWISS PFANDBRIEFE®

By Dr. Robert Horat, Pfandbriefbank schweizerischer Hypothekarinstitute AG

I. FRAMEWORK

The legal framework for the Swiss Pfandbrief system is the Pfandbrief Act ('Pfandbriefgesetz', 'PfG'). It is complemented by the Pfandbrief Ordinance ('Pfandbriefverordnung', 'PfV'), the statutes of the Pfandbrief institutes and the valuation regulations. These have to be authorised by the Swiss Federal Council.

According to the PfG, the issuance of Swiss Pfandbriefe is reserved to two specialised Pfandbrief institutes, namely the 'Pfandbriefzentrale der schweizerischen Kantonalbanken AG' (PZ) and the 'Pfandbriefbank schweizerischer Hypothekarinstitute AG' (PB). These issue Swiss Pfandbriefe to refinance their member banks' Swiss mortgage business. As of article 1 of the PfG the purpose of the Pfandbrief institutes is to enable mortgages for real estate owners at interest rates which are as constant and favourable as possible. 'The Swiss Pfandbrief®' is a registered trademark. The reputation of this brand shall underpin its uniqueness within the world of covered bonds.

The Swiss Pfandbrief system is an indirect one: The Pfandbrief institutes raise money by issuing Swiss Pfandbriefe in order to grant Pfandbrief loans to their member banks. Sourced volume, currency and interest terms must be equal within each series of issuance. To get a loan, each member bank has to pledge first class Swiss mortgages to the Pfandbrief institute as a cover in advance. The Pfandbrief investors have a lien on the granted loans. The investors' lien on the loans as well as the issuers lien on the mortgages in the member banks' cover pool are determined by the Pfandbrief Act.

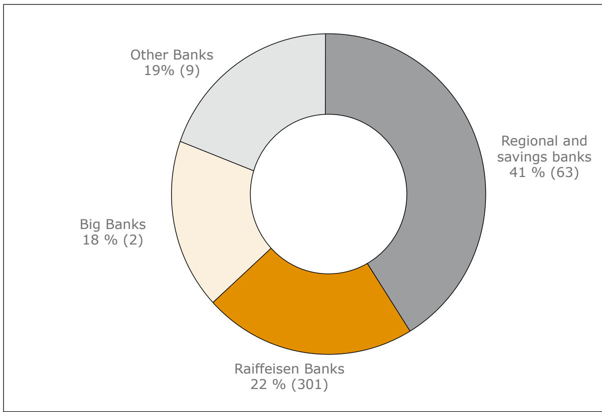
PfG came into effect in 1930. Its 52 articles are well balanced and the PfG had to be modified only marginally in the meantime. The fact that the Swiss Pfandbrief has a special legal basis, provides legal certainty as well as stability and predictability.

Pfandbrief institutes have a strictly limited scope.

II. STRUCTURE OF THE ISSUER

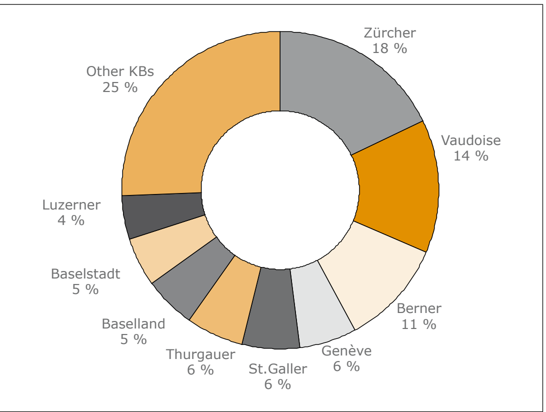
Pfandbriefzentrale operates as the Pfandbrief issuing vehicle of the Swiss cantonal banks and Pfandbriefbank of all other Swiss banks. Both are special institutions with their business scope limited to the issuance of Swiss Pfandbriefe, to granting Pfandbrief loans to their member banks and to investing their share capital and reserves. Both Pfandbrief institutes are supervised by the Swiss financial market authority (FINMA). They are owned by their member banks. The chart below shows the structure of the shareholders:

> FIGURE 1: SHAREHOLDERS OF PB



Source: PB as of 31.12.2013

> FIGURE 2: SHAREHOLDERS OF PZ



Source: PZ as of 31.12.2013

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.

PB was founded in 1931 and counts 355 member banks with loans. Any Swiss bank has the right to become a member of PB, provided that it is headquartered in Switzerland and that Swiss mortgages account for at least 60 % of the bank's balance sheet. As of 31 December 2013 the total outstanding Swiss Pfandbriefe of PB amount to CHF 54.1 billion (EUR 44.1 billion).

PZ was also founded in 1931 and has 24 member banks. Only cantonal banks have the right to become members of the PZ (Article 3 PfG). PZ does not have its own staff but has fully outsourced its operations to Zürcher Kantonalbank. As of 31 December 2013 the total outstanding Swiss Pfandbriefe of PZ amount to CHF 33.9 billion (EUR 27.6 billion).

The total volume of all outstanding Swiss Pfandbriefe as of 31 December 2013 amounts to CHF 88 billion (EUR 71.7 billion). For years the two Swiss Pfandbrief institutes have been the major bond issuers in Switzerland, even more important than the government. In 2013 they issued Swiss Pfandbriefe amounting to CHF 15.4 billion (EUR 12.6 billion).

Swiss Pfandbriefe are standardised to a great extent. They are a commodity, denominated only in Swiss francs, with an original time to maturity up to 30 years. 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. Whenever possible, existing bonds are reopened.

Generally, Swiss Pfandbriefe are issued as public bonds through a banking syndicate at fixed term fees (the last private placement has been placed in 2011). All of these public issuances are listed on the SIX Swiss Exchange. In the segment of the domestic bonds in Swiss Francs public issuers (Swiss sovereign, cantons, cities) amount to 37 %, followed by Swiss Pfandbriefe with 28 %, the banking sector with 14 % and other industries with 21 %.

In total about 9.8 % of all Swiss mortgages are refinanced through Swiss Pfandbriefe.

III./IV. COVER ASSETS, VALUATION AND LOAN TO VALUE (LTV) CRITERIA

As a principle, Pfandbrief loans are only granted against a pledge of eligible first class mortgages on Swiss properties.

PB has got an electronic cover pool. Mortgages are pledged to PB by the member banks through entry of a complete 'cover proposal' into the electronic pool register, which all member banks are linked to. The system immediately evaluates the member bank's 'cover proposal', which is then reviewed by one employee and authorized by another. PB valuates the mortgages independently from the member bank. Substantial cover proposals are additionally reviewed by a special cover pool committee.

The PfG defines a general maximum LTV of two thirds (Article 5 PfG). Member banks are obliged to replace impaired, non-performing and other ineligible mortgages. Furthermore, contractual repayments of the mortgage can also reduce the cover value of the asset pool. Therefore, member bank and PB have to supervise overcollateralisation daily. If total cover value is below the overcollateralisation limit, latest by close of business new eligible mortgages have to be pledged by the member bank.

The 'Pfandbriefbank pool' consists of more than 141'000 mortgages all over Switzerland, which provides a good diversification. 99 % of the properties are residential and 1 % commercial.

If macro economic conditions change materially, FINMA may request a new valuation of the real estate properties (Article 32 PfG).

V. ASSET - LIABILITY MANAGEMENT

Cover principles

The PfG stipulates that the principal amount and interest payments of outstanding Swiss Pfandbriefe be at all times covered by an equivalent amount of Pfandbrief loans to the member banks (Article 14 PfG). The loans granted by Pfandbrief institutes to their member banks must be collateralised by liens on eligible real estate property (Article 19 PfG). If the interest proceeds total of the pledged mortgages of a member bank is smaller than its total Pfandbrief loan interest, the asset cover pool must be increased (Article 20 PfG).

Overcollateralisation

Additionally to eligibility and valuation principles (LTV legally at maximum 2/3, for PB the average LTV is less than 50 %), the cover value of the cover register assets have to exceed the Pfandbrief loans given to member banks by at least 8 % for PB und by 15 % for PZ. The higher overcollaterisation of PZ compensates for the fact that PZ does not have an electronic cover pool register.

Additional 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.

Growth of the Pfandbrief institutes is limited as the required capital must exceed 2 % of the total Pfandbrief issuance volume of the respective institute (Article 10 PfG).

VI. TRANSPARENCY

Although Switzerland does not participate in the 'Covered Bond Label' self-certification programme, PB publishes the 'Pfandbriefbank Pool' report (incl. member bank rating distribution, region, property type, property type by cover value size, loan to value) semi-annually on its home page (www.pfandbriefbank.ch).

VII. COVER POOL MONITOR AND BANKING SUPERVISION

PB valuates the cover pool independently of the member bank (which grants the mortgage to the house owner) and monitors eligibility and overcollateralisation of the cover pool daily. Mortgages are back-tested by means of a hedonic valuation model. Additionally, a special cover pool committee reviews substantial mortgages and visits major properties.

The Swiss Federal Council approves by-laws and valuation regulations and nominates one member of the board of directors.

Swiss Pfandbrief institutes as well as their member banks are supervised by FINMA and audited by external audit firms.

In addition, Moody's rates all Swiss Pfandbriefe with Triple A, investors analyse the annual reports of the Pfandbrief institutes, analysts of CS, UBS and ZKB publish research reports and last but not least capital market values Swiss Pfandbriefe on a daily basis.

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

In the event of a member bank's insolvency, the Pfandbrief institute has a priority claim on the registered collateral (Article 23 PfG). The insolvency of a member bank does not directly trigger the acceleration of outstanding Pfandbriefe. In this respect, the Pfandbrief institute functions as a buffer between the investors and the member banks. The Pfandbrief institutes have own funds at their disposal and maintain an unencumbered

SNB-/repo-eligible bond portfolio (market value as of 31.12.2013: PB CHF 1.1 billion, PZ CHF 0.5 billion) within their free assets.

Should there be justified concern that a member bank is over indebted, has serious liquidity problems or that the bank not longer fulfils the capital adequacy provisions (Article 25 Banking Act - BankG), FINMA can order

a) protective measures pursuant to Article 26 BankG. However, it is to mention that FINMA can order deferment of payments or payment extension, except for mortgage-secured receivables of the Pfandbrief institutes (Article 26 h BankG).

b) restructuring procedures pursuant to Article 28 – 32 BankG: If it appears likely that the member bank can continue to provide individual banking services (regardless of the continued existence of the bank concerned) or can recover, FINMA can issue the necessary provisions and restructuring orders (Article 28 BankG). The approval of the bank's General Assembly is not necessary (Article 31 BankG).

c) the member bank's liquidation due to bankruptcy pursuant to BankG art. 33 - 37 g: Should there be no prospect of restructuring or if a restructuring were to fail, FINMA will have to revoke the bank's licence, order its liquidation and make this public (Article 33 BankG).

The Banking Insolvency Ordinance (BIV) defines restructuring proceedings and bankruptcy proceedings under Article 28 – 37 g BankG in detail. This includes that FINMA may draw up a separate schedule of claims for claims secured by a registered pledge of the Pfandbrief institutes, if systemic risks can only be restricted by doing so (Article 27 BIV). FINMA can also order the delivery of the cover assets and then act as fiduciary (Article 40 PfG) or arrange for a sale of the cover assets to other banks. In such a case Pfandbriefe would accelerate and Pfandbrief investors would rank pari passu among themselves on the proceeds of the asset sales (Article 29 PfG).

IX. RISK-WEIGHTING & COMPLIANCE WITH INTERNATIONAL LEGISLATION

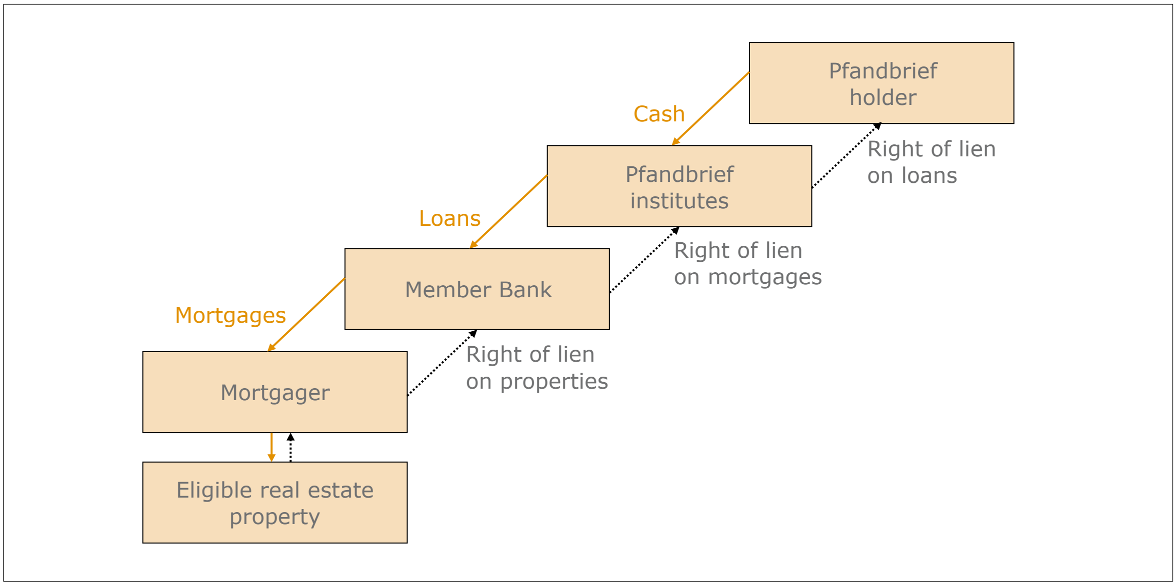
Basel III capital

Switzerland implements Basel III capital requirements by means of the 'Banking Act' and the 'Swiss Capital Adequacy Ordinance' (CAO) into national law. The CAO has two approaches to measure credit risks in banking books: The BIS standard approach and the internal ratings-based approach. Under the BIS standard approach Swiss Pfandbriefe have a 20 % risk weighting.

Basel III liquidity

Switzerland implements Basel III LCR requirements by means of the 'Banking Act' and the 'Liquidity Ordinance' (LiqO) into national law. Swiss Pfandbriefe are on the SNB GC basket list and are therefore eligible for SNB repo transactions. As Swiss Pfandbriefe fulfil the criteria for high-quality liquid assets (HQLA) they are not affected by the redefinition of collateral eligible for SNB repos effective 1 January 2015.

> FIGURE 3: THE SWISS PFANDBRIEF MODEL



Source: Credit Suisse AG

X. INVESTORS BENEFITS

An investor in Swiss Pfandbriefe benefits from

> the special institute principle with strictly limited scope.

> Swiss legislation applicable for all contracts within the Swiss Pfandbrief collateral chain.

> the cover pool, which only includes eligible Swiss franc mortgages on Swiss real estate properties.

> 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) the market value of the real estate property itself.

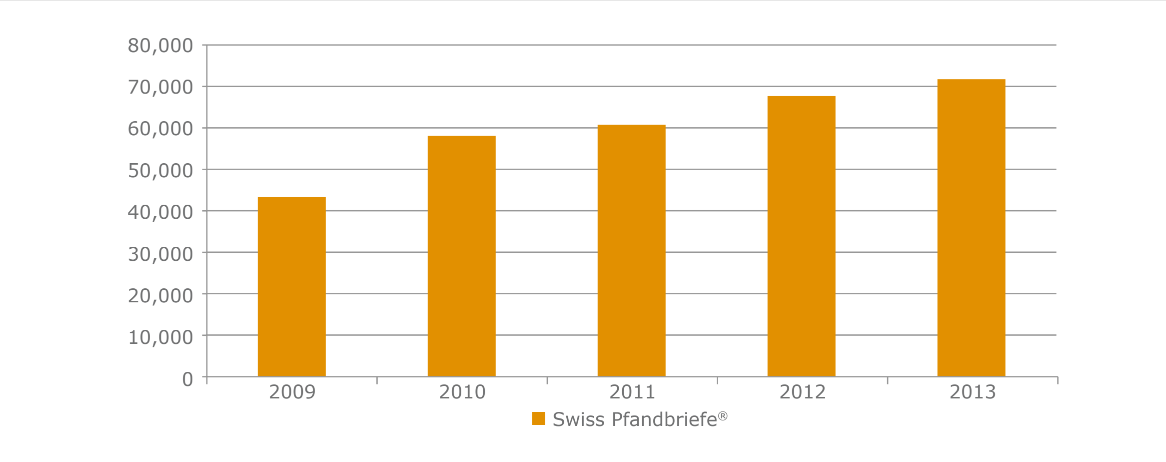
> in the case of PB: The value of the real estate property is independently determined by PB and not by the member bank.

> in the case of PZ: Explicit state guarantee for most of its member banks[1].

> the fact that since the establishment of the PfG in 1930 neither an investor nor a Pfandbrief institute have ever suffered a loss.

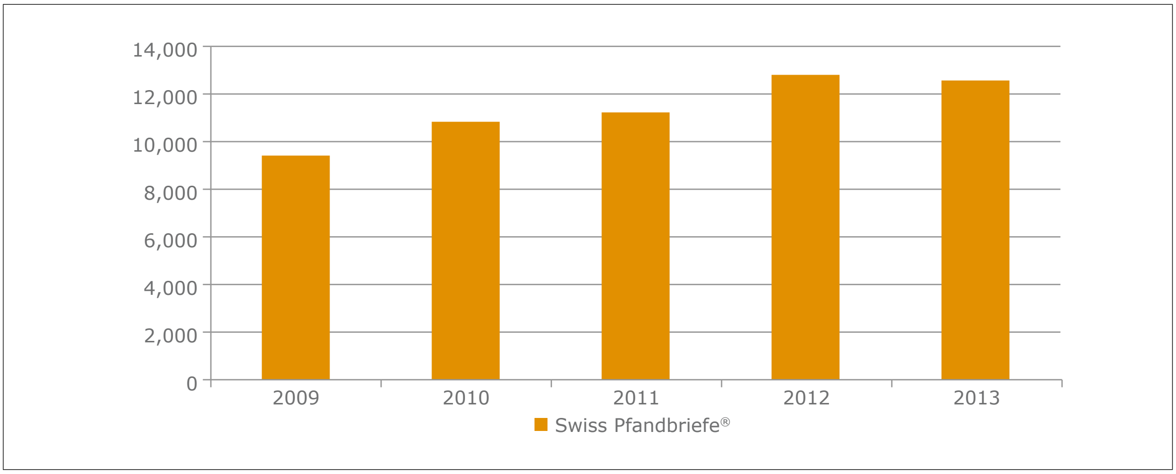
1 Three of PZ's member banks do not benefit from a cantonal guarantee or have a limited guarantee, namely Banque Cantonale de Genève AG (limited guarantee until 2016), Banque Cantonale Vaudoise AG (no guarantee) and Berner Kantonalbank (no guarantee).

> FIGURE 4: SWISS PFANDBRIEFE OUTSTANDING, 2009-2013, EUR M



Source: EMF/ECBC

> FIGURE 5: SWISS PFANDBRIEFE ISSUANCE, 2009-2013, EUR M



Source: EMF/ECBC

Issuers: Pfandbriefbank schweizerischer Hypothekarinstitute AG (PB) and Pfandbriefzentrale der schweizerischen Kantonalbanken AG (PZ).

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/82/Swiss_Pfandbriefe

3.34.2 SWITZERLAND - STRUCTURED COVERED BONDS

By UBS

In addition to instruments issued under the Swiss covered bond act, the Swiss Pfandbriefe as described above, two Swiss banks (Credit Suisse and UBS) have chosen to establish covered bond programmes based on contractual agreements with the relevant parties. Instruments issued under such contractual agreements qualify as structured covered bonds that allow Credit Suisse and UBS to also access the deeper liquidity of the non-CHF denominated covered bond market.

In line with the Swiss Pfandbriefe, the programmes are both backed by prime Swiss domestic residential mortgage collateral.

Given that the two covered bond programmes are based on contractual agreements, the issuers have been free to include various structural features designed to enhance investor protection and ensure a robust AAA/Aaa rating. Both of the programmes launched to date have adopted very similar structures, the minor differences are highlighted where appropriate below.

I. FRAMEWORK

Although not relying on the Swiss covered bond act, both programmes use Swiss (as well as English) legal frameworks to ensure, inter alia, a segregation of the assets and the bankruptcy remoteness of the guarantor.

The issuers have separately mandated two Swiss-based special purpose companies (Credit Suisse Hypotheken AG and UBS Hypotheken AG) to guarantee their payment obligations for the benefit of the covered bondholders. The guarantee then comes into operation following an issuer event of default, subject to certain conditions. All covered bonds issued under the respective programme rank *pari passu* with each other and benefit equally from the guarantee. Furthermore, the covered bonds are either fungible with an existing series, or constitute a new series with different terms.

The guarantors are ring-fenced, bankruptcy-remote entities that will be unaffected by the insolvency of the group to which they are consolidated (both guarantors are majority-owned by their respective issuer).

II. STRUCTURE OF THE ISSUER

Both issuers today are large financial institutions regulated by the Swiss banking regulator, "Swiss Financial Market Supervisory Authority" (FINMA).

The covered bonds issued by Credit Suisse and UBS are direct, unsubordinated, unsecured and unconditional obligations benefiting from a guarantee given by the respective guarantor vehicles. Before an issuer event of default, the issuers shall make all payments of interest and principal on the covered bonds.

III. COVER ASSETS

In both programmes, the collateral consists of Swiss mortgage loans to private individuals and the related mortgage certificates securing such mortgage loans. The geographical scope for the mortgage assets is limited to Swiss domestic mortgage loans.

Substitution assets can be included in the cover pool. Their aggregate value can make up to a maximum of 15% of the cover pool and may consist of cash and short-term investments such as bank deposits, domestic Pfandbrief bonds and AAA government debt.

In order to ensure that the overcollateralisation (OC) level is compatible with the triple-A rating objective, the programmes include a dynamic Asset Coverage Test (ACT) that requires the balance of the mortgages in the collateral pool to significantly exceed the balance of the outstanding covered bonds. The level of OC will depend on the credit quality of the mortgages in the cover pool as well as other risks as assessed by the rating agencies.

IV. VALUATION AND LTV CRITERIA

For Credit Suisse, the LTV limit is set at 70% while for UBS at 80%. When calculating the appropriate loan balance within the asset coverage test (ACT), Credit Suisse allows higher LTV loans to be included in the pool, but loan amounts exceeding the cap are disregarded. For Credit Suisse, the LTV ratio of the mortgage loans cannot be more than 100%. UBS does not allow loans with LTV above 80% to be included in the Cover Pool, and if this LTV cap is breached after inclusion the loan amounts exceeding the cap will be credited with a reduced multiplication factor. In addition, the ACT gives reduced value to loans more than 90 days in arrears.

For both programmes LTV is calculated using market values.

For all properties that comply with its standard valuation boundaries (e.g. value below CHF3mn or property less than 15 years old) Credit Suisse utilises a hedonic automatic valuation model provided by IAZI, one of the two main providers of such automated appraisals in Switzerland. Should the purchase price lie above 15% off the IAZI valuation, Credit Suisse performs an onsite valuation of the property (this also applies for properties that fall outside the valuation boundaries).

UBS uses a hedonic automated valuation model from Wüst&Partner (the second main provider) for all loan applications. W&P and IAZI together value about two-thirds of all residential property transactions in the country. Input factors for the W&P model are property characteristics such as year of construction, volume of property and net living space. Additionally, the property's positioning within the local area and macro-level information (e.g. accessibility, tax level and price level of the municipality) are taken into account. If UBS deems on-site valuation as appropriate these will by specialist UBS staff (e.g. engineers or architects).

V. ASSET-LIABILITY MANAGEMEMT

Both covered bond programmes benefit from a number of safeguards:

> Exposure to market risk (i.e. interest rate and currency risks) needs to be neutralised by use of derivatives. Subject to certain rating triggers, swaps with suitable counterparties have to be entered into to ensure that exposure to market risk is properly hedged;

> Liquidity risk is mitigated by the requirement to establish a reserve fund as well as by other contractual arrangements. Initially, all of the bonds issued to date had 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). More recently, a number of issuance have been set-up as soft bullet with a maximum extension of 12 months

> 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 by way of the swaps;

> Commingling risk is mitigated by the requirement of all collections arising from the cover assets to be swept into the Hypotheken accounts after loss of F1/P-1 short-term ratings of the issuers;

> Minimum rating requirements are in place for the various third parties that support the transaction, including the swap counterparties and account banks. There are also independent audits of the calculations undertaken on a regular basis;

As a default of the issuer does not accelerate the covered bonds, an amortisation test has been created to ensure that no time subordination exists between the covered bonds series. The amortisation test will fail if the aggregate loan amount falls below the outstanding balance of all the covered bonds.

VI. TRANSPARENCY

Both issuers have committed to publishing monthly investor reports on a timely basis.

These reports provide various information relevant to investors including,

> the monthly calculations of the Asset Coverage Test and the Interest Coverage Test,
> details of outstanding covered bonds and list of parties involved in the transaction,
> balance of programme accounts,
> a mortgage portfolio summery outlining total contract balance, average loan balance, number of properties, WA remaining terms (in years) and WA LTV (in %),
> tables showing number of contracts or properties and mortgage amounts per remaining terms, current loan to value, total balance by property, interest rate type, distribution by W&P property region, property type, and arrears.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Although there is no mandatory reporting requirement, both of the issuers have committed to provide detailed and regular disclosure. The issuers are regulated Swiss financial institutions, which are subject to regulation and supervision by the Swiss banking regulator (FINMA). The issuers are responsible for the monthly pool monitoring and Asset Coverage, Interest Coverage and Amortisation Test calculations. The results are checked and verified by an independent asset monitor who immediately advises the trustee upon their breach. The cover pools themselves are audited by independent professional auditors at regular intervals.

In addition, rating agencies are involved in the programme and re-affirm the ratings of the program upon a pre-defined issuance volume. They also monitor the amount of over-collateralisation required to maintain the triple-A ratings.

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

Upon transfer for security purposes of the mortgage loans and the related mortgage certificates, each of the guarantors (Credit Suisse Hypotheken AG and UBS Hypotheken AG) becomes the legal holder of the mortgage loans as well as the legal owner of the mortgage certificates.

In an insolvency scenario over the issuers Credit Suisse or UBS, the mortgage loans 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;

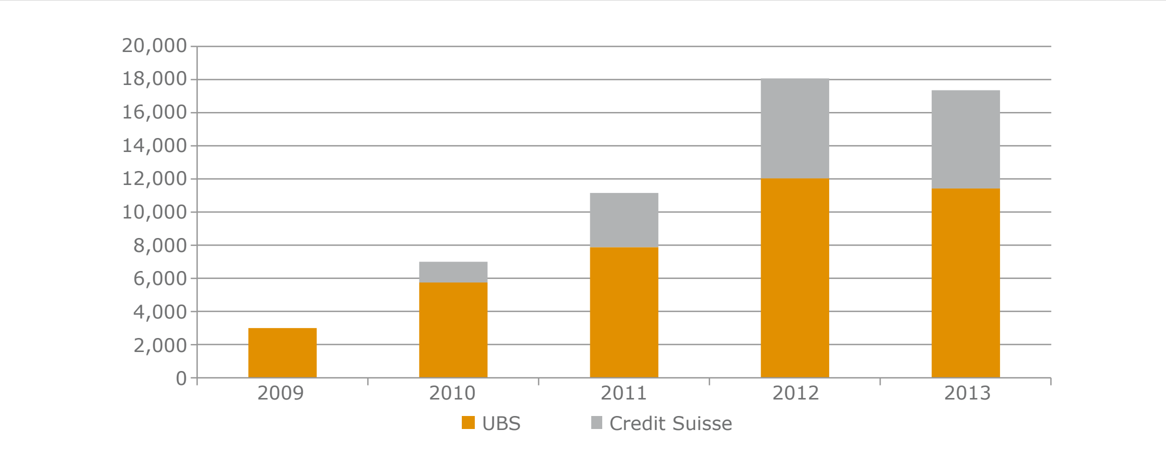
An issuer event of default would not accelerate payments to covered bondholders, but would allow the trustee to activate the guarantee.

The second event of default is the guarantor event of default. This would arise after an issuer event of default if the guarantor failed to make any payments when due, an amortisation test failed or the guarantor was declared bankrupt. A guarantor event of default would cause the acceleration of payments to covered bondholders and their early redemption at the amount relevant to that particular covered bonds series.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

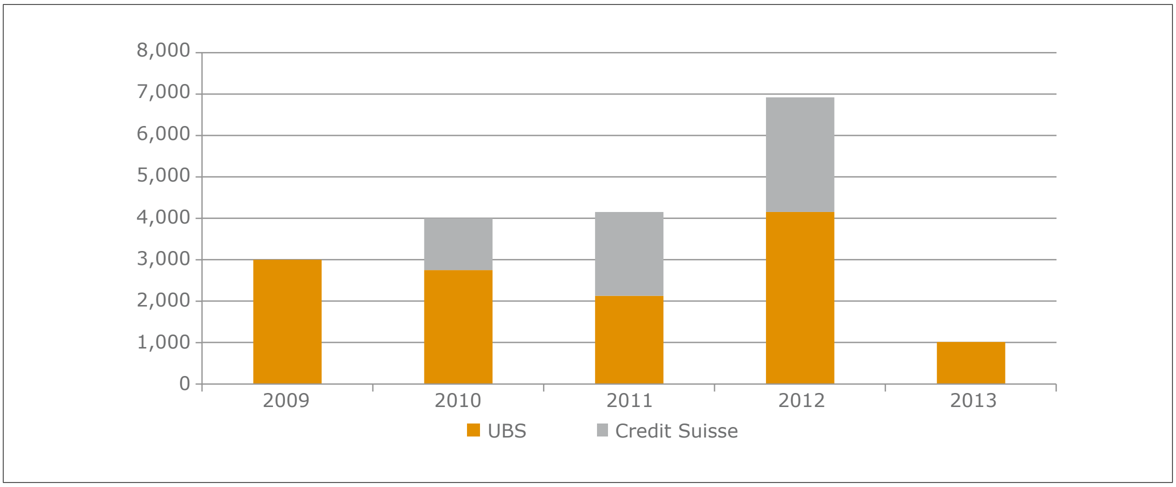
Swiss general-law based covered bonds have a 20% risk-weighting in accordance with the Capital Requirements Regulation (CRR). They fall under Liquidity Category III (structured covered bonds) of the ECB eligible assets criteria.

> FIGURE 1: COVERED BONDS OUTSTANDING 2009-2013, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2009-2013, EUR M



Source: EMF/ECBC

Issuers: Credit Suisse Hypotheken AG and UBS Hypotheken AG.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/92/Credit_Suisse_CB and http://www.ecbc.eu/framework/78/UBS_CB

3.35 TURKEY

By Özlem Gökçeimam and Serdar Sarı, Garanti Bank

I. FRAMEWORK

Turkish covered bonds are defined as "*İpotek Teminatlı Menkul Kıymetler (İTMK)*" or "Turkish mortgage covered bonds (MCBs)" and are trademarked by the legislation.

Published on 21 January 2014 by the Turkish Capital Markets Board (CMB), the Communiqué on Covered Bonds (Series III-59.1) replaced the older Communiqués on Mortgage Covered Bonds and Asset Covered Bonds (Series: III, No: 33 and 38 respectively), creating a single framework for both types. The new Communiqué itself is based on the Articles 13, 59 and 60 of the new Capital Markets Law (CML) No. 6362.

Together with its predecessors, the Communiqué on Covered Bonds is part of a series of legislation enacted following the 6 March 2007 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.

Even though the current Communiqué covers both Asset- and Mortgage- covered bonds, this chapter focuses on MCBs only.

II. STRUCTURE OF THE ISSUER

İTMKs are capital market instruments qualified as debt instruments, issued within the scope of the issuer's general liability and collateralized by cover assets.

İTMKs may be issued by Housing Finance Institutions (HFIs) and Mortgage Finance Institutions (MFIs). While MFIs are joint stock companies defined in Article 60 of the CML (which entities are joint stock companies, established for the purpose of acquiring and transferring assets qualifications designated by the CMB, managing such assets or taking such assets as collateral and conducting other activities approved by the CMB within the scope of housing finance and asset finance), HFIs are banks, financial leasing companies and finance corporations authorized by the Banking Regulatory and Supervision Agency (BRSA) to perform housing finance activities.

The issuers are required to apply to the CMB for approval to issue covered bonds, and the CMB must also approve the related prospectus if the covered bonds are to be offered to public in Turkey and provide the required "issuance certificate". Where the issuer is a bank, the consent of the BRSA must be included in the application documents submitted to the CMB. Additionally, an approved tranche issuance certificate is required to be obtained from the CMB before any sale and issuance of the MCBs.

III. COVER ASSETS

Eligible assets for MCBs are:

> receivables of banks and financing corporations, arising from housing finance which have been secured by mortgage (or another type of collateral that is approved by the CMB),

> receivables arising from financial lease agreements arising from housing finance,

> mortgage secured commercial loans and receivables of the banks, financial leasing companies or financing corporations,

> receivables arising from the instalment sale contracts of houses by the Housing Development Administration of Turkey (TOKİ) (only for the issuance to be made by MFIs),

> substitute assets,

> other assets whose characteristics shall be determined by the CMB.

Bank loans

- > that have been disbursed to natural persons and legal entities with financial creditworthiness,
- > the principal and interest payments of which have been structured with respect to the solvency and cash flow of the debtor,
- > the repayments of which has been made within specified periods,
- > for which no repayment problems are expected in the future and that can be fully collected, and
- > for which no weakening of the creditworthiness of the applicable borrower has been found, can be included in the cover register.

The immovable properties securing the mortgage loans must be located in Turkey and the market price of the immovable property is required to have been determined by an appraisal company that is listed by the BRSA or the CMB, at the time of utilization of the mortgage loan or creation of the receivable.

With respect to loan to value requirements, the portions of the residential mortgage loans and commercial mortgage loans exceeding respectively 75% and 50% of the value of the real estate securing them shall not be taken into consideration in the calculation of the cover matching principles.

Up to 15% of the net present value of the cover pool may be comprised of certain approved substitute assets, which can include cash, certificates of liquidity issued by the Central Bank of Turkey, domestic and foreign government bonds of Turkey, lease certificates issued by the asset leasing corporations established by the Undersecretariat of Treasury, securities guaranteed by the Treasury within the framework of the Law on the Regulation of Public Financing and Debt Management dated 28 March 2002 and numbered 4749, securities issued by or with the guarantee of the central administrations and central banks of the countries that are members of the Organisation for Economic Co-operation and Development and other assets that the CMB approves and discloses to the public.

Rights and liabilities regarding derivative instruments relating to the cover pool and/or MCBs may also be included in the cover assets; however, at the stage of applying to the CMB, information on derivative instrument agreements that are planned to be entered into, and the positions that are planned to be hedged against risk, are required to be provided to the CMB.

IV. ASSET - LIABILITY MANAGEMENT

The cover pool must also comply with certain cover matching principles, which shall be monitored by the issuer at every change relating to the cover assets and, in any case, at least once a month. The matching principles involve:

- > **Nominal Value Matching:** The nominal value of the cover assets may not be less than the nominal value of the MCB. While calculating the nominal value for purposes of this test, the balance of the principal amounts of the mortgage loans, the issuance price of the discounted debt instruments, and the nominal value of the premium-debt instruments shall be taken into consideration. Derivative instruments shall not be taken into consideration for the calculation of nominal value matching.
- > **Cash flow matching:** The sum of interest, revenues and similar income that are expected to be generated from cover assets within 1 year following the calculation date may not be less than the payment obligations expected to arise from total liabilities under the MCBs and derivative instruments if any, during the same period.
- > **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 MCBs.

> **Stress Tests:** The responsiveness of the net present value matching to the potential changes in interest rates and currency exchange rates shall be measured with monthly stress tests. In order to measure the effect of the changes in interest rates, the yield curves obtained from swap rates shall be slid downward and upward in parallel. Parallel sliding shall be made by increasing or decreasing the TL interest rate applicable for each maturity by 300 basis points and the foreign currency interest rate applicable for each maturity by 150 basis points. In order to measure the effect of changes to the currency exchange rates on the cash flows in foreign currency, the foreign exchange buying rate shall be increased and decreased by 30%.

V. TRANSPARENCY

According to Article 15 of the CML, information, events and developments which may affect the value and price of capital market instruments or the investment decision of investors shall be disclosed to public by issuers or related parties.

The Public Disclosure Platform (PDP) is an electronic system through which electronically signed notifications required by the capital markets and Borsa Istanbul regulations are publicly disclosed. In addition to Borsa İstanbul companies and ETFs, investment firms, mutual funds, pension funds and foreign funds may submit notifications to PDP. Independent audit companies, on the other hand, send the electronically signed financial statements for which independent audit is required, to the relevant company electronically in order to be announced to the public. Please see http://www.kap.gov.tr/en/about-pdp/general-information.aspx for further information.

For any issuer of MCBs subject to these reporting requirements, this published information will be available to investors in the MCBs However, some of this information may be published only in Turkish.

In order to ensure that the covered bond holders are informed:

a) compliance reports on the cover matching principles and the notifications made by the transaction's cover monitor (a third party who monitors the cover pool) are required to be announced on the website of the issuer and on the PDP on the day on which the cover monitor delivers its report or the notification to the issuer;

b) an investor report is required to be announced on the website of the issuer and on the PDP within six business days following the end of the quarterly accounting period; and

c) the fact that the issuer has not fulfilled its payment liabilities under the MCBs partially or fully is required to be announced on the website of the issuer and on the PDP on the date when such fact is known to the issuer.

If MCBs are issued without any public offering, the above-noted announcements are required to be delivered to the MCB investors online, through the Central Registry Agency, and shall be published in the website of the issuer for access by the MCB investors.

VI. COVER MONITOR AND BANKING SUPERVISION

A cover monitor is required to be in place to supervise the cover pool. The cover monitor is appointed by the issuer and must possess the expertise and experience necessary to fulfil all of its statutory duties. A qualification as a certified auditor by the CMB suggests that the necessary expertise is provided, though this would need to be confirmed in each circumstance. The cover monitor can only be removed with CMB approval.

Cover monitor should, among others:

> monitor formation of the cover pool with eligible assets as of the date of application for issuance to the CMB,

> monitor cover pool's compliance with cover matching principles as of the date of application for issuance to the CMB, and thereafter inspect compliance with the cover matching principles and accuracy of the stress test measurements,

- in case the cover register is kept in electronic form, inspect the adequacy of such system and submit a report including the results of this inspection to the issuer, together with a copy to the Board,
- examine the accuracy of the entries made regarding addition, removal or replacement of cover assets by reviewing the underlying loan documentation and other information and documents, as it may deem necessary,
- in the event of a cover matching principle violation or a default by the issuer, inspect whether measures in connection therewith set forth under the Communique is followed,
- prepare a report at least semi-annually in case of (international issuances) indicating its findings regarding compliance with cover matching principles and entries made regarding removal or replacement of cover assets and, if applicable measures to be taken following violation of cover matching principles or default.

The cover monitor is required to report any inconsistencies in the cover register or failures in matching principles to the issuer.

The cover monitor is also authorised to conduct a discretionary review of the cover assets, including substitute assets as well as the derivative instruments in place.

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

A cover register held by the issuer permits the identification and segregation of the cover assets. The collateral backing the MCBs is to be registered in book and/or in electronic form.

The issuer, prior to the sale of MCBs, is required to identify a replacement servicer and disclose such information in the prospectus or the issuance certificate. In the events listed below, the replacement servicer will manage the cover assets and make payments arising from the total liabilities, as long as the income generated from the cover assets is sufficient, without assuming the total liabilities:

a) the issuer fails to perform its liabilities in due time,

b) the total liabilities of the MCBs exceed the total value of the cover assets,

c) the management or supervision of the issuer is transferred to public institutions,

d) the operation license of the issuer is cancelled, or

e) the issuer goes bankrupt.

If the replacement servicer assigned by the issuer is not able to fulfill its duties for any reason whatsoever, the CMB will appoint another bank or an MFI that qualifies to be an issuer or, the cover monitor or an independent audit company to act as administrator, without assuming the total liabilities, in order to manage the cover assets and to fulfill the total liabilities (i.e. liabilities with respect MCBs and derivative instruments), to the extent the revenue generated from the cover assets is sufficient.

Until the MCBs are completely redeemed, even if the management or the supervision of the issuer is transferred to public institutions, cover assets cannot be disposed of for any purpose other than securing MCBs, pledged, or designated as collateral, attached by third parties, including for the collection of taxes or other public receivables, or subject to injunctive decisions of courts or included in the bankruptcy estate of the issuer.

The administrator for an issuer of MCBs may transfer the cover assets and total liabilities partially or fully to another bank or to an MFI that qualifies to be an issuer, after obtaining the affirmative opinion of CMB. In such case, transferee bank or MFI shall become the owner of the cover assets upon such transfer and shall become responsible for the payments arising from total liabilities. After performance of the total liabilities in full, the balance of the cover assets would belong to the transferee bank or MFI.

If the cover assets cannot be transferred to another issuer or if the cash flows from the cover assets are insufficient to pay total liabilities, the administrator can allocate the residual cash to MCB investors according to their respective shares and further request from the CMB that the MCBs be redeemed early. Should the cover pool not suffice to cover all outstanding MCB liabilities (including interest), the MCB investors may recourse to issuer's other assets with respect to which they will (with respect to the shortfall) rank pari-passu with unsecured creditors of the issuer.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

As Turkey is not currently a member of the EU, MCBs are not UCITS-compliant and, therefore, are not compliant with the EU's Capital Requirements Regulation (CRR) and do not qualify for beneficial treatment under the CRR.

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 CRR.

The EU progress report on Turkey, published in October 2013, acknowledges that preparations in the area of financial markets are "advanced" and specifically mentions the newly adopted Capital Markets Law, which aims at "further aligning the legislative framework with the acquis", the whole body of EU law.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/50/Turkey

3.36 UNITED KINGDOM

By Jussi Harju, Barclays and John Millward, HSBC

The UK covered bond market has been established since 2003, initially based on general English law structured finance principles prior to the introduction of a dedicated covered bond regulatory framework by HM Treasury in March 2008 (the Regulated Covered Bonds Regulations 2008 (the "Regulations")). The Regulations overlaid the existing general law and contractual structures, providing the necessary underpinning for compliance under Article 52(4) of Directive 2009/65/EC (the "UCITS Directive")[1] compliance and thereby provided the UK structure with benefits including higher investment limits and higher investment thresholds for insurance companies. All UK regulated covered bonds also comply with the definition of covered bonds set out in Regulation (EU) 575/2013 (Capital Requirements Regulation, or "CRR") thereby qualifying for lower risk-weightings. The Regulations were further amended in November 2011 and November 2012 to further promote the "transparency of UK covered bonds and creating a more prescriptive regulatory framework"[2]. The amendments became effective for regulated programmes from 1 January 2013.

Regulated covered bonds are subject to special public supervision by the Financial Conduct Authority (FCA) as Special Public Supervisor, whose stated aims are to ensure a robust regulated covered bond market in the UK, and to ensure that quality is maintained to preserve investor confidence in the UK regulated covered bond market's reputation. The FCA has a wide range of enforcement powers under the Regulations, including the power to issue directions, de-register issuers or fine persons for any breaches of the requirements under the Regulations.

I. FRAMEWORK

Under the Regulations, in order to attain "regulated" status there are two general sets of requirements the issuers need to comply with – those relating to issuers and those relating to the covered bond programmes. Issuers are permitted (but are not required) to submit their covered bond programmes to the FCA for recognition. Those issuers and covered bonds that meet all of the criteria set out in the Regulations and are approved by the FCA are added to the register of regulated covered bonds maintained by the FCA[3]. The Regulations only apply to those covered bonds which have been admitted to the register.

Most elements of the regulated covered bond structure are governed by contract, with the Regulations providing an overarching legislative and supervisory framework without prescribing the complete design and contractual arrangements for the product. The Regulations do, however, prescribe certain key structural principles and requirements, including the requirements that assets must always remain capable of covering claims attaching to covered bonds at all times, and priority of claims against the cover pool in a winding up scenario. The FCA also has a veto over material amendments to the contracts, broad powers to enforce its provisions and conducts its own rigorous ongoing review of regulated programmes.

II. STRUCTURE OF THE ISSUER

The Regulations require the issuer to be a credit institution authorised in the UK to carry out regulated activities, such as deposit-taking. It must also have a registered office in the UK and meet certain additional criteria set out by the FCA.

1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

2 All UK regulated covered bond key documents are available at the following link: http://www.fca.org.uk/firms/systems-reporting/register/use/other-registers/rcb-key-documents.

3 The register may be found at http://www.fca.org.uk/firms/systems-reporting/register/use/other-registers/rcb-register.

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 default by the issuer. The Regulations require all cover assets (including any substitution assets) to be segregated from the insolvency estate of the issuer by being sold to a special purpose entity (referred to in the Regulations as the "owner"), which guarantees the issuer's obligations under the bonds and provides security over the cover assets to a security trustee on behalf of the investors. All transactions to date have used a limited liability partnership (LLP) for this purpose, with the transfer effected via equitable assignment. 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 (a "capital interest in kind").

If the guarantee is activated, the LLP will use the cash flows from the cover pool to service the covered bonds. If these cash flows are insufficient, or within a certain timeframe of the legal final maturity of the bonds, the LLP is permitted to sell cover assets, within certain defined parameters and subject to meeting certain tests to ensure equality of treatment of bondholders.

III. COVER ASSETS

The Regulations broadly allow the following asset types:

> Assets which are listed in Article 129 CRR, subject to the following restrictions:

> > Exposures to credit institutions with ratings below Credit Quality Step 1 (AA-) as set out in the CRR are not permitted; and

> > Securitisations are not permitted.

> Certain assets which are not permitted under the CRR - namely loans to registered social landlords and loans to public-private partnerships (and loans to providers of finance to such companies, and subject in each case to certain restrictions).

> Liquid or "substitution" assets up to the prescribed limit (10% in most cases to date).

Issuers are required to designate programmes as either "single asset type" or "mixed asset type". Mixed asset type programmes are allowed to include any of the assets set out above, whereas single asset type programmes would be required to select either residential mortgages, commercial mortgages, or public sector loans (including social housing and PPP loans, which are not CRR-eligible), in each case as defined in the CRR.

The Regulations include a narrow definition of liquid or "substitution" assets, which are defined as UK government bonds (or other government bonds which comply with the requirements set out in Article 129(1)(a)) or (b) CRR or deposits in GBP or another specified currency held with the issuer or with a credit institution which comply with the requirements set out in Article 129(1)(c) CRR.

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.

The Regulations require cover assets to be of high quality, and the FCA 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.

In all of the programmes that have been registered to date, 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 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 automated valuation models) are also accepted. 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 15% haircut is applied.

The LTV limit for mortgages varies across the different programmes (see Figure 1), but in all existing programmes it is below the 80% level for residential mortgages required under the CRR and the Regulations. Loans with LTV above this limit may be included in the pool, but the amount of the loan which exceeds the limit is excluded from the Asset Coverage Test (ACT). Loans which are in arrears are either repurchased by the issuer or subject to additional haircuts (see Figure 1).

V. ASSET – LIABILITY MANAGEMENT

For UK regulated programmes, over-collateralisation (OC) levels are determined according to the higher of: (i) the regulatory minimum amount specified in the Regulations of 8% on a nominal basis, (ii) contractual minimum amounts specified in the legal agreements, (iii) requirements imposed by the FCA, and (iv) amounts required to pass the programme's ACT (in particular as required to support the given rating level from the relevant rating agencies). However, in many programmes, the contractual minimum amounts specified are already in excess of this regulatory minimum requirement, and in any case the OC required by the rating agencies and/or FCA are significantly higher.

A key principle of the Regulations is that they require the cover pool to be capable of covering all claims attaching to the bonds at all times. In addition to the amounts required either under the regulatory minimum or under the contractual requirements, the minimum OC level for any programme is also considered by the FCA on a case-by-case basis, taking into account the quality of the cover assets, risk-mitigation measures (such as swaps and downgrade triggers) and asset-liability mismatches. The FCA has the power to require the issuer to add further assets to its cover pool if it deems the collateral to be insufficient.

The principal contractual requirement under UK structures is the presence of a dynamic ACT which must be carried out on a monthly basis to ensure that minimum OC requirements are satisfied. The ACT requires the discounted value of the cover pool (after applying the haircuts listed below) to be equal to or exceed the principal amount outstanding of covered bonds. The following haircuts are applied:

> The adjusted value of the mortgage pool is calculated by taking the lower of: (i) balance of mortgages up to the indexed LTV limit specified in the programme documents, and (ii) the asset percentage multiplied by the balance of mortgages.[4] Performing mortgages get credit 60-75% while for non-performing mortgages (i.e. >3m in arrears) this is 0-40%, depending on the programme.

> Any cash or substitution assets are also included.

> Additional haircuts are applied to mitigate set-off risk, redraw risk on flexible mortgages (if appropriate), and potential negative carry.

The asset percentage is determined on an on-going basis by the rating agencies and is subject to a maximum as set out in the programme documents (which corresponds to the minimum contractual requirement, Figure 1).

4 For example: Let us assume a cover pool which contains two loans. Each loan has a principal balance of GBP 80 and is secured by a property worth GBP 100. If the ACT applies an LTV cap of 75% and an asset percentage of 90%, the issuer will get credit for GBP 144 of loans: applying the LTV cap would allow GBP 150 (maximum 75% LTV for each loan); but the asset percentage allows a lower amount (GBP 160 x 90% = GBP 144) and therefore takes precedence.

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 (see Section VIII below). The issuer may also become liable to enforcement action by the FCA.

An amortisation test is run on each calculation date after the delivery of a notice to pay (see Section VIII below), which is designed to ensure that the cover pool will be sufficient to make payments under the covered bonds as required under the guarantee. The amortisation test is similar to the ACT, but more simply tests whether the principal balance of mortgages is sufficient to make payments in full on covered bonds, taking into account negative carry. If the test is failed, the covered bonds will accelerate against the LLP.

Most UK covered bond transactions currently in the market have been issued with 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. It is important to note that the issuer does not have the option to extend the bond's maturity; failure by the issuer to repay the bond in full on the scheduled maturity date would result in an event of default.

Certain programmes include a hard bullet option, whereby a "pre-maturity test" is designed to ensure that the LLP has sufficient cash available to repay the bonds, in full, on the original maturity date in the event of the issuer's insolvency. If, in a specified period before a maturity date (6-12 months, depending on the issuer and the rating agency), the issuer's ratings fall below certain specified triggers (typically A-1+ / P-1 / F1+), the pre-maturity test requires the LLP to cash-collateralise (either via cash contributions from the issuer or by selling cover pool assets) its potential obligations under the guarantee.

All regulated covered bond programmes include a number of other safeguards. In particular, there are minimum rating requirements for the various third parties that support the transaction, including the swap counterparties and bank account providers, and an independent asset monitor is required to undertake an audit of the cash manager's calculations on a regular basis. Furthermore, if the issuer's short-term ratings are below certain trigger thresholds (most programmes have triggers of A-1+/P-1/F1+), the LLP is required to establish and maintain (from the asset cash flows), a reserve fund which is the higher of (i) the next three months' interest payments on a rolling basis, and (ii) the next following interest payment, together with the relevant amount of senior costs and GBP 600,000 (as required under the UK's Enterprise Act). This amount is retained in the LLP's bank account.

VI. TRANSPARENCY

UK regulated covered bond programmes benefit from extremely detailed investor reporting conventions in comparison to other jurisdictions. The market has conformed to a relatively high standard of reporting since inception, but in addition the FCA requires detailed reporting to be provided by regulated issuers in its capacity as special public supervisor.

Similarly, transparency is to a large extent driven by the eligibility criteria in the Bank of England (BoE) Sterling market operations, under which (among other things) issuers must publish transaction documentation, provide homogenised transaction summaries and investor reports, and publish loan level data.

FCA reporting requirements, which were updated in December 2011 and became effective in January 2013, are closely aligned with the BoE criteria but also include certain additional items not included in the BoE criteria. Since the introduction of the updated amendments, all regulated issuers comply with both sets of rules.

In addition, six of the twelve UK regulated covered bond issuers (Abbey National Treasury Services, Clydesdale Bank, Coventry Building Society, Lloyds Bank, Nationwide Building Society, Royal Bank of Scotland and Yorkshire Building Society) have adopted the ECBC label initiative and report in the UK National Transparency Template: https://www.coveredbondlabel.com/issuers/national-information-detail/27/

VII. COVER POOL MONITOR AND BANKING SUPERVISION

An applicant under the Regulations must be a credit institution authorised in the UK to carry out regulated activities, such as deposit-taking. Issuers must satisfy the FCA that their programmes comply with the criteria set out in the Regulations and provide, among other things:

> Details on the quality of cover assets and the ability of the assets on the issuer's balance sheet to satisfy substitution requirements;

> Details concerning the programme structure, such as the cover pool eligibility criteria, the formulae used to calculate compliance with minimum OC requirements, ability to meet payments on a timely basis and ratings triggers;

> Details concerning asset and liability management, audit and controls, risk management and governance framework;

> Details on the proficiency of cash management and servicing functions;

> Detailed analysis on the ability of the assets and the mitigants within the programme structure to address inherent interest rate, currency, asset and liability mismatch and market value risks;

> Arrangements for the replacement of key counterparties; and

> Independent legal and audit opinions on the compliance of the issuer and programme with the Regulations.

The issuer is responsible for monthly cover pool monitoring. The FSA must be notified by the issuer of any breaches of the ACT, and may also require the issuer to provide such additional information about the cover pool as it considers fit. All existing programmes have at least two internationally recognised rating agencies who will also undertake detailed reviews both on a condition precedent to each issuance, and thereafter on at least a quarterly basis as part of ongoing transaction surveillance. The rating agencies may revise the asset percentage as part of these review processes, either due to variations in asset quality or embedded transaction risk factors, or due to periodic rating criteria change.

All programmes since inception have included an independent third party asset monitor within the existing contractual arrangements who are required to perform various functions within the transaction including an annual review of the ACT calculation, and periodic audit procedures to be undertaken with respect to the asset pool.

In November 2011, the Regulations were updated to formally codify the role of an independent "Asset Pool Monitor" which (i) must be eligible to act as an independent auditor (ii) is conveyed with certain powers to inspect books and records associated with the relevant programme, (iii) must conduct a biannual inspection of the issuer's compliance with its duties as set out in the Regulations, and (iv) must report to the FCA on an annual basis (or sooner if the issuer is found to be failing to comply with its duties). These additional requirements became effective on 1st January 2013 and regulated programmes have generally been updated to reflect the amendments.

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

The Regulations require all cover assets (including any substitution assets) to be segregated from the insolvency estate of the issuer by being transferred to a special purpose entity (referred to as the "owner" in the Regulations), which guarantees the issuer's obligations under the bonds. All transactions to date have used an LLP for this purpose.

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 FCA. 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 obliged 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 (in most cases); and

> Failure to rectify any breach of the pre-maturity test (if applicable).

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. The delivery of a notice to pay does not however accelerate payments to noteholders, and the LLP will continue to make payments of interest and principal on the covered bonds on their originally scheduled payment dates (provided that an LLP acceleration event (as described below) has not occurred).

LLP acceleration events typically include:

> The LLP fails to pay any interest or principal when due under the guarantee;

> Bankruptcy or similar proceedings are commenced involving the LLP; and

> After delivery of a notice to pay, the LLP breaches the "amortisation test".

The occurrence of an LLP acceleration event causes the acceleration of payments by the LLP to covered bondholders and the redemption of the bonds at the relevant early redemption amount.

The LLP is reliant on the proceeds derived from the cover assets to make payments under the guarantee. Under the Regulations, in a winding up scenario, no claims against the cover assets can rank ahead of the claims of the regulated covered bondholders. If the proceeds from the cover pool are insufficient to meet the obligations to bondholders in full, investors will continue to have an unsecured claim against the issuer (and any group guarantors) for the shortfall.

IX. 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 CRR (particularly for single asset type programmes as described above). To date, all existing regulated covered bonds are contractually restricted to containing only residential mortgage assets (as well as substitution assets up to the prescribed limit), meaning they are CRR compliant and therefore benefit from the same preferential treatment as covered bonds from other EU jurisdictions. However, certain assets which are excluded from the CRR – such as loans to UK housing associations – are technically permitted in the cover pool under the Regulations, and so it is possible that in future programmes could be structured which do not qualify for the preferential risk weightings.

> FIGURE 1: OVERVIEW – REGULATED UK COVERED BOND PROGRAMMES

At the time of writing there are 12 regulated covered bond issuers in the United Kingdom: Abbey National (ABBEY); Barclays Bank Plc (BACR); Bank of Scotland Plc (HBOS); Clydesdale Bank Plc (CLYDES); Co-operative Bank (COOPWH); HSBC Bank (HSBC), Leeds Building Society (LEEDS), Lloyds TSB Bank (LLOYDS), Nationwide Building Society (NWIDE); Royal Bank of Scotland (RBS); Coventry Building Society (COVBS) and Yorkshire Building Society (YBS).

	ABBEY	BACR	CLYDES	COOPWH	COVBS	HBOS	HSBC	LEEDS	LLOYDS	NWIDE	RBS	YBS
Programme volume (bn)	€ 35	€ 35	€ 10	€ 3	€ 7	€ 60	€ 25	€ 7	€ 30	€ 45	€ 25	€ 7.5
LTV cap	75%	75%	75%	75%	75%	60%	75%	75%	75%	75%	75%	75%
House price index	Halifax	Halifax	Nation-wide	Halifax	Nation-wide	Halifax	Halifax	Halifax	Halifax	Nation-wide	Halifax	Avg. of Halifax & Nation-wide
Maximum asset percentage	91.0%	94.0%	90.0%	93.5%	90.0%	92.5%	92.5%	93.5%	93.0%	93.0%	90.0%	92.5%
Minimum OC*	10%	6%	11%	7%	11%	8%	8%	7%	8%	8%	11%	8%
Current asset percentage	89.3%	74.4%	81.5%	77.5%	78.4%	77.0%	87.0%	77.8%	85.0%	84.5%	74.4%	83.7%
Current OC (Adj. Loan balance/CB outstanding)	8%	10%	26%	55%	3%	42%	698%	12%	18%	10%	23%	41%
Credit for loans in arrears (>3 months)	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	No credit	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	<3M: 75%, >3M: 40%	LTV<75: 40% LTV>75: 25%
Can issue hard bullets? **	Yes	Yes	Yes	Yes	No	Yes	Yes	No	Yes	Yes	Yes	No
Asset monitor	Deloitte	PWC	E&Y	PWC	E&Y	KPMG	KPMG	Deloitte	PWC	PWC	Deloitte	KPMG

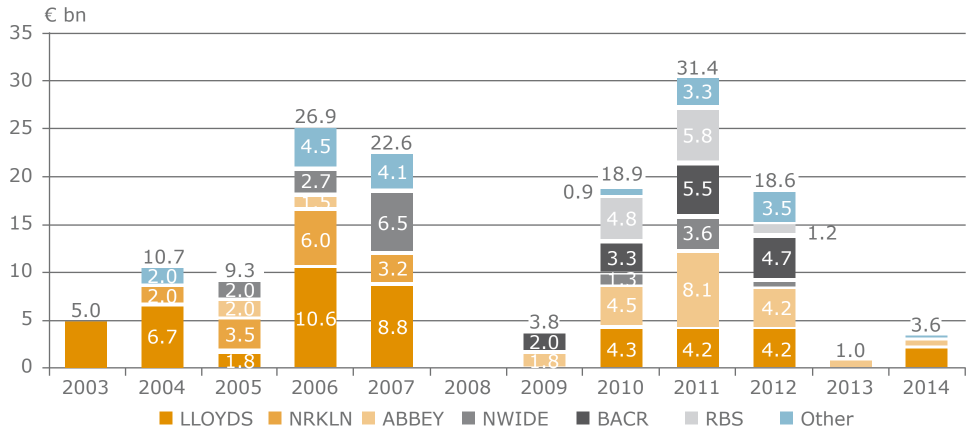
* OC = Over-collateralisation, minimum OC calculated as (1 / maximum asset percentage)-1 (ie it excludes other items in the ACT).
** Hard-bullets possible only if pre-maturity test is in place and passed / soft-bullets issued with 12-months extension.

Source: transaction documents, investor reports, Barclays Research

X. ADDITIONAL INFORMATION

The current outstanding volume of regulated, publicly placed benchmark covered bonds and respective taps (benchmark covered bonds hereafter) amounts to EUR 103 bn (equivalent). Issuance in 2013 was slow with only one EUR1 bn benchmark covered bond in 2013. Primary activity picked up slightly this year with four new benchmark bonds totalling EUR 3.6bn equivalent being issued at the time of writing. Owing to the very limited supply, the outstanding volume of UK regulated covered bonds shrank EUR14bn equivalent in 2013.

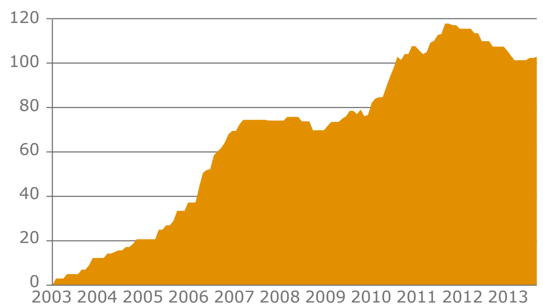
> FIGURE 2: ANNUAL SUPPLY OF UK BENCHMARK COVERED BONDS BY ISSUER (2014 YTD)



Source: Barclays Research

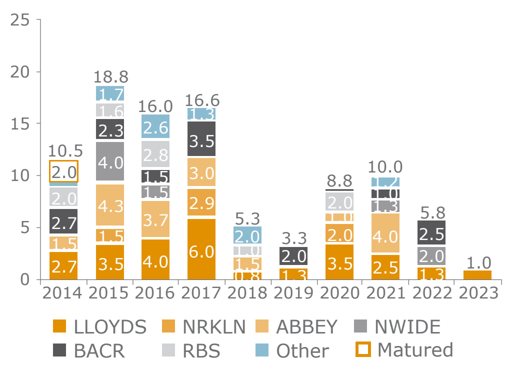
Figures 3 and 4 show the development of total outstanding benchmark UK covered bonds and the annual redemptions per issuer. Figures 5 and 6 show the market share (as measured by covered bonds outstanding) per issuer and the currency distribution for outstanding issuances.

> FIGURE 3: DEVELOPMENT OF OUTSTANDING VOLUME (BENCHMARK COVERED BONDS), EUR BN



Source: Barclays Research

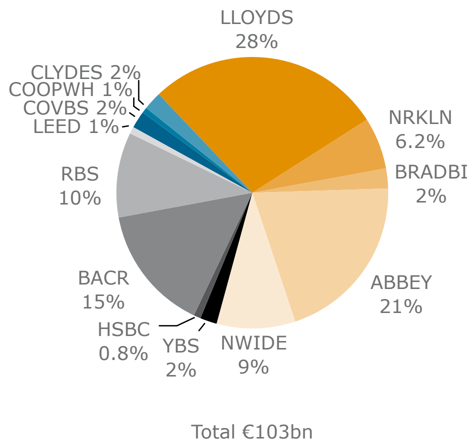
> FIGURE 4: ANNUAL REDEMPTION PER ISSUER (BENCHMARK COVERED BONDS), EUR BN



Source: Barclays Research

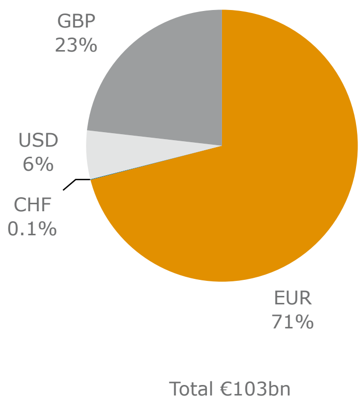
UK covered bond market still remains predominantly denominated in EUR. The uptick in GBP denominated benchmark issuance seen in 2011-12 has not been repeated since and at the time of writing 71% of all UK benchmark covered bonds were denominated in EUR (23% in GBP and 6% in USD).

> FIGURE 5: MARKET SHARE OF OUTSTANDING, JUNE 2014 (BENCHMARK ISSUANCES)



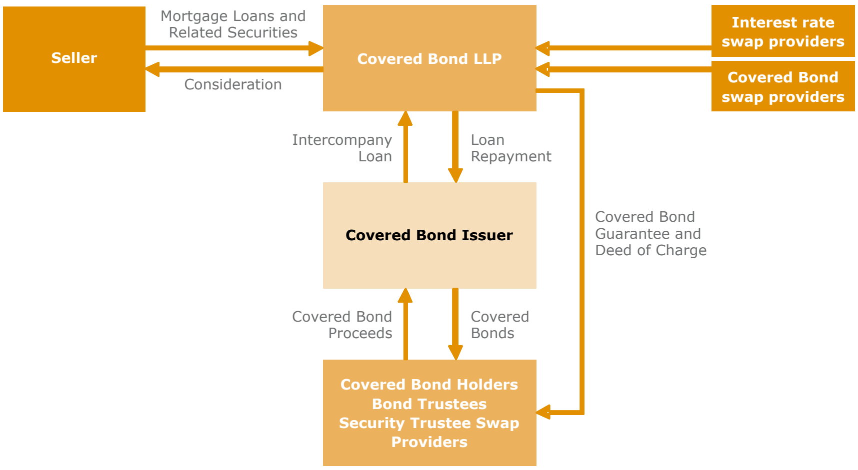
Source: Barclays Research

> FIGURE 6: OUTSTANDING BENCHMARK ISSUANCES BY CURRENCY, JUNE 2014



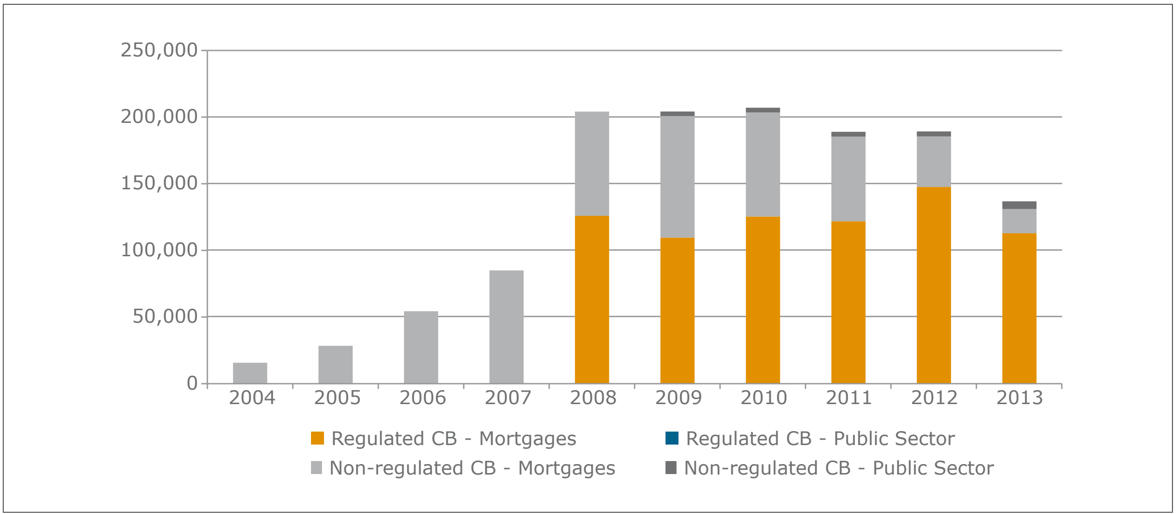
Source: Barclays Research

> FIGURE 7: GENERIC UK COVERED BOND PROGRAMME STRUCTURE



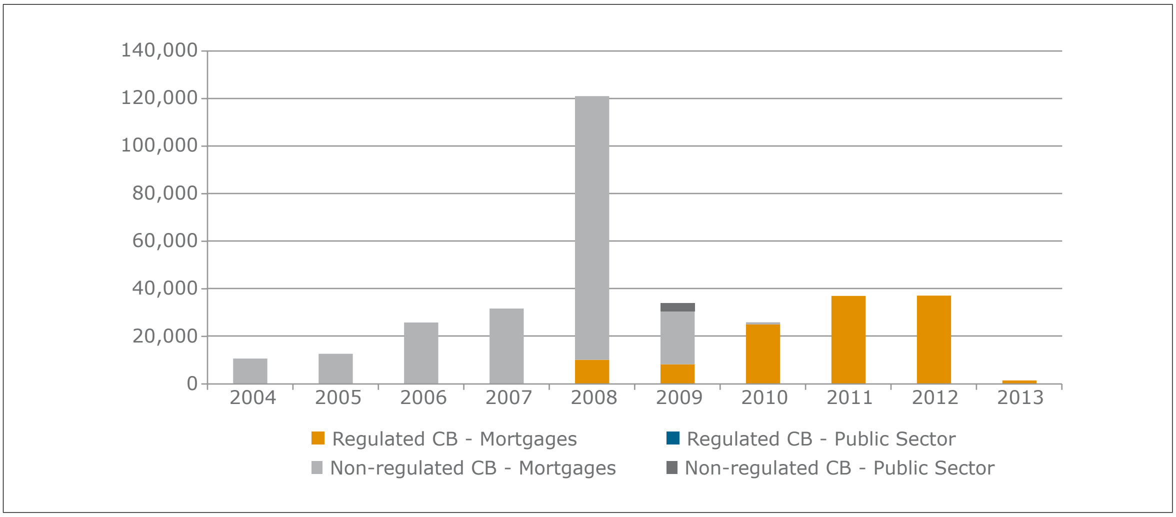
Source: Barclays Research

> Figure 8: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC. Please note that this data includes private placements, floating rate covered bonds and self-retained issuances that may have been used to access central bank liquidity.

> Figure 9: Covered Bonds Issuance, 2004-2013, EUR m



Source: EMF/ECBC. Please note that this data includes private placements, floating rate covered bonds and self-retained issuances that may have been used to access central bank liquidity

Issuers: There are 12 regulated issuers each with one regulated mortgage programme (some regulated issuers also have unregulated programmes). For more details, please refer to the FCA's website http://www.fca.org.uk/firms/systems-reporting/register/use/other-registers/rcb-register.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/52/Regulated_Covered_Bonds_-_RCB

Covered Bond Label: Abbey National Treasury Services plc; Clydesdale Bank €10 billion Global Covered Bond Programme; Coventry Building Society – 1006; Lloyds Bank plc EUR60bn Global Covered Bond Programme; Nationwide Covered Bond LLP; RBS Covered Bond programme; YBS Covered Bonds

3.37 UNITED STATES

By Anne Caris, Bank of America Merrill Lynch

No covered bond legislation has been passed yet in the US despite several attempts in recent years. As such, the two outstanding bonds by Bank of America and Washington Mutual (acquired by JP Morgan) maturing in 2016 and 2017, respectively, are structured covered bonds. The Federal Deposit Insurance Corporation (FDIC) published a Covered Bond Policy Statement back in 2008, which was supplemented by the US Treasury's Best Practices for Residential Covered Bonds. However, the covered bond market never took off on that basis, notably due to possible repudiation by the FDIC.

The latest two legislation attempts, the United States Covered Act in 2011 and the Protecting American Taxpayers and Homeowners (PATH) Act in 2013, aimed to address this concern together with other details but none so far made it through the full legislative process. Within PATH, covered bonds have been discussed as part of the Government Sponsored Enterprises (GSEs) reform being considered as a secondary priority to the latter. However, a speech on 26 June 2014 by Jack Lew, the US Treasury secretary, suggests possible new avenues where covered bonds could have a role to play alongside GSEs.

I. WHAT IS CURRENTLY IN FORCE

I.1. The FDIC's Covered Bond Policy Statement

The FDIC Covered Bond Policy Statement, effective from 28 July 2008, aimed to clarify the treatment of covered bonds in a conservatorship or receivership. Under the Federal Deposit Insurance Act (FDIA), any liquidation of collateral of an Insured Depositary Institution (IDI) placed into conservatorship or receivership requires the consent of the FDIC during the initial 45 days or 90 days after its appointment, respectively. Under such conditions, covered bond issuers would need to hold extra liquidity to prevent any default during that time if the FDIC as a conservator or receiver were to fail to make payment or provide access to the pledged collateral. Conscious that this would impair the efficiency of covered bonds, the FDIC decided to grant consent for expedited access to pledged covered bond collateral for covered bonds meeting specific criteria.

Eligible covered bonds must be authorised by the IDI's primary federal regulator and cannot exceed 4% of total liabilities. They consist of non-deposit, recourse debt obligations of an IDI with maturity between one year and 30 years secured by eligible mortgages or AAA-rated mortgage-backed securities secured by eligible mortgages, if no more than 10% of the cover assets. Substitute assets may be included (namely US Treasury and agency bonds) as need be for prudent management of the cover pool. Eligible mortgages are defined as first-lien mortgages on one-to-four family residential properties underwritten at the fully indexed rate, relying on documented income and complying with the existing supervisory origination guidance. Issuers should also disclose LTVs for transparency purposes.

The FDIC consents include the following events: (1) if at any time after appointment the conservator or receiver is in default and remains so after actual delivery of a written request to the FDIC for 10 business days, the covered bond holders can exercise their contractual rights including the liquidation of the cover assets; (2) if the FDIC as a conservator or receiver of an IDI provides a written notice of repudiation of a contract to covered bond holders and the FDIC does not pay the damages due by reason of such repudiation within 10 business days after the effective date of the notice, covered bond holders can exercise their contractual rights including the liquidation of cover assets. The liability of a conservator or receiver in such circumstances shall be limited to the par value of the covered bond issued plus interest accrued following its appointment. The statement also highlights that these consents do not waive, limit or affect the rights or powers of the FDIC.

I.2. The US Treasury's Best Practices

The Treasury Best Practices issued in July 2008 supplement the FDIC's covered bond policy statement. Their purpose was to support the growth of a transparent and homogeneous covered bond market in the absence of dedicated US legislation. While targeting high-quality residential mortgages to safeguard market liquidity and stability, the US Treasury did not exclude at the time expansion of the covered bond market to other asset classes. As emphasised by the US Treasury, these best practices do not provide or imply any government guarantee but serve only as a template with the following key features:

> **Issuer:** can be (1) an IDI and/or a wholly owned subsidiary of this IDI (the so-called "direct issuance structure") or (2) a newly created bankruptcy SPV ("SPV structure"). Issuance authorisation must be provided by the IDI's primary federal regulator. Only well-capitalised IDIs may issue covered bonds.

> **Cover assets:** are owned by the IDI and remain on balance sheet, but must be clearly identified and provide a first priority claim to covered bond holders. The issuer must enter into a Specified Investment contract with one or more financially sound counterparties which, in case of issuer default or FDIC repudiation, will continue to pay interest and/or principal accordingly as long as proceeds from cover assets at least equal the par value of covered bonds.

> **Covered bond terms:** must be between one and 30 years; issuance may be in any currency as long as currency risks are hedged; bonds can be fixed or floating. Interest rate swaps may be entered for hedging purposes with financially sound counterparties, which must be disclosed to investors. SEC registration is possible but not a requirement.

> **Eligible assets:** must be performing first-lien residential mortgages on one-to-four family residential properties with 80% maximum LTVs. Underwriting must be at the fully indexed rate, with documented income and in line with the existing supervisory origination guidance. Any loan that has been non-performing for more than 60 days should be replaced. A single Metro Statistical Area must be a maximum 20% of the cover pool.

> **Over-collateralisation (OC):** must be at least 5% of outstanding covered bonds at all times. When calculating the cover pool value, loans with a LTV exceeding 80% are still eligible but up to the 80% LTV limit only. LTVs must be indexed on a quarterly basis using a nationally recognised, regional housing price index or other comparable measurement.

> **Issuance limit:** is capped at 4% of the IDI's liabilities after issuance.

> **Asset Coverage Test (ACT):** must be performed on a monthly basis by an independent Asset Monitor to safeguard the quality and adequacy of the cover pool. Results must be made public. The asset monitor must also periodically check the accuracy of the ACT. Any ACT breach must be remedied within one month. If not after one month, the Trustee may terminate the program and return principal and accrued interest to covered bond investors. During an ACT breach, no covered bond can be issued.

> **Disclosure:** must be monthly. If substitute assets account for more than 10% of the cover pool within any month (or 20% within any quarter), the issuer must provide updated information on cover assets to investors. Any material information on the IDI's or SPV's financial profile or on any other relevant area must also be made public.

> **Independent trustee:** must be designated by the issuer to represent the interests of covered bond investors and enforce their rights over the cover pool in case of issuer insolvency. All covered bond holders backed by a common cover pool rank pari passu.

> **Insolvency procedures:** the FDIC has three options at its disposal: (1) covered bonds are repaid according to initial terms; (2) covered bonds are paid off in cash, up to the value of the pledged collateral;

(3) liquidation of the pledged collateral is permitted to pay off the covered bonds. Options 2 and 3 occur in case of default or FDIC repudiation as mentioned above. In such cases, covered bond holders will recover up to the value of the collateral. Any collateral excess must be returned to the FDIC, while covered bond holders rank pari passu with unsecured debt holders for the amount due in the event of a shortfall.

II. TWO KEY LEGISLATION ATTEMPTS SO FAR

II.1. United States Covered Bond Act

The 112th Congress saw an active push for the establishment of covered bond legislation in the US during 2011. The United States Covered Bond Act of 2011 was the most concerted attempt yet in that respect, although it never completed the full legislative process. For legislation to become law, identical text needs to be approved by both the House of Representatives (HR) and the Senate, and the final legislative text has to be signed by the President to become law. This was not the case as the Bill approved at the HR ("H.R. 940") contained some differences from that introduced at the Senate ("S. 1835") despite their similarities. These were as follows: an expansion of the definition of eligible issuers; for issuers that are not subject to the jurisdiction of a federal banking agency, the covered bond regulator would be the Board of Governors of the Federal Reserve System rather than the Secretary of the Treasury; a right afforded to the respective covered bond regulator and a majority of covered bond holders to replace the independent asset monitor; the omission of tax provisions. Furthermore, the start of the 113th Congress on 3 January 2013 meant that it needed to be re-introduced.

The US Covered Bond Act, whether in its "H.R. 940" or "S. 1835" format, contained major differences from the FDIC and US Treasury's foundations, especially with respect to the following points:

> **Covered bond regulators:** must be the Federal banking agency where appropriate, otherwise the Board of Governors of the Federal Reserve System ("S.1835") or the Secretary of the Treasury ("H.R. 940").

> **Eligible assets:** consist of any first-lien residential mortgage loan secured by a one-to-four family residential property but also (1) any residential mortgage loan insured or guaranteed e.g., under the National Housing Act; (2) commercial mortgage loans (including multi-family); (3) public sector assets – namely any bond or loan from or insured/guaranteed by a State, municipality or other governmental authority; (4) any auto loan or lease; (5) any student loan (guaranteed or unguaranteed); (6) any extension of credit to a person under an open-end credit plan; (7) any loan made or guaranteed by a small business administration; (8) any asset designated by the Secretary, by rule and in consultation with covered bond regulators.

> **Eligible issuers:** include any FDIC depository institution (or subsidiary), bank or savings and loan holding companies (or subsidiary) but also registered nonbank financial companies such as any intermediate holding company. "S.1835" widens eligible issuers to brokers or dealers and supervised insurers as well.

> **Substitute assets:** are limited to 20% of cover assets and may be cash, direct obligations of the US State or GSE of the highest credit quality.

> **Issuance limit:** must be established upon the soundness of the underlying issuer while the maximum amount of covered bond to be issued must be defined as a percentage of the issuer's total assets (with a possible review of this cap, whether up or down, on a quarterly basis).

> **Over-collateralisation:** must meet the minimum defined by the Secretary for each asset class but no specific amount is mentioned. Cover pool must be single asset only.

> **Insolvency procedures:** gives specific powers to the FDIC which, if appointed as a conservator or receiver prior to a default event, shall have an exclusive right during the one-year period beginning on the date of the appointment to transfer any cover pool owned by the issuer in its entirety, together with all covered bonds and related obligations. During that year, the FDIC shall ensure the full and timely payment of covered bond holders.

In case of default prior to conservatorship or receivership, a separate estate shall be created for each affected covered bond programme which comprises all related cover assets and covered bonds. This estate is fully liable for covered and other secured obligations only. In case of collateral insufficiency, covered bond holders retain a residential claim against the issuer.

II.2. The PATH Act

In 2013, political interest in covered bond legislation emerged again as part of broader reform initiatives addressed in the Protecting American Taxpayers and Homeowners (PATH) Act. PATH has aimed notably to reform GSEs in order to prevent any future liability to taxpayers and increase mortgage competition, enhance transparency and maximise consumer choices. Details related to covered bonds in the PATH Act have been similar to the US Covered Bond Act of 2011, with the Treasury being proposed as a regulator instead of the Fed. However this bill, a Republican initiative, has lacked bipartisan support unlike the previous one, notably as it foresees the wind-down of GSEs, and has been thus another unsuccessful attempt so far.

III. WHAT NEXT?

A speech made in early July by the US Treasury secretary, Jack Lew, might revive hopes of US covered bond legislation in the foreseeable future. The US government currently seems to be looking for private solutions to support mortgage lending. In a survey published by the US Treasury for market feedback, the emphasis is on private residential mortgage-backed private label securities (PLS) and thus not directly targeted at covered bonds. However, they could be complementary and a new attempt at covered bond legislation might emerge from the political debate (see box).

US COVERED BOND LEGISLATION: THE POLITICAL CONUNDRUM

by Jerry Marlatt, Morrison & Foerster LLP

Legislation in the United States for covered bonds has generally received favorable support both in Congress and in the administration, especially from the Department of the Treasury. What has been missing in the last several years has been any significant support from major banks. With a very crowded legislative agenda for Syria, Ukraine, taxes, health care, financial regulation, etc., covered bonds tends to fall to the bottom in the absence of support from one or more major banks.

In the current environment, banks are focused on preserving funding through Fannie Mae and Freddie Mac or some other government assisted program because that will provide the most cost efficient financing and the widest profit margins. And in the current economic environment with moderate lending activity, the banks have no shortage of cash to finance mortgage loans that do not qualify for Fannie Mae and Freddie Mac.

The current state of legislation is tied to bills to resolve the conservatorship of Fannie Mae and Freddie Mac. In the House of Representatives this is H.R.2767, which is known as the PATH Act. A portion of this bill includes the covered bond provisions of H.R.940, a bill introduced in 2011, which is discussed below. The major part of the PATH Act, however, deals with replacing Fannie Mae and Freddie Mac and proved very divisive at the hearing for the bill before the House Financial Services Committee. As a result the bill passed the committee solely on the strength of the Republican vote and did not draw a single Democratic vote. The bill has not been taken up by the full House.

In the Senate, the legislation to address the GSEs is in S.1217, but this legislation has no covered bond provisions. This bill has been drafted pretty much on a bi-partisan basis and after amendment and a considerable number of hearings before the Senate Banking Committee, was passed by the committee. The plan apparently was to insert covered bond provisions into the bill in the Joint Conference Committee process to resolve the differences between the House and Senate bills. However, it is not expected that GSE reform is actually going to considered by the Senate or the House before 2017.

In the prior Congress, covered bond legislation was in H.R.940 in the House and S.1835 in the Senate, both of which were standalone covered bond bills. The bills were quite similar, although there were differences including that the Senate bill omitted the special tax provisions protecting the cover pool from being subject to tax. H.R.940 passed the House Financial Services Committee on a very strong bi-partisan vote of 44-7. However, the bill was also assigned to the House Ways and Means Committee for consideration of the tax provisions in the bill. The Ways and Means Committee did not release the bill until late December 2012, too late for consideration by the full House. In the meantime, S.1835 had been introduced in the Senate in late 2011, but the bill languished and no action was taken.

On a more promising note, the Secretary of the Treasury, in a speech on June 26, called for Congressional action to resolve the GSEs and for public comments on steps that could be taken to encourage private funding of residential mortgage loans, citing the near-dormant state of the private label securities market. While the speech did not specifically refer to covered bonds, adopting covered bond legislation would appear to be much easier than adopting GSE reform. Covered bonds are at least one approach to private funding that appears to get bi-partisan support and therefore may be achievable in the current Congress, particularly if the legislation enjoyed the support of the Treasury.

The only significant issue that has arisen in connection with covered bond legislation has been a concern expressed by the Federal Deposit Insurance Corporation about levels of encumbrance in covered bond programs. In its Covered Bond Policy Statement of 2008, the FDIC had included a 4% limit on covered bond issuance to address encumbrance issues. None of the legislation to date has included a specific issuance limit. More recently it has been rumored that the FDIC had gotten comfortable with the prospect of an 8% issuance limit. Although a one-size-fits-all limit may not be optimal, it could be an acceptable starting place.

It would seem that the best current prospect for covered bond legislation lies with this Treasury effort to encourage private funding, although it is possible that in this climate Representative Garrett could on his own initiative again introduce covered bond legislation in the House. This would appear more likely if there were some back channel support from Treasury.

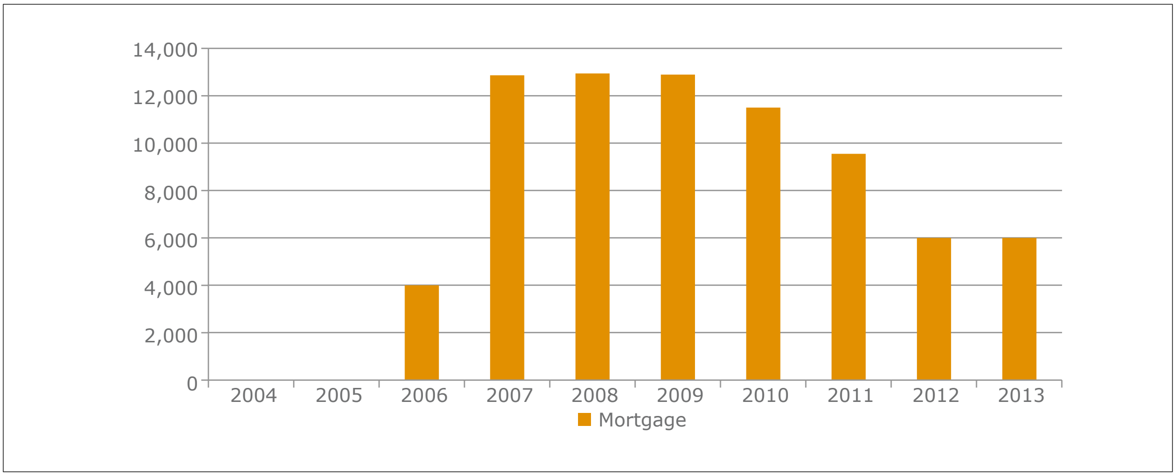
The Treasury effort is only in its early stages. The deadline for comments requested by the Treasury is not until August 8, 2014. Additionally, this is a mid-term election year. All of the members of the House and a third of the members of the Senate are up for reelection in November. Therefore, it is difficult to say with any confidence at this point when, or even if, covered bond legislation will be taken up by Congress this year.

IV. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

US covered bonds are neither Article 52(4) UCITS-compliant nor CRR-compliant given the absence of EU membership.[1] Therefore, they do not benefit from preferred risk-weighting for regulatory capital purposes. Under the Standardised Approach, they are treated similarly to senior unsecured bank debt. That said, if denominated in €/£/¥/US$, US covered bonds are eligible for European Central Bank repo operations, conditional on an investment-grade rating. Specific haircuts are applied depending on the rating and characteristics of the covered bond.

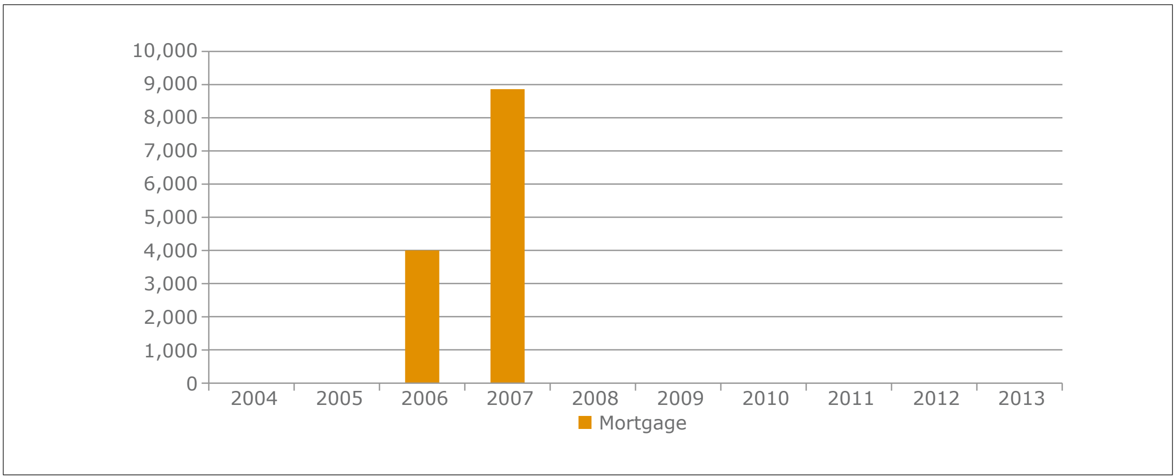
1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2004-2013, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2004-2013, EUR m



Source: EMF/ECBC

CHAPTER 4 - RATING AGENCIES & METHODOLOGY

4.1 CREDIT RATING AGENCY APPROACHES

By Boudewijn Dierick, BNP Paribas and ECBC Rating Agency Approaches Working Group Chairman

The main topics and trends related to the ratings of covered bond seen in the 12 months following July 2013 are as follows:

> Tighter link to sovereign rating and various upgrades of covered bond ratings following upgrades of sovereign ratings reversing the previous downward trend;

> Higher starting point for European covered bond ratings to account for the bail-in exemption of covered bonds outlined in the EU Bank Recovery and Resolution Directive (BRRD);

> More market parties becoming aware of potential clearing problems and convinced of expected exemption of covered bond swaps for central clearing as required by the European Market Infrastructure Regulation (EMIR);

> New covered bond markets where sovereign ratings cap covered bond ratings (Turkey);

> Conditional pass-through covered bonds (CPTCB) attracting a lot of attention but not yet many followers: all rating agencies can now rate these on a delinked basis independent of the supporting bank's rating; and

> Various initiatives of rating agencies to increase transparency of ratings: more frequent criteria reports, comments on law changes and request for comments preceding significant criteria changes.

IMPACT OF SOVEREIGN RATINGS

S&P published a report in October 2013 on their approach to covered bond and structured finance ratings above the sovereign rating. It aligned its criteria globally, having the largest impact in Europe where more delinkage was possible in the Economic and Monetary Union (EMU). Delinkage now caps at maximum 4 notches above sovereign rating from 6 previously, due to high severity, in case it ever occurs. For covered bonds with refinancing risk not sufficiently mitigated, ratings could even be capped at 2 notches above the sovereign. This resulted in downgrades by multiple notches of almost all covered bonds from Spain and Italy, and one Portuguese programme.

Moody's indicated earlier that sovereign downgrades were key drivers for rating migration. This is still the case but the trend reversed at the end of 2014 and the upgrades of various sovereigns have also triggered various covered bond upgrades that were capped by the country ceilings. In many cases the ceiling went up by more notches than the sovereign rating itself triggering also upgrades of covered bonds by several notches. Often the timely payment indicators (TPIs) improved simultaneously which further supported the upward trend of covered bond ratings in non-AAA countries.

The topic of capping ratings to sovereign ceilings remains highly debated and contested even by regulators. Mr Mersch from the European Central Bank (ECB) even criticised it in his speech at the global ABS conference in June 2014. Various rating agencies have published reports since, outlining their approach and the maximum possible rating when ignoring the country ceiling cap.

EU BANK RECOVERY AND RESOLUTION DIRECTIVE (BRRD)

This has been the other major topic that triggered rating criteria changes and upgrades, and will continue to impact covered bond ratings in the coming years. Moreover, the BRRD has directly triggered changes in the rating methodologies of Moody's in March 2014, quickly followed by Fitch, while S&P published an advance notice of criteria change on 29 April 2014.

Both Fitch and Moody's do now start from rating levels which are 1 or 2 notches above the senior unsecured ratings of banks issuing or supporting covered bonds.

The number of notches Moody's adds to the senior unsecured rating as starting point depends on the level of cushion (5% or 10%) of bail-inable debt of a bank, while Fitch uses a more subjective approach allowing for more delinkage for what they consider as "covered bond-intensive" countries.

Due to the fact that this legislative document has the form of a directive, the BRRD should be implemented uniformly in the national legal systems of all Member States of the European Union (EU) and, most likely, similar rules will be implemented as well in some other covered bond jurisdictions such as the Canadian and Australian ones.

Going forward, it has to be seen how the unsecured ratings will be affected by the BRRD framework. As mentioned, Moody's and Fitch have already started to adjust their covered bond criteria by starting from senior unsecured rating as the basis for their approach; however, they have not yet adjusted (i.e. downgraded) the unsecured ratings of banks to account for future bail-inability of unsecured debt. It remains to be seen how the rating agencies will incorporate the bail-in requirement in their approach for bank ratings and how this may affect the ratings of issuers and covered bonds as the recent upgrades may be (more than) reversed if bank ratings would go down in the future.

INITIATIVES OF RATING AGENCIES TO INCREASE TRANSPARENCY OF RATINGS

The rating agencies continue to put in a lot of effort to be more transparent in their approach via various initiatives:

> More detailed presale reports (with appendices on the issuer and its activities);

> Publishing number of notches delinkage, minimum OC level required for different rating levels and different components determining the OC level;

> Both Fitch and S&P have started to assign outlooks to their rating for covered bonds;

> Fitch published a report on "Breaking down breakeven overcollateralisation" in July 2014, in which they identify three quantitative factors most likely to impact covered bond performance, namely credit losses, cash flow valuation and asset disposal loss. The aim is to increase transparency by publishing the breakeven OC and to communicate if the rating agency considers that the timely payment plus ROE overrides the given default or solely the recoveries given default;

> Moody's published a report on the changes in TPI in various markets over the recent years;

> Other reports published by rating agencies: Most of these reports did not affect the outstanding rating agencies but clarified their approaches in relation to certain risks and/or aligned their approach for covered bonds with SF. For example, set-off risk by Moody's, counterparty criteria by Fitch, sovereign caps by S&P. Fitch also published updated counterparty criteria for structured finance and covered bonds in May 2014 and updated its interest rates and refinancing stresses for various assets and markets.

CONDITIONAL PASS-THROUGH COVERED BONDS (CPTCB)

All rating agencies can now rate CPTCB on a delinked basis independent of the supporting bank's rating. Moody's published a report in April 2014 explaining that they can rate fully delinked as well as partly linked CPTCB. The pass-through feature removes the risk of an asset fire sale which is nowadays the main driving factor for the OC in most covered bonds. If other risks, such as legal, servicing and counterparty risks are sufficiently addressed and there is sufficient OC to cover credit risks, the ratings can be fully delinked form the bank rating.

EUROPEAN MARKET INFRASTRUCTURE REGULATION (EMIR)

Although this topic has not yet triggered any changes in the criteria of rating agencies, it remains a very important topic for the covered bond market, especially for issuers and swap counterparties, as it could unnecessarily result in higher costs. Luckily, regulators are becoming more aware of the importance of this topic. The expectation is that covered bond swaps will be exempted from the central clearing obligation.

4.2 DBRS RATING METHODOLOGY

By Vito Natale and Claire Mezzanotte, DBRS

INTRODUCTION

As described in the rating methodology "Rating European Covered Bonds", DBRS covered bond ratings are composed of the following three building blocks:

1. Issuer Rating (IR)
2. Assessment of each covered bond programme's Legal and Structuring Framework (LSF)
3. Cover Pool Credit Assessment

DBRS assigns a rating to a covered bond issuance using a step by step process. The first step is to determine the Maximum Achievable Rating (MAR) for a covered bond programme based on the IR and LSF assessment. Once the MAR is determined, a rating can be assigned to the covered bond issuance based on a Cover Pool Credit Assessment and evaluation of the sufficiency of programme over-collateralisation (OC) levels.

In cases where the application of the LSF matrices is not possible or would otherwise result in the same rating as the IR, DBRS may grant up to one notch uplift from the IR if the analysis of the Cover Pool shows that it would provide substantial support following a default on the covered bonds.

THE THREE BUILDING BLOCKS

1. Issuer rating (IR)

The covered bond issuer is the primary source of the timely payment and repayment of both the interest and principal of a covered bond. As covered bonds have a dual repayment mechanism, covered bond holders have recourse to the issuer if the covered bonds are not fully repaid from proceeds of the cover pool (residual claim over "unsecured assets", pari passu with unsecured creditors). As a result, the IR is the anchor rating of a covered bond programme. The IR is assigned and monitored by the DBRS Financial Institutions Group (FIG) following the analytical process described in the relevant FIG rating methodologies. Each issuer rating has two components: Intrinsic Assessment (IA) and Support Assessment (SA). The Intrinsic Assessment is DBRS opinion about the issuer's intrinsic fundamentals whereas, the Support Assessment reflects DBRS opinion about the likelihood and predictability of timely external support for a bank, in case of need. Accordingly, the covered bond rating incorporates the support element that may exist in the IR. Because of the importance of the issuer in covered bond transactions, DBRS rates covered bonds only in cases where the issuer has a DBRS public or private rating or internal assessment.

2. Legal and structuring framework (LSF) assessment

The LSF assessment is the largest of the three building blocks, as once the LSF assessment is assigned, DBRS can determine the MAR for a covered bond programme. Additionally, the LSF assessment implicitly limits the number of notches a covered bond can be rated above the IR.

Assessing the strength of the LSF primarily entails an in-depth review of the dedicated covered bond legislation and the legal environment of the relevant jurisdiction. This analysis is supported by external legal opinions when necessary. The second element of the LSF assessment is an in-depth review of the structuring features supplemental to the dedicated legislation. When such dedicated legislation does not exist or when an issuer chooses to issue outside of the relevant legislation, the LSF assigned solely reflects the contractual arrangements between transaction parties. Most importantly, the true sale agreements are reviewed to ensure bankruptcy remoteness of the Cover Pool (CP) in case of an issuer default.

The LSF grade is assigned by the DBRS Covered Bond team for each covered bond programme. DBRS analyses the specific terms of each covered bond programme to assess if the issuer manages the CP in a more conservative manner than required by jurisdictional laws. A more conservative approach by the issuer may benefit the covered bond. For example, in jurisdictions where covered bonds are issued directly from the issuer's balance sheet where repayment of mortgage credits is considered part of the segregated covered pool, the establishment of a bank account to hold collections in a segregated account may give more comfort in the continuity of cash flows in case of issuer insolvency and assigned a higher LSF grade, all else equal.

The LSF assessment is one of four grades: Very Strong, Strong, Adequate, and Modest. In addition to analysing the covered bond legislation to ensure segregation of the CP from the issuer's bankruptcy estate, DBRS assesses the current market environment, need and ability to liquidate the CP, and analyses structural qualitative features which may have an effect on the continuity of cash flows to the covered bond, in the case of issuer insolvency. This includes factors such as the existence and role of a regulatory supervisor in the normal course of business and issuer insolvency as well as contingency plans in case of issuer default.

Within the LSF grade, DBRS incorporates sovereign risk by assessing the willingness and ability of regulators and central banks to support a covered bond programme. For example, although legislation within a jurisdiction ensures the CP assets are ring-fenced from the bankruptcy estate of an issuer and warrant an LSF of Very-Strong or Strong, a lower assessment may be assigned due to the risks related to a lower rated sovereign.

3. Cover pool credit assessment and cash flow analysis

The Cover Pool Credit Assessment begins with the structured finance rating approach used to analyse similar types of assets in asset-back transactions (e.g., RMBS, CMBS, etc.). Rating specific Probability of Default (PD) and Loss Given Default (LGD) assumptions are estimated for the cover pool after applying the appropriate methodology. Following the CP assets analysis, a multi-scenario cash flow analysis is conducted to incorporate the expected cash flows from the issuer and/or CP (including expected proceeds from the sale of all or part of the CP in case of issuer default), and liquidity provisions, as well as the interest rate stresses and currency stresses to ensure all covered bonds within a programme receive timely interest and full principal by the stated maturity date under a scenario in line with the Cover Pool Credit Assessment.

The cash flow analysis assumes that if an issuer is solvent, all payments to the covered bonds are made by the issuer. Post issuer insolvency, it is assumed that the CP (including any hedging contracts) will be the sole source of payment to the covered bonds. In addition to any proceeds received from the CP under normal repayment schedules, DBRS assumes that the CP will need to be liquidated at the appropriate time to repay covered bond interest and/or principal. The collateral liquidation value is estimated assuming a 0% conditional prepayment rate (CPR) on the CP with the cash flows discounted by a market value stress to calculate the Net Present Value (NPV) at liquidation. Three tiers of market value stresses were estimated by DBRS based on market value spreads for senior RMBS securities in multiple European jurisdictions.

SOVEREIGN STRESS

DBRS incorporates the probability of sovereign default into its asset level analysis by applying a sovereign related stress component to its stress scenarios. In addition, DBRS incorporates the ability of a sovereign to provide support to an insolvent covered bond issuer when assigning the LSF assessment.

DBRS LSF MATRICES

The probability of default of a covered bond is function of the joint probability of default of the Issuer and the Cover Pool Credit Assessment, and a non-zero probability that the covered bond will receive the full benefit of the cash flows from the CP. This benefit is determined by the assignment of the LSF grade. The four categories are assigned so as this probability of not receiving such full benefit (increased possibility of disruption of cash flows) decreases as the LSF weakens. The four LSF matrices are generated, for each of the LSF grades, based on an assumed Weighted Average Life (WAL) of the outstanding debt which is fixed at five years (see example in Appendix).

The ratings of the issuer and CP become a more constraining factor when determining the rating (within and up to the MAR) under Strong, Adequate, and Modest LSFs, as the impact of rating deterioration is magnified by the strengths and weaknesses of the relevant Legal Framework and supplementary structural features. Legal uncertainties and corresponding potential legal challenges, as well as lack or inadequacy of replacement mechanisms might increase delays and lengthen the time needed to transfer the CP to another bank or a special administrator in charge of maintaining timely payments to covered bond holders. These considerations lead to a reduced uplift for the covered bond rating vis-à-vis the IR in weaker LSFs, notably in "Adequate" and "Modest" assessment.

Once the matrices are generated and the LSF is determined, the MAR for a covered bond can be determined based on the IR and the "AAA" Cover Pool Credit Assessment. Ratings are assigned when programme OC level exceeds the target OC level for a given Cover Pool Credit Assessment in the LSF matrix.

COUNTERPARTY RISK

In covered bond programmes where there is an interest rate or currency swap, DBRS analyses the counterparty risk as detailed in the "Swap Criteria for European Structured Finance Transactions" methodology.

COVERED BONDS SURVEILLANCE

DBRS monitors outstanding covered bond ratings in accordance with the Master European Structured Finance Surveillance Methodology. As part of the surveillance of the CP Credit Assessment, DBRS monitors changes to the assets of the CP due to reinvestments and substitutions on a quarterly basis at a minimum. To the extent the quality of the Cover Pool degrades over time, the DBRS analysis may find that the OC level is insufficient to maintain the outstanding rating of the covered bond.

RELATED RESEARCH

- "Rating European Covered Bonds", January 2014. http://www.dbrs.com/research/264725/rating-european-covered-bonds.pdf
- "Derivative Criteria for European Structured Finance Transactions", May 2013. http://www.dbrs.com/research/257489/derivative-criteria-for-european-structured-finance-transactions.pdf
- "Legal Criteria for European Structured Finance Transactions". June 2013. http://www.dbrs.com/research/258212/legal-criteria-for-european-structured-finance-transactions.pdf
- Commentary: "The Effect of Sovereign Risk on Securitisations in the Euro Area". May 2012. http://www.dbrs.com/research/239786/the-effect-of-sovereign-risk-on-securitisations-in-the-euro-area.pdf
- Commentary: "DBRS Commentary on Italian Obbligazioni Bancarie Garantite Legal and Structuring Framework". December 2012. http://www.dbrs.com/research/253498/dbrs-commentary-on-italian-obbligazioni-bancarie-garantite-legal-and-structuring-framework.pdf
- Commentary: "DBRS Commentary on Spanish Cédula Hipotecarias Legal and Structuring Framework". August 2012. http://www.dbrs.com/research/250212/dbrs-commentary-on-spanish-c-dula-hipotecarias-legal-and-structuring-framework.pdf

> FIGURE 1: ADEQUATE LSF

	COVER POOL											
ISSUER RATING	**AAA**	**AA (high)**	**AA**	**AA (low)**	**A (high)**	**A**	**A (low)**	**BBB (high)**	**BBB**	**BBB (low)**	**BB (high)**	**BB**
AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
AA (high)	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AA (high)	AA (high)	AA (high)	AA (high)	AA (high)
AA	AAA	AAA	AAA	AAA	AAA	AAA	AA (high)	AA	AA	AA	AA	AA
AA (low)	AAA	AAA	AAA	AAA	AA (high)	AA (high)	AA	AA	AA (low)	AA (low)	AA (low)	AA (low)
A (high)	AAA	AA (high)	AA (high)	AA (high)	AA	AA	AA	AA (low)	AA (low)	A (high)	A (high)	A (high)
A	AA (high)	AA (high)	AA (high)	AA	AA	AA	AA (low)	AA (low)	AA (low)	A (high)	A	A
A (low)	AA	AA	AA	AA (low)	AA (low)	AA (low)	A (high)	A (high)	A (high)	A	A (low)	A (low)
BBB (high)	AA (low)	AA (low)	A (high)	A (high)	A (high)	A (high)	A	A	A (low)	A (low)	A (low)	BBB (high)
BBB	AA (low)	A (high)	A (high)	A (high)	A	A	A	A (low)	A (low)	A (low)	BBB (high)	BBB (high)
BBB (low)	A (high)	A (high)	A	A	A	A	A (low)	A (low	A (low)	A (low)	BBB (high)	BBB (high)
BB (high)	A (low)	A (low)	A (low)	A (low)	A (low)	BBB (high)	BBB (high)	BBB (high)	BBB	BBB	BBB (low)	BBB (low)
BB	A (low)	A (low)	A (low)	BBB (high)	BBB (high)	BBB (high)	BBB (high)	BBB	BBB	BBB (low)	BBB (low)	BBB (low)
BB (low)	BBB (high)	BBB (high)	BBB (high)	BBB (high)	BBB (high)	BBB	BBB	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BB (high)
B (high)	BBB	BBB	BBB	BBB	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BB (high)	BB (high)
B	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BB (high)	BB (high)	BB (high)	BB (high)
B (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BB (high)	BB (high)	BB (high)	BB (high)	BB	BB
CCC (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB	BB	BB (low)	BB (low)
CCC	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB	BB	BB	BB (low)	BB (low)
CCC (low)	BB	BB	BB	BB	BB	BB (low)	BB (low)	BB (low)	BB (low)	BB (low)	B (high)	B (high)

4.3 FITCH RATINGS' COVERED BOND RATING METHODOLOGY

By Carmen Muñoz and Beatrice Mezza, Fitch Ratings

INTRODUCTION

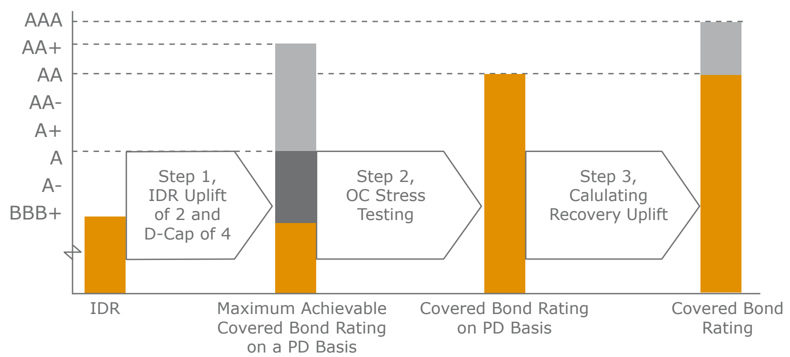
Fitch Ratings' covered bond ratings mainly address the bonds' probability of default (PD), but also incorporate recovery on the bonds given default. Fitch's covered bond rating methodology involves the following steps.

1. **Determining the maximum achievable rating for the covered bond on a PD basis.** The covered bonds rating on a PD basis may exceed the Issuer Default Rating (IDR) by the number of notches represented by the Fitch IDR uplift, if any, plus the number of notches expressed through the agency's Discontinuity Cap (D-Cap). The IDR uplift applies in cases where bank resolution frameworks favourably treat covered bonds by exempting them from bail-in measures. The D-Cap qualifies the risk of a payment interruption on the covered bonds upon a transition from the issuer to the cover pool as a main source of payment.
2. **Stress-Testing OC to set the covered bond rating on a PD basis.** Within the range of achievable ratings, the covered bonds rating on a PD basis is set at the level for which the overcollateralisation (OC) taken into account by the agency enables a timely payment on the covered bonds under the corresponding stress scenario. This is tested by comparing the future stressed cover assets cash flows to scheduled payments on the privileged liabilities.
3. **Defining the recovery uplift.** The assigned covered bond rating can be lifted above its rating on a PD basis by a maximum of two or three notches, depending on whether the rating on a PD basis is in the investment or sub-investment grade range. This is subject to OC taken into consideration producing outstanding stressed recoveries on covered bonds assumed to be in default.

Fitch also assigns Outlooks to covered bond ratings to give an early indication of the potential future direction of the rating over a one- to two-year period. In March 2014, Fitch amended its covered bonds rating criteria to reflect the impact of bank resolution frameworks. This resulted in 11 ratings being placed on Positive Outlook and 27 being placed or maintained on Negative Outlook, depending on whether the assigned IDR uplift could compensate for a potential downgrade of the bank's IDR related to the expected weakening of state support.

Figure 1 illustrates the steps Fitch takes in rating covered bonds. Each step and their components are explained in the following paragraphs.

> FIGURE 1: STEP-BY-STEP EXAMPLE OF A COVERED BOND RATING



IDR: Issuer Default Rating ; OC: Overcollateralisation ; PD: Probability of Default

Source: Fitch

DETERMINING THE MAXIMUM ACHIEVABLE RATING FOR THE COVERED BOND ON A PD BASIS

Stage A - *Setting the IDR uplift*

An IDR uplift is granted to programmes issued in jurisdictions where bank resolution measures preserve the integrity of covered bonds. Resolution tools, particularly the bail-in tool, allow for a preservation of the issuing bank as a going concern and would avoid the source of covered bonds payments switching from the issuer to the cover pool. Despite a default on senior unsecured debt, covered bonds would continue to be serviced by their issuer.

Fitch assigns an uplift above the IDR of up to two notches, if applicable, to programmes of issuers rated in the 'BB' category and above, and up to three notches, if applicable, for programmes of issuers rated in the 'B' category and below. The IDR uplift depends on the following three factors:

> **Relative ease and motivation for resolution methods other than liquidation:** There is greater motivation for alternative resolution tools to liquidation to be applied in instances when the bank in question is systemically important, with a high degree of economic interconnectedness in a certain country, or if it is a large, complex institution. The liquidation of such banks would be complicated, drawn out and risks wider financial market instability. Conversely, it could prove easier to liquidate smaller banks and specialised financial institutions, especially if they are unlikely to threaten financial stability.

> **Importance of covered bonds to a financial market in a jurisdiction:** If covered bonds are important to a jurisdiction's financial markets, Fitch considers that there will be greater political and regulatory incentives to avoid possible financial contagion resulting from the cover pool's segregation from the issuer in the event of a resolution. Fitch considers Germany, France, Spain, Norway, Sweden and Denmark to be covered bond intensive countries, based on measures such as the volume of covered bonds as a proportion of banking assets and the relative size of domestic covered bonds in proportion to the total covered bonds market.

> **Level of an issuer's senior unsecured debt available for bail-in:** Senior unsecured debt that could be bailed-in serves as an additional buffer for covered bonds, if equity and other junior instruments prove insufficient to absorb losses. Where this is substantial, it further reduces the likelihood of the cover pool becoming the direct source of payment for the covered bonds. Fitch derives the uplift from the level of outstanding senior unsecured debt (excluding debt known to be held by retail investors), if it represents at least 5% of the total balance sheet, adjusted for insurance assets and derivatives.

The two-notch uplift will be granted if at least two of the three factors are present; a one-notch uplift will be granted if at least one of the three factors is present; and no uplift will take place if none of the three factors is present. The three-notch uplift for banks rated 'B' or below is only expected to apply when idiosyncratic issues result in a low IDR for the issuer, rather than broader operating environment factors affecting all financial institutions in a given country.

Stage B – *Setting the D-Cap*

Fitch's D-Caps are a qualitative assessment of payment interruption risk on covered bonds in the transition to the cover pool as a source of covered bonds payments. The D-Cap assigned to a given programme reflects the highest risk assessment of asset segregation, liquidity gap and systemic risk, alternative management and privileged derivatives. The range of possible D-Caps, together with their associated risk assessments, are as follows: 8 (Minimal discontinuity; for cases with no liquidity gaps, such as pass-through programmes with interest coverage for three months), 6 (Very low), 5 (Low), 4 (Moderate), 3 (Moderate high), 2 (High), 1 (Very high) and 0 (Full discontinuity; for cases where a covered bond default is expected upon the enforcement of recourse against the cover pool).

> **Asset Segregation:** Fitch analyses the strength of the asset segregation mechanism, notably whether it also places OC beyond the reach of other creditors until all covered bonds have been repaid in full. Other identified risks relate, for example, to the potential claw back of assets set aside for covered bond investors, commingling with the issuer's other cash flows, or borrower set-off rights.

> **Liquidity Gap and Systemic Risk:** In most programmes, incoming cash flows from the cover pool do not exactly match at all times payments due on the privileged liabilities. The analysis of the liquidity gap and systemic risk component considers liquidity risks, principal payment risks and systemic risks.

Short-term liquidity shocks may arise from interest payments due shortly after the recourse to the cover pool has been enforced. Fitch expects programmes to provide protection, which covers at least covered bond interest payments over the next three months on a rolling basis, plus a buffer to cover senior expenses and potential interest rate movements.

In terms of principal payment risks, Fitch first compares the time needed to monetise cover assets in a stress scenario to the length of time granted by the programme's protection mechanism and also considers the strength of this mechanism. Apart from pass-through programmes, where there is no reliance on asset liquidation to ensure timely payment on the covered bonds should the issuer fail to provide for it, protection against this risk can be offered via an automatic extension of the maturity of the covered bonds; pre-maturity tests; mandatory liquidity requirements; and access to central bank market operations.

In a systemic crisis, Fitch expects it will be more difficult and will take more time to refinance cover assets once recourse against the cover pool has been enforced. Because systemic risk issues are less likely to develop in higher-rated sovereigns, this component of the D-Cap will be capped if the sovereign where the issuer and /or the cover assets are located is in the 'A' category and below.

> **Systemic Alternative Management:** 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. Fitch considers the timing of the appointment of a substitute manager or government administrator, as well as the scope of their responsibilities — whether exclusively focused on the interests of the covered bond holders or also encompassing other creditors — to be especially crucial to a programme's survival following the issuer's insolvency. The agency will evaluate if the alternative manager has all powers and means to take the necessary actions, such as liquidating assets or borrowing against the cover pool, in order to make timely payments on the covered bonds.

> **Cover Pool-Specific Alternative Management:** The cover pool-specific assessment focuses on the likely ease of the transferability of relevant data and IT systems to an alternative manager and buyer, considering the quality and quantity of data provided to Fitch. Fitch evaluates whether cover assets, debtors' accounts and privileged swaps can be clearly identified within the issuing bank's IT systems, whether standardised rather than custom-made IT systems are used, the degree of automation and speed of cover pool reporting, and recordkeeping standards on loan documentation for cover assets and attached security. Dormant or in wind-down programmes may attract a worse risk assessment.

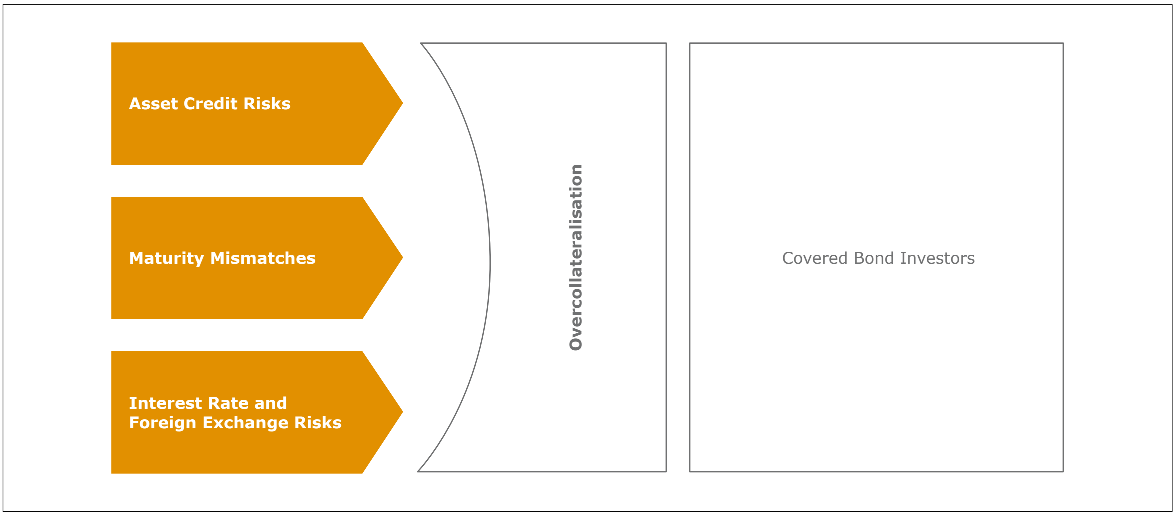
> **Privileged Derivatives:** Fitch considers programmes encompassing privileged hedging agreements to be more vulnerable to a potential issuer insolvency. Unlike non privileged swaps entered into by the issuer, which would terminate upon an issuer event of default, privileged swaps remain obligations of the cover pool and swap counterparties generally rank *pari passu* with covered bonds. Replacement provisions for privileged derivatives post issuer insolvency may lack clarity, replacing a defaulted counterparty may not be the priority of an alternative manager, and replacement prospects will vary depending on the characteristics of the swap. The agency differentiates between intra-group and external counterparties in its assessment. Another consideration made is whether termination payments to swap counterparties rank *pari passu* with covered bonds.

STRESS-TESTING OC TO SET THE COVERED BOND RATING ON A PD BASIS

Whereas the IDR, the IDR uplift and the D-Cap add up to the maximum theoretical rating which the covered bonds can reach in terms of PD, the timely payment of covered bonds, once the source of payment switches to the cover pool, will depend on the level of OC protecting investors. To test this, Fitch applies stresses that reflect expectations for the portfolio in an economic downturn, and compares the stressed incoming cash flows to the payments due on the covered bonds and privileged swaps. In this scenario the agency assumes that the cover pool becomes static under the care of a third party manager, and that cash flows are trapped if not needed immediately to repay covered bonds when due. The agency generally models the point at which recourse against the cover pool is enforced up to six quarters after the pool cut-off date; if this period does not comprise a large principal redemption, the transition to the cover pool will also be tested shortly ahead of the next major upcoming maturity.

Fitch's cash flow model includes stress scenarios addressing three major sources of risk once recourse against the cover pool is enforced (see Figure 2): i) the credit risk of the cover assets; ii) the cost of bridging maturity mismatches if any; and iii) adverse interest rate and foreign currency movements, to the extent there are open positions between the cover pool and the related covered bonds, after taking into account privileged swaps.

> Figure 2. Major sources of risk – cover pool primary source of payment



Source: Fitch

To evaluate the **asset credit risk**, Fitch conducts a static analysis and forms assumptions about the cumulative defaults and recoveries expected to arise in a given rating scenario, over the life of a cover pool. They depend on the nature and geographical location of the underlying assets or obligors. For similar assets, Fitch applies the same models and criteria as in structured finance transactions; as such, there will be consistency in the pool analysis for a given type of asset, irrespective of whether it serves as collateral for covered bonds programmes or structured finance transactions.

Maturity mismatches, arising notably as a result of bullet covered bonds being issued and secured against a pool of amortising assets, are amongst the key drivers of the need for OC. For each period after an assumed enforcement of recourse against the cover pool, Fitch compares the incoming cash flows to the amount due on the covered bonds, taking into account features such as extendable maturities, if any. In case of temporary surplus, excess cash is modelled to be invested at a sub-market rate, creating losses from negative carry. In the event of a shortfall of funds, and depending on the liquidity of the cover assets, asset sales are simulated at a price below par. The sale price is calculated as the net present value of future asset cash flows, using a stressed interest rate to which a stressed refinancing spread is added, and applying a minimum discount to the first sale.

Fitch's stressed refinancing spread assumptions are derived from observable sales' prices on comparable assets where available, such as publicly traded sovereign and local debt. For mortgage loans, in the absence of pricing evidence for portfolio sales, Fitch uses secondary market spreads from residential mortgage-backed securities, covered bonds and other relevant securities as a reference. This is because the agency believes the most likely exit for an alternative manager would be to sell the cover assets to another financial institution that already originates similar assets and will have to bear this funding cost.

The assets' cash flow profile is modified by applying Fitch's published high and low prepayment assumptions for the given asset class. The calculation takes into account the post swap excess spread earned on the assets, disregarding potential issuer-driven asset margin variations, but incorporating the effect of natural amortisation and product switches (for instance from an initially fixed rate to a floating rate of interest) that may occur once recourse against the cover pool has been enforced.

Both the asset and liability cash flows, incorporating payments from and due to counterparties of privileged interest rate and cross-currency swaps, are discounted using the Fitch **stressed interest rate** under a flat, high and low scenario. In a theoretical programme without margin or basis risk, floating rate assets and liabilities would therefore be valued at par in any rating scenario, whereas fixed rate cash flows would be valued at substantially below par in high interest rate scenarios and above par in low interest rate scenarios. Should there be post swap **open currency positions**, Fitch would model the respective foreign currency cash flows using standard base case, appreciation and depreciation scenarios. For instance, in a 'AAA' scenario, cash flows denominated in British pounds may be modelled by Fitch to lose 50% of their value compared with the euro.

DEFINING RECOVERY UPLIFT

Should covered bonds suffer a default post enforcement of the recourse against the cover pool, they may still benefit from high recoveries stemming from the residual cover assets. Fitch recognises this through a potential uplift above the covered bonds' rating on a PD basis. For stressed recoveries estimated in the 91-100% range, the uplift can reach up to two notches if the covered bonds' rating on a PD basis is in the investment-grade range, and three notches if the covered bonds' rating on a PD basis is in the non-investment-grade range.

> Figure 3. Maximum notching above covered bond rating on a PD basis

Recovery Prospects	Recovery Range (%)	Investment Grade	Non-investment grade
Outstanding	91-100	+2	+3
Superior	71–90	+1	+2
Good	51-70	+1	+1
Average	31-50	-	-
Below average	11-30	-1	-1
Poor	0-10	-1/-2	-2/-3

Source: Fitch

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 are insufficient to repay their debt in full. However, it may not be practical for them to enforce their right if the two liquidation procedures do not start at the same time. The outcome is also 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 liquidation.

Recovery prospects are assessed by dividing the stressed present value of the cover pool's cash flows, incorporating defaults and recoveries, by the stressed present value of the privileged liabilities (ie covered bonds and, if any, privileged swap agreements). This calculation takes place under the same principles applied when testing OC to determine the covered bonds' rating on a PD basis, except for the price cap and from the refinancing spread used. In a recovery situation, where the covered bonds have defaulted, there would be less pressure for an administrator to conduct a fire-sale of the assets than in a situation whereby covered bonds have to be paid on a timely basis. As a result, Fitch applies one-half of its usual refinancing margin on cover assets for a given rating scenario and does not apply a price cap. For consistency purposes, present values are determined at the date of an assumed enforcement of recourse against the cover pool. The stresses applied are those that correspond to the rating of the covered bonds, incorporating the notching for potential recoveries, rather than the rating of the covered bonds on a PD basis.

RELATIONSHIP BETWEEN OC AND RATINGS

The level of OC in covered bond programmes can change over time, as assets pay down and/or issuers actively manage their pools. Fitch gives credit — in decreasing order of comfort — to the following (when available) in its cash flow analysis:

> Contractual commitments, if legally binding and enforceable against the issuer; and

> Non-contractual public statements and/or covenants — such as undertakings given in the programme's investor reports, the bank's annual reports, or published on the investor relations section of the issuer's web site; or

> The lowest level of OC recorded during the preceding 12 months, provided that the issuer's Short-Term IDR is at least at 'F2' and the programme is not in wind-down.

For issuers with a Short-Term IDR below 'F2', or for programmes Fitch considers to be in wind-down or dormant, in the absence of valid contractual or otherwise public statements, the cash flow analysis will be run by giving credit only to the minimum level of OC, if any, required by the relevant covered bond legal framework.

CONCLUSION

The covered bond ratings assigned by Fitch are driven by: the bank IDR, the IDR uplift; the discontinuity assessment; and the level of OC taken into account by the agency compared to the breakeven percentage for the rating. The rating corresponding to the IDR plus the number of notches indicated by the IDR uplift constitutes a floor for the covered bond rating on a PD basis. The covered bonds rating can reach a maximum number of notches above this floor as indicated by the D-Cap plus the recovery uplift. Finally, the cover pool's credit risk, the maturity, interest rate and currency mismatches between the cover pool and the covered bonds are stressed to test whether OC enables the covered bonds to be paid timely in rating scenarios above the IDR plus IDR uplift, and whether it leads to recoveries on covered bonds assumed to be in default in line with Fitch bands for recovery uplifts.

COVERED BONDS SURVEILLANCE

Fitch's covered bonds surveillance platform constitutes a single, comprehensive source of periodic information on key covered bond credit characteristics. It gives an overview of the IDR, the IDR uplift, the D-Cap and the covered bond ratings, including Outlooks, for all programmes publicly rated by the agency. A rating history window lists all past rating actions at programme level since rating inception. Users will further find the amount of outstanding covered bonds and corresponding cover assets, highlighting available nominal OC as of each reporting date, as well as the breakeven percentage of OC (or asset percentage) for the assigned rating.

The platform 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. Furthermore, the surveillance pages display indicators of maturity, interest rate and currency mismatches between the cover pools and the covered bonds.

In addition, the agency publishes a periodic snapshot which presents statistics about the universe of covered bonds rated by Fitch, including information on rating migration. The key metrics are also available to subscribers in an excel format.

Fitch Ratings' Applicable Covered Bond Criteria

- Covered Bonds Rating Criteria (10 March 2014)
- Counterparty Criteria for Structured Finance and Covered Bonds (14 May 2014)
- Counterparty Criteria for Structured Finance and Covered Bonds: Derivative Addendum (14 May 2014)
- Criteria for Interest Rate Stresses in Structured Finance Transactions and Covered Bonds (23 January 2014)
- EMEA RMBS Master Rating Criteria (28 May 2014)
- Criteria for the Analysis of Commercial Real Estate Loans Securing Covered Bonds (22 May 2014)
- Covered Bonds Rating Criteria – Mortgage Liquidity and Refinancing Stress Addendum (4 February 2014)
- Asset Analysis Criteria for Covered Bonds of European Public Entities (30 January 2013)
- Covered Bonds Rating Criteria – Public Sector Liquidity and Refinancing Stress Addendum (7 February 2014)

4.4 MOODY'S COVERED BOND RATING METHOD

By Jane Soldera, Nicholas Lindstrom and Juan Pablo Soriano, Moody's

This chapter is a summary of our covered bond methodology set out in the report "Moody's Approach to Rating Covered Bonds", 12 March 2014, available at Moodys.com.

OVERVIEW

Our rating for a covered bond is determined after applying a two-step process:

> Moody's Expected Loss Covered Bond Model (*EL Model*): This determines a rating based on a largely quantitative calculation of expected loss, taking into account (1) the issuer's credit strength relative to its covered bond obligations (the *CB anchor*) and (2) the value of the cover pool, should the issuer cease to make payments on the covered bonds.

> Timely Payment Indicator (*TPI*) Framework: This applies a ceiling to the rating arrived at using Moody's EL Model. The TPI framework determines the maximum covered bond rating based on (1) the issuer's credit strength as expressed by the CB anchor and (2) the TPI assigned to the programme. The TPI assigned will reflect the probability of timely payments continuing on the covered bonds if the issuer, or a rated entity supporting the issuer, ceases to make payments on the covered bonds. We refer to the issuer ceasing to support the covered bonds as a CB anchor event.

MOODY'S EXPECTED LOSS (EL) MODEL

Our covered bond ratings are primarily determined by the expected loss under Moody's EL Model. The model assumes there is recourse, first, to the issuer and, second, to the cover pool. The model accordingly calculates the expected loss as a function of (1) the probability of a CB anchor event; and (2) the subsequent losses (if any) on the cover pool. Following a CB anchor event, the level of losses will be determined assuming a stressed environment where, most likely, the bank that originated the cover pool assets has failed. The key factors affecting the loss assumptions include:

> The credit quality of the assets in the cover pool;

> Refinancing risk, which arises when funds need to be raised to refinance the cover pool following a CB anchor event; and

> Any interest rate and currency mismatch risks to which the cover pool is exposed.

Moody's EL Model calculates expected loss on a month-by-month basis, from the point of issuance to the final maturity of a covered bond. For each period it calculates the probability of a CB anchor event on the basis of the issuer's credit strength as expressed by the CB anchor, and the estimated loss on the collateral (if any) assuming the issuer has defaulted on the covered bonds. The results are then summed and discounted back to a net present value to give the overall expected loss on the covered bond.

MOODY'S EL MODEL - ROLE OF THE ISSUER

The issuer's role is crucial to the performance of a covered bond programme. Before a CB anchor event, we assume the issuer is performing its obligations and there should be no loss to covered bondholders. The probability of a CB anchor event is expressed by the level of the CB anchor, which is the measure of an issuer's credit strength relative to its covered bond obligations. To assess the CB anchor we look first at either the issuer's (1) senior unsecured rating (*SUR*) or (2) baseline credit strength, adjusted for any parent or group support (*adjusted BCA*)[1]. We then consider whether the CB anchor should be notched up from either of these measures.

1 Or, if the issuer is unrated, we may use the rating of another group entity provided it has a sufficiently robust obligation to provide financial support to the issuer.

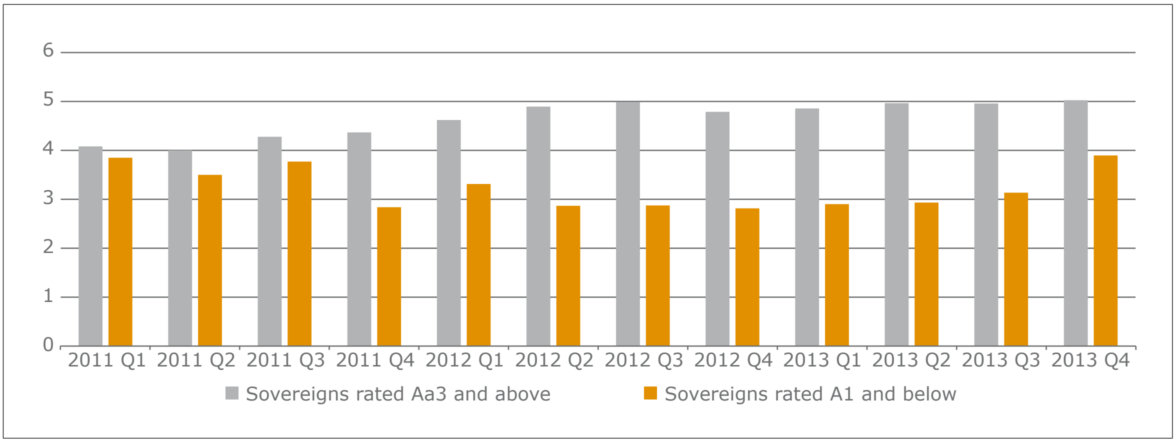
The CB anchor may be up to two notches above the issuer's adjusted BCA or up to one notch above the issuer's SUR. The rationale for notching up is to reflect that (1) covered bonds are excluded from the "bail-in" risk that could lead to a default on unsecured debt under "resolution" proceedings[2]; and (2) issuers with more "bail-in-able" unsecured debt have greater scope for recapitalisation and preservation as a going concern. If the issuer remains a going concern after resolution, it can continue to fulfil its obligations under the covered bonds.

We determine the CB anchor as follows:

Unsecured (bail-in-able) debt /total liabilities	**CB anchor: the higher of (A) and (B):**	
Threshold (1): <5%	(A)	Adjusted BCA + 0
	(B)	SUR + 0
Threshold (2): 5 – 10%	(A)	Adjusted BCA + 1
	(B)	SUR +1
Threshold (3): >10%	(A)	Adjusted BCA + 2
	(B)	SUR +1

Moody's EL Model also takes into account various issuer and issuer group-related benefits in addition to the issuer's CB anchor. For instance, the issuer will normally actively manage the cover pool to the benefit of the covered bondholders: this may include replacing defaulted assets with performing assets, or replacing high loan-to-value (LTV) loans with lower LTV loans, particularly if this is required by law. This kind of support from the issuer explains why the issuer's role is more important than that of a simple guarantor.

> FIGURE 1: SIMPLE AVERAGE NUMBER OF NOTCHES UPLIFT OF COVERED BOND RATING OVER ISSUER RATING (COUNTRIES STATICALLY DISTRIBUTED BY THEIR SOVEREIGN RATING AS OF END OF Q4 2013)



Source: Moody's European Covered Bonds Monitoring Overview, Q4 2013

2 We refer here to the possibility of resolution proceedings and use of the bail-in tool under the EU Directive on bank resolution and recovery, adopted 15 April 2014. As the directive only applies to the EU, and is expected to be followed by Norway, for the present we assume issuers outside this area will have a CB anchor of SUR+0. We introduced the CB anchor into our covered bond methodology in March 2014 as an initial step toward incorporating the impact of bank resolution into our methodology. We expect to refine our analysis as more certainty emerges on regulatory implementation and application of the directive.

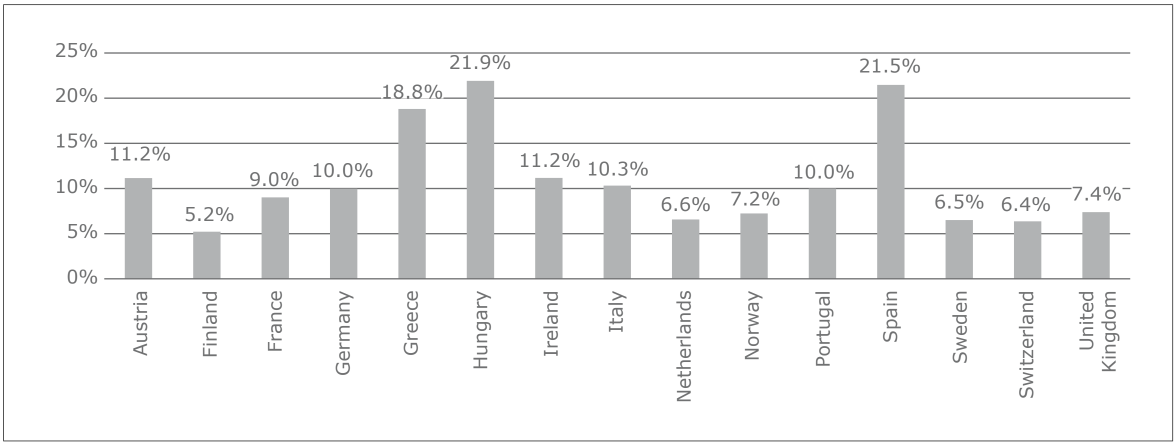
MOODY'S EL MODEL - VALUE OF THE COVER POOL AFTER A CB ANCHOR EVENT

To avoid losses on covered bonds following a CB anchor event, the realisable value of the cover pool, including any over-collateralisation, will need to be sufficient to cover the principal and interest payable on the covered bonds. In our analysis, there are three key factors affecting the value of the cover pool: (1) the credit quality of the collateral; (2) refinancing risk; and (3) interest rate and currency risks. Taken together, refinancing risk and interest rate and currency risks are referred to as market risks.

Credit quality of the collateral in the cover pool

We determine the credit quality of the cover pool by estimating the level of borrower loan losses that will accrue after a CB anchor event in a highly stressed environment. The collateral score measures the level of loss, whereby the lower the collateral score, the stronger the credit quality of the cover pool. Factors that affect the collateral score vary, but for mortgage loans they will normally include (1) the range and distribution of loan-to-value ratios; and (2) the quality of the loan underwriting, in particular, the calculation of whether the borrower can afford the loan. Factors most relevant for public-sector loans include the credit strength of the public-sector borrowers and the concentration levels of those loans. The credit quality of the cover pool may vary over time, as issuers typically have discretion to add and remove assets, but we monitor this by re-calculating on a quarterly basis the collateral score for most programmes.

> FIGURE 2: SIMPLE AVERAGE COLLATERAL SCORE BY COUNTRY: MORTGAGE BACKED COVERED BONDS



Source: Moody's European Covered Bonds Monitoring Overview, Q4 2013

Refinancing risk in the cover pool

The expected maturity of the assets in the cover pool is generally longer than that of the covered bonds. This mismatch means that, following a CB anchor event, funds may need to be raised against the cover pool to enable timely payment of principal on the covered bonds. Moody's EL Model assumes that when funds must be raised against the cover pool this will be done at a discount to the notional value of the cover pool. The refinancing environment for the assets at this time is likely to be stressed and this is taken into account in the level of discount we build into our credit enhancement assumptions.

The credit enhancement necessary to address refinancing risk is based on three factors:

(1) The level of discount required to sell or refinance the assets (referred to as refinancing margin);

(2) The portion of the cover pool exposed to refinancing risk; and

(3) The average life of the refinancing risk, i.e., the average duration of the refinancing risk for assets in the cover pool at the time of a CB anchor event.

For (2) and (3), we typically assume that the portion of the cover pool exposed to refinancing risk is a minimum of 50% and, at time of a CB anchor event, the average duration of the refinancing risk is a minimum of five years.

For (1), the refinancing margins are set by reference to each jurisdiction and then adjusted for individual programmes. Factors that influence the refinancing margins in our analysis include (i) on a jurisdiction level, the margins observed for covered bonds in a given market; (ii) on programme and/or jurisdiction level, the mitigants to refinancing risk; and (iii) on a programme level, the collateral quality.

Interest-rate and currency risks in the cover pool

Following a CB anchor event, investors in covered bonds may be exposed to interest rate and currency mismatches. These mismatches result from different interest rates, the duration of these rates, and different currency denominations of cover pool assets compared with the covered bonds.

Under Moody's EL Model, the potential mismatches are estimated by taking into account:

(1) The size of the possible interest rate (or currency) movement over the relevant period, for example looking at the impact of increasing and decreasing interest rates and taking the path that leads to the harshest expected loss on the covered bonds;

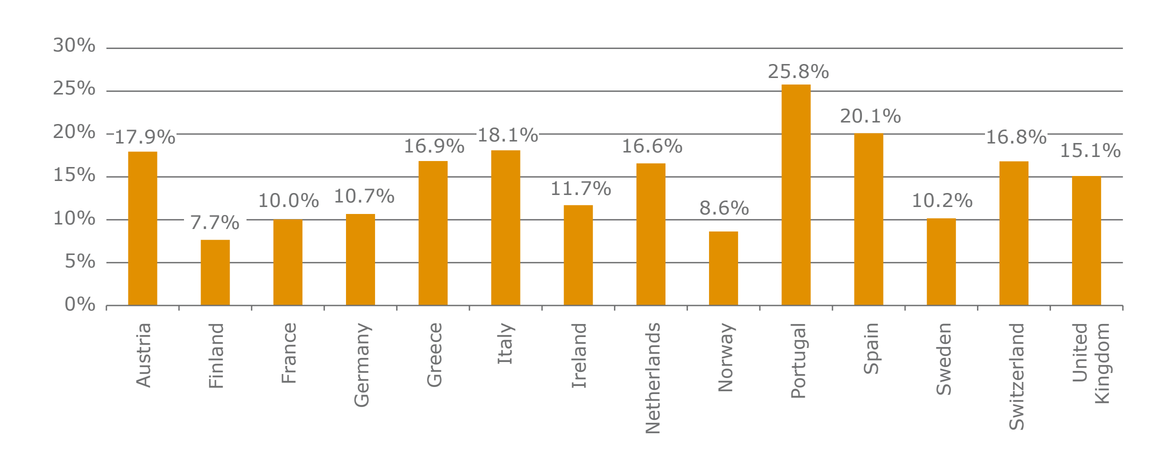
(2) The portion of the assets with interest-rate (or currency) mismatches; and

(3) In the case of interest-rate risk, the average duration of the mismatch based on how quickly the rates or margins on the assets in the cover pool may be adjusted.

Moody's EL Model takes into account whether derivatives hedging is in place at the point of a CB anchor event and the probability of the covered bonds subsequently becoming unhedged. The transaction may become unhedged following either swap counterparty default or issuer payment default due to insufficient proceeds from the cover pool. We assess the risk of counterparty default by applying the principles outlined in our cross sector methodology for assessing swap counterparties in structured finance cash-flow transactions.[3] We assess the risk of payment default by assuming that the risk of the issuer having insufficient cover pool proceeds to pay the swap will be equivalent to the risk that such proceeds will also be insufficient to pay the covered bonds. The risk of non-payment can therefore be estimated by the TPI. However, in no case do we currently assume that derivatives used to hedge interest rate and currency risk completely remove these risks from a covered bond.

3 "Approach to Assessing Swap Counterparties in Structured Finance Cash Flow Transactions", 12 November 2013, available at Moodys.com.

> FIGURE 3: WEIGHTED AVERAGE MARKET RISK BY COUNTRY: MORTGAGE BACKED COVERED BONDS



Source: Moody's European Covered Bonds Monitoring Overview, Q4 2013

MOODY'S TIMELY PAYMENT INDICATORS (TPIS): LINKAGE AND DE-LINKAGE

TPIs link the issuer, via the CB anchor, to the covered bond rating

Following a CB anchor event, the issuer can no longer be relied on to make timely payments on the bonds and bondholders must therefore rely on external support, liquidity and the legal/contractual framework of the bonds to provide for timely payment. A "timely payment indicator" or "TPI" is Moody's assessment of the likelihood that timely payment would continue to be made to covered bondholders following a CB anchor event. TPIs range from "Very High" to "Very Improbable".

TPIs indicate a ceiling for the rating of a covered bond that limits it to a certain number of notches above the CB anchor. We determine TPIs on a jurisdiction-by-jurisdiction basis as many of the factors we analyse are common within jurisdictions. TPIs may then be adjusted at the programme level to reflect particular features of a programme. We publish a TPI Table setting out the expected maximum covered bond ratings for different CB anchor/TPI combinations (see Moody's rating methodology report referred to at the end of this chapter). We will normally determine the rating ceiling based on the TPI table. However, for some programmes the actual rating ceiling may be higher or lower, particularly if the issuer has a low investment grade rating, or is rated below investment grade.

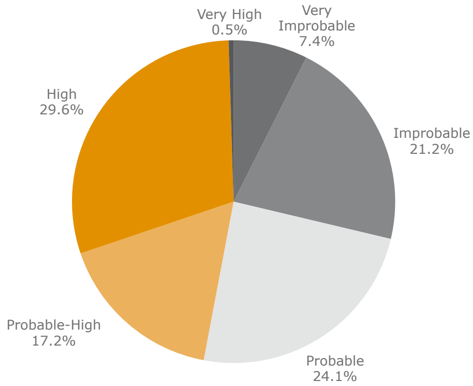
We consider a range of qualitative factors to determine TPIs. The most important of these – and the biggest risk to timely payment for most covered bonds – is the existence of refinancing risk. This risk is highly volatile, which is why our highest ratings cannot be maintained on covered bonds that are subject to material refinancing risk, unless they are also backed by a highly-rated issuer.

One important way in which we assess the effects of refinancing risk for each jurisdiction is to consider covered bonds' systemic importance in that jurisdiction. We consider whether, following a CB anchor event, covered bonds would be likely to receive support from the government or market participants. Other factors that we consider relevant to TPI levels include (1) continuity of servicing and cash management; (2) the risk that any relevant swaps might be terminated; (3) the risk of acceleration of the covered bonds; (4) over-collateralisation levels; and (5) the issuer's ability to change the programme (in particular to add new assets and enter into new hedging arrangements).

TPI de-linkage

Covered bonds can be TPI de-linked. TPI de-linkage would typically imply a level of de-linkage equivalent to the de-linkage of a securitisation note from the rating of the relevant originator, where the originator has a rating. For a covered bond to achieve TPI de-linkage we would consider whether refinancing risk and the risks around the role of the issuer have been sufficiently neutralised to negate their impact on the covered bonds. One method of removing refinancing risk would be to replace a hard or soft bullet principal repayment on the bonds with a pass-through or conditional pass-through from asset cash-flows.

> FIGURE 4: TPI DISTRIBUTION



Source: Moody's European Covered Bonds Monitoring Overview, Q4 2013.

References:

> Moody's EMEA Covered Bond Monitoring Overview: Q4 2013 (updated quarterly)

> Moody's Approach to Rating Covered Bonds; 12 March 2014

> European Covered Bonds: Sovereign Downgrades Key to Bond Rating Migration; 5 March 2012

> European Covered Bonds: Downgrades Accelerate due to Bank and Sovereign Credit Deterioration; 30 October 2012

> Global Covered Bonds 2014 Outlook; 10 December 2013

> European Covered Bond Legal Frameworks: Moody's Legal Checklist; 9 December 2005

4.5 STANDARD & POOR'S

By Roberto Paciotti and Bernd Ackermann, Standard & Poor's

Standard & Poor's Ratings Services' covered bond rating approach is explained in the criteria "Covered Bond Ratings Framework: Methodology And Assumptions," published on 26 June 2012, and available on the Global Credit Portal and at www.standardandpoors.com/coveredbonds.

The covered bond ratings framework determines the covered bond rating in three key stages (see Figure 1):

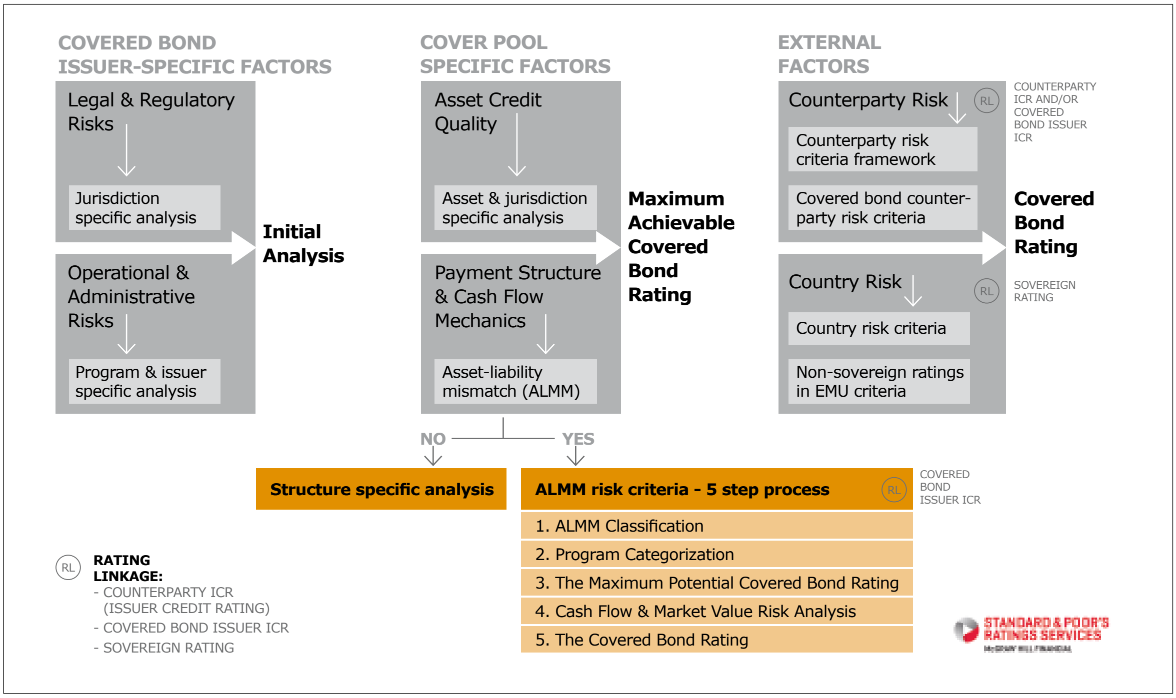
I. The Initial Analysis of covered bond issuer-specific factors, which include the assessment of the legal and regulatory framework that is governing the issuance, and the operational and administrative risks;

II. The Maximum Achievable Covered Bond Rating based on cover pool-specific factors, which include the asset credit quality and the payment structure and cash flow mechanics; and

III. The Covered Bond Rating, which is the final rating assigned to the covered bonds by combining the results of the above and considering additional external factors such as counterparty and country risks.

The outcome of S&P's rating analysis is a rating on the covered bond programme and the bonds issued under the programme. The quarterly publication "Global Covered Bond Characteristics" (see www.standardandpoors.com/coveredbonds) gives an overview on the key rating factors including credit and cash-flow indicators of the programmes that S&P rates.

> FIGURE 1: COVERED BOND RATINGS FRAMEWORK – BASED ON PRINCIPLES OF RATINGS



COVERED BOND ISSUER-SPECIFIC FACTORS

The Initial Analysis of the covered bond ratings is conducted with the primary aim of determining whether the covered bond rating may exceed the rating on the issuer. Due to the dual-recourse nature of covered bonds, the covered bond rating is typically no lower than the relevant rating on the covered bond issuer.

Legal & regulatory risks

The assessment of legal and regulatory risks focuses primarily on the degree to which a covered bond program isolates the cover pool assets from the bankruptcy or insolvency risk of the covered bond issuer. If the asset isolation analysis concludes that covered bonds are not likely to be affected by the bankruptcy or insolvency of the issuer, then we may assign a rating to the covered bonds that is higher than the rating on the issuer.

S&P typically reviews the following legal aspects when assigning a rating to a covered bond programme:

> 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 on a failure of the issuing bank;
> Whether there are any limits to overcollateralization levels, i.e. if a programme may overcollateralize its covered bonds above the minimum limit defined under the legislation or the programme documents, and whether this additional overcollateralization 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 programme 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 & administrative risks

The analysis of operational and administrative risks focuses on the relevant transaction parties to assess whether they are capable of managing a covered bond program for as long as any bonds issued remain outstanding.

A key transaction party in a covered bond program is typically the issuer, hence why S&P also reviews the issuer's origination, underwriting, and servicing operations to assess whether to factor any additional risks into its rating process.

COVER POOL-SPECIFIC FACTORS

The aim of the second stage of the covered bond ratings framework is to determine the Maximum Achievable Covered Bond Rating, i.e. the rating level that is consistent with the available credit support to achieve repayment on the covered bonds.

Asset credit quality

S&P analyses the underlying cover pools to form a view on the expected stressed asset performance using jurisdiction- and asset-specific assumptions. These cover assets typically contain residential mortgage loans, public sector bonds and loans, or some other form of high credit-quality collateral. The credit analysis also incorporates issuer-specific aspects such as the impact of its underwriting policies or its collateral management.

The output from the asset credit quality analysis (typically, stressed loss amounts expressed as stressed default rate and stressed recovery rate levels) forms the input for the cash flow analysis.

Payment structure & cash flow mechanics

S&P's criteria reflects its belief that the rating on a covered bond exhibiting mismatches between the underlying assets and the covered bond liabilities should be linked to the issuer credit rating on the issuing or sponsor bank, as we consider the bank the primary source to manage this mismatch risk. When the programme is exposed to such asset-liability maturity mismatch (ALMM) risk, the maximum potential rating uplift the covered bond rating can achieve above the issuer credit rating is up to seven notches. Only if a covered bond can be isolated from that bullet repayment risk can S&P rate the covered bonds on a de-linked basis from the issuer.

Established covered bond programmes typically issue debt with a broad range of maturities and there is an inherent timing mismatch between the redemption of assets and that of the liabilities. The timing and weighting of the degree of this mismatch is important in S&P's analysis. Generally, the expected cash inflow from the cover pool can partially mitigate some of the ALMM risk. In most circumstances, 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 bullet maturity, especially under the assumption of a defaulted issuer – which is what S&P considers to happen. The market value risk assumptions S&P makes are a function of its view of the relative liquidity in the market for these same assets and a stressed discounting of cash flows.

To assess the effect of asset-liability mismatches, the rating analysis thus focuses on the covered bond programme'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 programme based on a combined assessment of its ALMM risk exposure, its country categorization and the available credit enhancement.

> Step 1: ALMM classification

S&P first calculates its view of a programme'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 risk (but market value 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 programme is the maximum cumulative mismatch expressed as a percentage of a programme's outstanding liabilities. Based on these stresses and assumptions S&P classifies each programme as a "low", "moderate" or "high" ALMM risk.

> Step 2: Programme categorization

Secondly, S&P segments covered bond programmes predominantly by country, based on the range of external funding options available to the programme and S&P's view on the likelihood of obtaining this funding. The programmes 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 programme's rating may potentially exceed the issuing bank's rating. S&P combines its assessments of a programme's ALMM exposure (from step 1) and its ability to cover such liquidity needs (as defined by its programme categorization from step 2) in Figure 2. 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 programme'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 programmes using an unrated subsidiary or special-purpose entity, S&P applies its general criteria, "Group Rating Methodology," published on 19 November 2013, to determine the starting point of the elevation.

> FIGURE 2: MAXIMUM POTENTIAL RATINGS UPLIFT FROM THE ISSUER'S ICR, BY NUMBER OF NOTCHES

ALMM risk	Category		
	1	2	3
Zero	Unrestricted	Unrestricted	Unrestricted
Low	7	6	5
Moderate	6	5	4
High	5	4	3

> Step 4: Cash flow and market value risk analysis

S&P then determines the target credit enhancement level that, in its view, is the level commensurate to support the maximum potential ratings uplift. In this step we analyze all those risks we believe the cash flows are exposed to and in particular apply market value stresses to assets that need to be sold in situations where asset-liability mismatches occur and there is a liquidity need. S&P models market value risk by applying an additional asset dependent "spread shock" when calculating a stressed net present value of the cash flows of the assets to be sold. In its calculation of the target credit enhancement, S&P also incorporates its asset default stresses (including any amounts for counterparty risks that are not structurally mitigated) and any interest and currency stresses to the extent not appropriately hedged.

Should the cash flow and market value risk analysis indicate that a programme 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.

> Step 5: The covered bond rating

Lastly, S&P determines a rating on the programme that reflects the cover pool's actual level of credit enhancement. In this step, S&P assesses whether the available credit enhancement in a programme is equal to or higher than the target credit enhancement determined in step 4. If this is the case, the programme can achieve the maximum potential rating given in step 3. If this 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 (including counterparty-related risk such as not appropriately mitigated bank account and commingling risk). The remaining credit enhancement is compared with the additional notches of potential ratings uplift to determine the uplift achievable.

EXTERNAL FACTORS

Last, in addition to the analysis of the risks outlined above, S&P reviews any counterparty or country risk exposures. These risks might constrain the achievable covered bond rating even if sufficient overcollateralization to cover other risks is provided. Therefore, we analyse whether these risks would limit the maximum achievable covered bond rating as determined based on the previous steps of the analysis.

Counterparty risks

To the extent a programme 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. Deviations can result in either capping the maximum achievable covered bond rating or incorporating the unhedged risks into the sizing of the target credit enhancement.

In its analysis, S&P also assesses how other counterparties that provide support to the transaction could impact the rating. This also includes whether account bank risk is adequately mitigated or whether in the event of an insolvency of the issuer, cash flows could become commingled and ultimately lost. The loss of cash flows, in our view, must also be seen as an asset default related risk. If not mitigated in accordance with our criteria, we typically incorporate any such risk in steps 4 and 5 of our analysis of the cover pool's payment structure and cash flow mechanics, alternatively the covered bond rating will be further constrained.

Country risks

When we assess covered bonds, we analyze the underlying assets' and transaction's sensitivity to country risk and the asset portfolio's diversification by jurisdiction. For covered bonds rated above the sovereign and issued from within the European Monetary Union (EMU), we assign, according to our EMU country risk criteria, an assessment of "low" or "high" to a covered bond's country risk exposure. We typically consider asset pools of domestic public sector assets to have "high" exposure to country risk. We currently classify as "low" the country risk exposure of covered bonds backed by commercial or residential mortgage loans due to their perceived lower sensitivity to a sovereign default.

We determine the maximum rating differential between sovereign and covered bond ratings based on the sovereign rating level and the covered bond programme's country-risk exposure (see "Non-Sovereign Ratings That Exceed EMU Sovereign Ratings: Methodology And Assumptions," published on 14 June 2011). This assessment caps any potential further uplift typically available under our criteria for rating covered bonds.

A covered bond programme that has what we consider to be a "high" country-risk exposure would typically only achieve a one-notch uplift above the rating on the country in which the cover pool assets are located. A "low" country-risk exposure allows a maximum uplift of up to six notches above the investment-grade rating on the country in which the cover pool assets are located. If the sovereign's rating is in the speculative-grade category, the maximum uplift is five notches.

We have published a request for comment on proposed criteria changes ("Request For Comment: Methodology And Assumptions For Ratings Above The Sovereign–Single Jurisdiction Structured Finance", on 14 October 2013). If adopted, these criteria would replace the current EMU framework for rating covered bonds above the sovereign.

THE ASSIGNMENT OF OUTLOOKS

Under its criteria, S&P's assigns an outlook to all covered bond ratings. These provide a view of a programme's potential for a rating change and its direction over the intermediate term (see "General Criteria: Use Of CreditWatch And Outlooks," published 14 September 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.

ADVANCE NOTICE OF PROPOSED CRITERIA CHANGE

On 29 April 2014, we published an advance notice of proposed criteria change stating that we plan to propose a revision to our methodology and assumptions for rating covered bonds (see "Advance Notice Of Proposed Criteria Changes For Covered Bonds"). We are assessing the impact of market developments on covered bonds worldwide, arising from, among other things, legislative changes, such as the new EU Bank Recovery and Resolution Directive, and from the broader role of jurisdictional support.

CHAPTER 5 - COVERED BOND STATISTICS

5.1 INTRODUCTION AND METHODOLOGY

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

The ECBC Statistics and Data Working Group has been collecting statistics on the outstanding volume and annual gross supply of covered bonds at year end for 11 years now. From the start its aim has been to provide a complete set of numbers that can serve as guidance for interested parties from issuers and investors to regulators.

The collection of statistics is a significant undertaking each year which is only possible thanks to the cooperation of the Working Group members, covered bond issuers and banking associations. One representative per country (the list of country representatives can be found on the ECBC website and at the start of the Fact Book) undertakes the initial data collection by approaching each issuer separately in most countries. These figures are then cross-checked on the basis of publicly available data by a small number of Working Group members. The 2013 numbers were cross checked by Anne Caris and Rondeep Barua from Bank of America / Merrill Lynch, Jean-David Cirotteau and Cristina Costa from Société Générale, Florian Hillenbrand from Unicredit Group, Gordon Kerr from DBRS, Jan King from Royal Bank of Scotland, Agustin Martin from BBVA, Johannes Rudolph from ING Bank, Alexandra Schadow from LBBW, Michael Weigerding from Commerzbank as well as myself.

GENERAL REMARKS ON THE 2013 STATISTICS

The aim of the ECBC statistics is to paint as realistic a picture of the actual market and picture relevant trends as accurately as possible. After last year's methodology changes, we have kept the framework unchanged this year with one small exception.

> In the past we had always shown the number of issuers as well as new issuers. There are many issuers who run multiple covered bond programmes though (public sector as well as mortgage backed covered bonds for example, or multiple mortgage backed ones). In Italy many issuers set up second covered bond programmes during the financial crisis, for example.

> We have thus decided to add a line to the statistics which shows the number of programmes as well. "Programme" in that context does not refer to documentation such as domestic as well as international issuance programmes. Issuers can issue covered bonds from multiple documentations that all belong to one programme. We rather define "programme" in this context as one cover pool which backs a number of covered bonds. A German issuer issuing Hypothekenpfandbriefe as well as Öffentliche Pfandbriefe would count as one issuer and two programmes irrespective of the type of documentation used.

We have tried in the past and will continue to try to improve the quality of the data even for previous years. It is always possible that we miss a bond or still include a bond that has been repaid early (just think of retained covered bonds). Wherever we realise that there was a mistake in previous year's data, we amend the numbers. As a result of this, there are some slight differences in the numbers for 2012 compared to what was published last year. In our view, these adjustments are perfectly normal and we would rather adjust historic data to reflect a more realistic picture than mechanically hold on to data that was once published but proven incorrect wherever we have sufficient information to make the change.

Before going into the actual statistics, we want to make some general remarks about the figures which are necessary to interpret them correctly:

> Covered bonds are divided into those denominated in euro, those in domestic currency (if not the euro), and those in a currency other than the euro and the domestic currency. The exchange rate used to convert all outstanding volumes at the end of the year in non-EUR-denominated bonds is the end-of-year rate published by the European Central Bank.

> For the purpose of counting the number of issuers and of new issuers the following applies. Issuers are entities with at least one outstanding covered bond at year-end. Issuers with multiple programmes still only count as one. The only exception to this rule is French covered bonds. In the case of France, the actual issuer is a specialised bank rather than the mother company. As a result, one mother company with two covered bond programmes also counts as two issuers as the issuance actually comes from two separate legal entities. 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.

> Spain: Spain's covered bond statistics are based on the data provided by Spain's AIAF (Asociación de Intermediarios de Activos Financieros). We have complemented this with USD denominated Cédulas issued under Reg/S or 144a documentation that are not listed in the AIAF as well as registered unlisted covered bonds from the ECBC Covered Bond Label Database. The breakdown into public and private placements in Spain is entirely based on non-AIAF sources as the AIAF database does not systematically include this criterion. Up to 2011, the number of issuers provided by AIAF included the new financial institutions established as part of the restructuring of the Spanish banking sector as well as all the former financial institutions with outstanding covered bonds at the end of 2011 - even if as a consequence of the aforementioned restructuring they were integrated into a new institution. Because of this the number of issuers had been going up rather than down which is what one would have expected. When adjusting for the merger activity, the number of issuers at the end of 2011 was 42 rather than 64. For this year as well as 2012, we have changed the way we calculate the number of Spanish issuers to only include those that are separate legal entities and disregard any previous entities that have by now been merged.

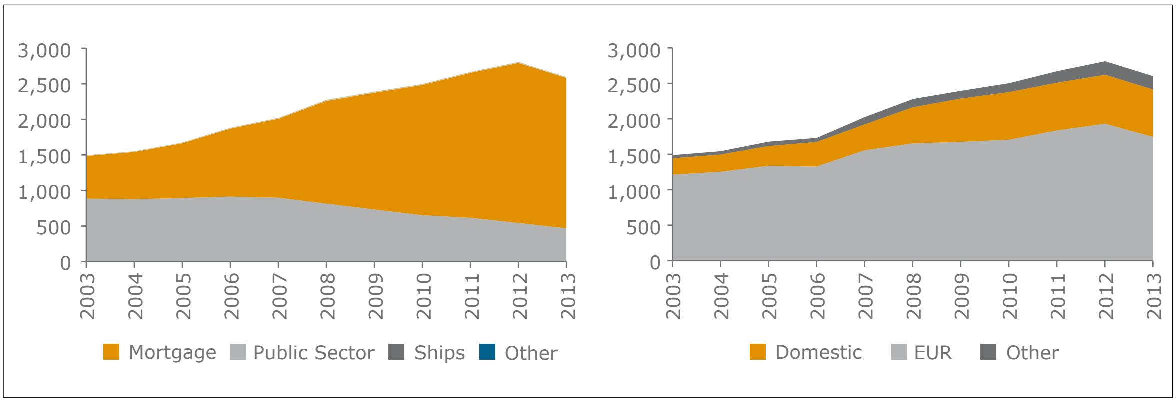
> Canada: Covered bonds backed by mortgages insured against borrower default by the Canada Mortgage and Housing Corporation are classified as mortgage covered bonds.

> 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).

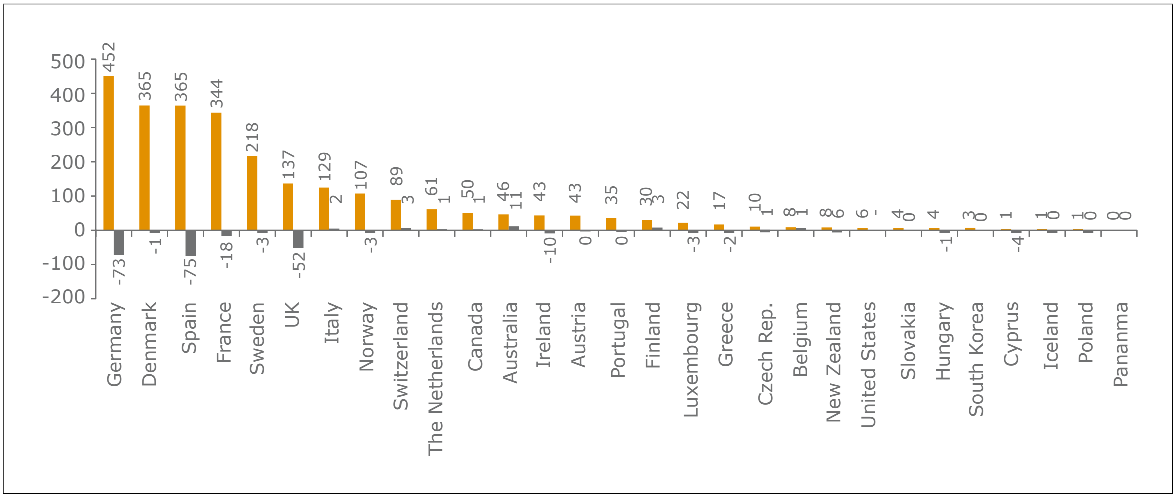
EVOLUTION OUTSTANDING VOLUMES 2013

Having grown every year since 2003, the overall covered bond market has contracted in size in 2013, which is the first time since we started collecting data in 2003. Overall, outstanding volumes fell by EUR213bn or 8% to EUR2.6tn. There were still a number of growing sectors such as Belgium or Australia, which grew by 6bn and 11bn respectively. At the same time, however, Spanish covered bond volumes fell by EUR75bn (or 18% of the Spanish outstanding) as the Spanish banks' balance sheet contraction continued, retained deals that had been used as collateral with the central bank were cancelled and publicly issued deals matured. German covered bond markets shrank by 72bn (or 14%) while the UK market contracted by EUR55bn (almost on third of the market).

> Figure 1: Outstanding covered bonds by collateral type (LHS) as well as currency (RHS) in EUR bn



> Figure 2: Outstanding covered bonds by country as well as change vs. 2012 (EUR bn)



Despite the significant drop, the German market is still the biggest covered bond market across collateral types with EUR452bn. With EUR365bn, the Danish market has, however, managed to squeeze past the Spanish by a mere 200m to gain second place. The Danes are also the clear number one when only looking at mortgage backed covered bonds. With EUR344bn, French covered bonds occupy fourth spot, the same as last year.

Covered bonds existed in 29 countries spreading across the globe from Australia to Canada and most of Europe. No new country joined in 2013. The number of issuers remained stable in 2013 at 306. On the one hand, the merger process in Spain reduced the number by 8 and one Italian issuer ceased to be active in covered bond markets. At the same time, however, this drop was offset by issuers joining in countries such as Belgium, Finland or New Zealand.

The trend away from public sector backed covered bonds towards mortgage backed ones continued in 2013 albeit at a slower pace than in 2012. Mortgage backed covered bonds accounted for 81.5% of the overall market up from 80.2% in 2012. Rather than having public sector backed covered bonds contract and mortgage backed ones grow as was the case in 2012, both categories have contracted in 2013. The drop in mortgage backed covered bonds was not as pronounced though (-6%) as the public sector backed ones (-14%). Other collateral types continue to not play any significant role in covered bond markets. Ship backed covered bonds are a mere 0.4% of the market at EUR11bn. In addition to this, they have shrunk by 17% vs. 2012 when their weight had still been 0.5%.

Having seen a big surge in volumes as banks in a number of countries used retained covered bonds as repo collateral during the crisis, the private placement category saw the biggest drop in 2013 (-85bn or 11%). European lenders paid back part of their LTRO money and consequently cancelled out retained covered bonds. At the same time, low interest rates led to reduced demand for privately placed deals with end investors. In public benchmark markets, reduced funding needs made themselves felt as well. Benchmark covered bonds above EUR1bn in all currencies dropped by 128bn or 9%. At the same time, the trend towards smaller benchmark deals continued. The category public placement 500m to 1bn was the only one to grow in 2013 (up by 2bn to 223bn). At 9% of the total amount outstanding, it still only represents a relatively small part of the market though.

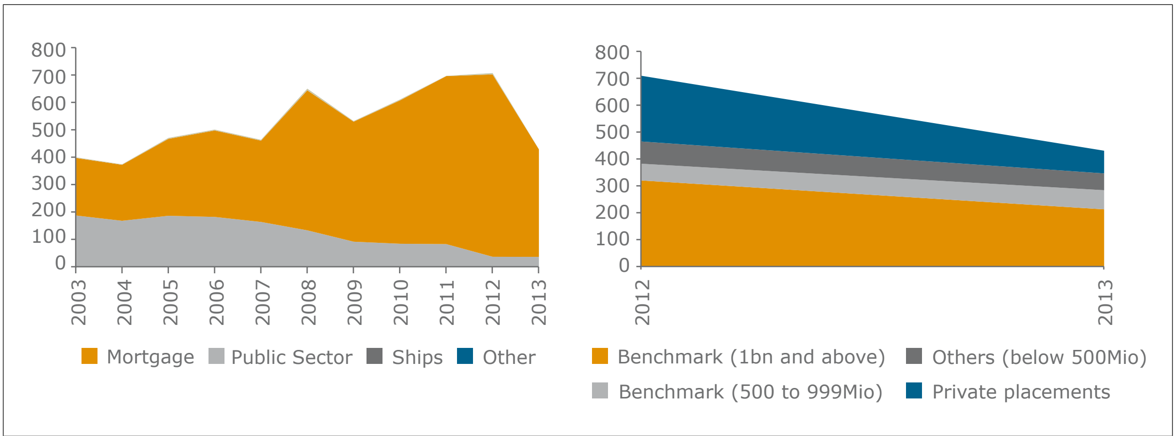
Covered bond markets continued to be dominated by fixed rate bonds. Despite the low interest rate environment, this coupon type makes up 78% of the market after 75% in 2012. Much of the retained covered bonds that were issued in FRN format to minimize central bank haircuts. Consequently outstanding FRN covered bonds dropped by -107bn or 16% compared to 2012.

Looking at currencies, the biggest contraction took place in EUR. When thinking about the countries with the biggest absolute drop in volumes (Spain and Germany), this should not come as a surprise. EUR denominated covered bonds fell by 186bn or 10%. Covered bonds denominated in domestic currencies such as DKK, SEK, NOK, AUD or CAD were fairly stable vs. last year dropping only 22bn or 2%.

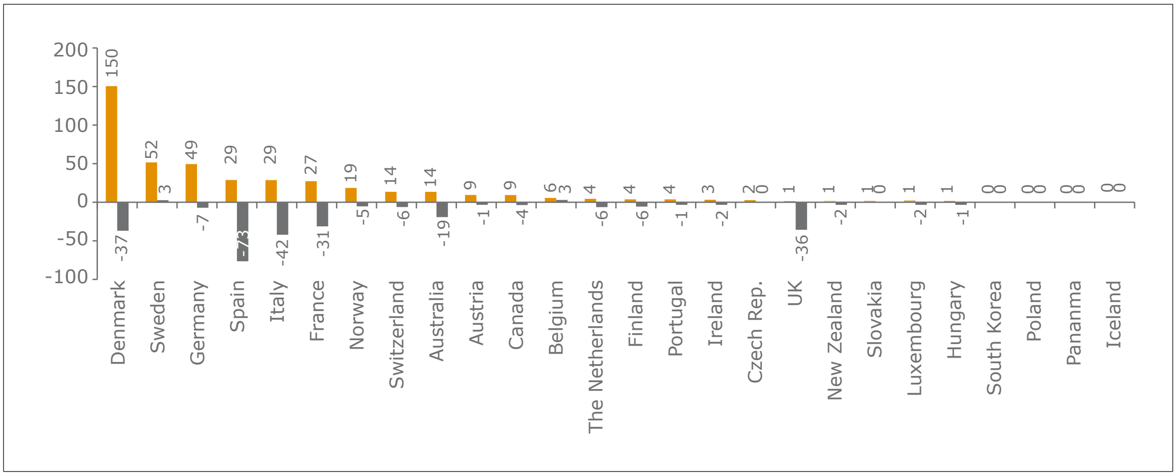
EVOLUTION OF COVERED BOND ISSUANCE 2013

Looking at issuance the trends mentioned above for the evolution of outstanding covered bond volumes become even more pronounced. Total covered bond issuance fell by 39% to EUR429bn after EUR707bn last year. In addition to the overall issuance dropping we have also witnessed a lower number of first time issuers. Had we still seen 20 new issuers in 2012, the number has fallen to 10 in 2013.

> Figure 3: Covered Bond Issuances by collateral type (LHS) as well as currency (RHS) in EUR bn



> FIGURE 4: COVERED BONDS NEW ISSUANCE BY COUNTRY AS WELL AS CHANGE VS. 2012 (EUR BN)



The biggest drops in issuance volumes could be witnessed in both privately placed covered bonds (-66% to EUR84bn) as well as those issued with floating rate coupons (-78% to EUR91bn). Many issuers simply cancelled and did not replace retained deals, which fall into the private placement category and are usually issued with floating rate coupons. In addition to this, interest in private placements by end investors fell as well due to low interest rates.

One area that actually grew vs 2012 was the smaller sized publicly placed benchmarks (+EUR9bn to EUR71bn). While it is the fairly obvious choice for smaller banks for which a 1bn deal creates challenges with regards to concentrating a big part of the wholesale funding on one maturity date, even bigger issuers have tended to go for smaller deal sizes in times of low funding needs.

Looking at currencies, issues in domestic currencies did not suffer as bad as EUR denominated and other non-domestic currency issuance. Many issuers concentrated their lower funding plans on their domestic investor base where the most attractive funding levels could be achieved and where ties with investors have been the strongest throughout the crisis.

HOW HAS 2014 STARTED AND WHAT COULD 2015 HOLD…?

Covered bond markets have continued to contract in the first half of 2014. Issuance at least in EUR benchmark markets is above 2013 figures at that time. However USD, AUD and GBP benchmark markets have been less active and private placement markets have suffered from ongoing low interest rates. And when looking at the net issuance rather than gross figures, the contraction becomes even more obvious. EUR benchmark covered bond markets are faced with around EUR150bn in redemptions this year, a level EUR benchmark issuance will fail to reach by quite some margin.

The contraction is led by the same countries that have already contracted in 2013 – Spain and Germany. But also in countries such as France, net issuance is negative as issuers have focused on other funding sources and hybrid capital deals. Covered bonds have been the funding product to get banks through the crisis but as markets have improved and more products have become available to a larger number of banks, funding officials have tried to make use of these new options. They have targeted the most complex trades first and covered bond volumes have suffered as a result.

2015 will most likely be a fairly similar story – covered bond funding plans are being pushed back for the sake of alternative funding sources. The main difference to 2014 could however be that a large number of banks resort back to central bank money again rather than more complex wholesale funding products. The Eurosystem's announcement of the TLTROs could be a drag on covered bond issuance. Banks will not use it because they do not have any other viable funding channels open to them but because it is too attractively priced to let it pass by unused. 2-4 year money is certainly not going to replace all long dated covered bond funding plans. Going for somewhat more pronounced maturity transformation and slightly bigger asset and liability mismatches is something that could however be acceptable for many. Especially in the first quarters after the asset quality review and stress test results are published in Europe it could be tempting to show better profitability in the short run by using TLTRO money rather than 10Y covered bonds. Covered bond issuers will therefore not replace long term funding plans entirely with 2-4 year central money but there will be some of this.

Country weights in the covered bond market could thus further shift to non-European countries. Australia has been the fastest growing country in recent years and also Canadian covered bond issuers are back in the market having registered their new legal based covered bond programmes with the Canadian regulator. But also countries such as Sweden or Denmark will gain relative weight. They are unlikely to grow massively but in an otherwise shrinking universe, merely staying stable means gaining market share.

Whether covered bond markets overall will contract in 2015 or whether there will be a renewed surge in retained covered bonds as collateral for the TLTRO money remains to be seen. The contracting should however most certainly find an end towards 2016 / 2017. 2015 will be the last year for the German public sector backed covered bond market to contract significantly which has played a big role in recent years. And 2017 is the first year when at least in EUR benchmark covered bond space redemptions start to drop from the plateau that was created by having the long dated issuance from the pre-crisis years falling due together with the shorter dated bonds from the crisis years.

5.2 STATISTICS

5.2.1 TOTAL

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total CB Outstanding										
Public Sector	879,320	894,944	915,003	899,500	815,550	733,076	653,022	616,551	543,977	464,799
Mortgage	665,071	772,081	958,415	1,112,594	1,446,835	1,646,212	1,834,599	2,042,410	2,253,583	2,121,853
Ships	9,542	10,586	11,341	12,167	16,327	15,151	14,527	12,640	13,571	11,306
Others	-	-	-	-	-	-	-	-	506	506
Total Outstanding	1,553,933	1,677,611	1,884,759	2,024,262	2,278,712	2,394,439	2,502,147	2,671,601	2,811,637	2,598,464
Public Placements										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,446,384	1,316,849
Benchmark (500 to 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	221,309	223,307
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	337,127	337,230
Private Placements	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	806,818	721,079
Total	1,553,933	1,677,611	1,884,759	2,024,262	2,278,712	2,394,439	2,502,147	2,671,601	2,811,638	2,598,464
Denominated in Euro	1,252,336	1,336,837	1,326,648	1,555,576	1,652,613	1,674,407	1,704,560	1,835,505	1,929,200	1,741,359
Denominated in domestic currency	243,278	278,597	346,388	364,936	509,403	610,742	671,389	673,074	691,401	669,039
Denominated in other currencies	47,568	62,178	57,121	103,749	116,695	109,291	126,197	163,020	191,036	188,066
Total	1,553,933*	1,677,611	1,884,759*	2,024,261	2,278,712	2,394,439	2,502,147	2,671,600	2,811,637	2,598,464
Outstanding fixed coupon	1,261,771	1,379,653	1,505,880	1,737,822	1,748,656	1,844,852	1,952,480	2,095,679	2,119,502	2,015,973
Outstanding floating coupon	177,148	178,093	203,972	255,458	497,805	513,575	509,032	543,568	652,024	545,501
Outstanding other	24,830	25,557	20,305	30,982	32,252	35,913	40,635	32,354	40,111	36,989
Sum	1,553,933*	1,677,611*	1,884,759*	2,024,261	2,278,713	2,394,340	2,502,147	2,671,601	2,811,637	2,598,463
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	414
Number of Issuers	167	194	214	235	267	300	302	321	306	306

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total CB Issuance										
Public Sector	167,844	186,098	181,992	163,611	132,988	91,526	84,018	82,711	36,495	36,096
Mortgage	204,362	280,671	315,502	296,779	510,892	438,066	523,221	613,267	665,642	392,248
Ships	1,785	3,579	3,334	3,143	6,289	2,221	3,325	1,016	4,643	761
Others	-	-	-	-	-	-	-	-	506	-
Total Issuance	373,991	470,348	500,829	463,533	650,169	531,813	610,564	696,994	707,286	429,105
Public Placements										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	319,064	211,902
Benchmark (500 to 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	62,032	70,889
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	82,450	62,254
Private Placements	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	243,740	84,061
Total	373,991	470,348	500,829	463,533	650,169	531,813	610,564	696,994	707,285	429,106
Denominated in Euro	267,724	284,635	344,027	332,243	384,653	303,839	374,030	438,040	405,271	213,118
Denominated in domestic currency	97,100	153,030	127,961	100,317	248,869	215,370	200,886	207,701	249,631	188,186
Denominated in other currencies	9,167	28,876	28,840	30,973	16,647	12,603	35,648	51,252	52,384	27,801
Total	373,991	470,346*	500,828	463,533	650,169	531,812	610,564	696,993	707,286	429,105
Issuance fixed coupon	309,890	375,583	396,931	373,842	350,866	405,130	492,587	497,465	271,042	337,400
Issuance floating coupon	43,732	67,387	55,828	85,017	292,124	122,152	115,629	196,586	410,994	90,917
Issuance other	7,160	9,860	6,035	4,673	7,179	4,530	2,348	2,943	25,250	790
Total	373,991*	470,348*	500,828*	463,532	650,169	531,813	610,564	696,994	707,285	429,107
Number of New Issuers	19	29	20	22	41	36	27	23	20	10

Please note that a few changes were undertaken in 2013 to the way data is grouped and shown. These changes impact the figures from 2012 onwards. A number of them, especially the size and placement type category changes, are substantial to how data is displayed. Backdating data to fit the new categories and maintaining consistent data history for previous years is a major challenge. Therefore, there is a full dataset going back to 2003 for some countries while there is only data from 2012 going forward for others. Consequently, on the aggregate covered bond market level, only data for the new categorisation for 2012 and 2013 is shown. The old categories together with the historic data can be found on the 2012 edition of the ECBC Fact Book. For further information on these changes, please see the Statistics introduction of the Fact Book.

Please note that the statistics contain "n.a." when data is not available, "-" when the value is zero and "*" indicates that the figure in question does not correspond to the sum of the above sub-components due to the unavailability in some countries of these breakdowns. In addition, please note that totals are calculated using available data only, and that any fluctuations of values in this table over time may be partly due to one or more countries' data becoming available or unavailable from one year to the next. In order to be sure about what causes changes in the totals, please see the individual country statistics. Finally, please also note that any small difference between Totals in the same year is due to rounding.

Source: EMF/ECBC

5.2.2 TOTAL 2013 STATISTICS BY TYPE OF ASSETS

COVERED BONDS OUTSTANDING 2013 in EUR million						
	Public Sector	Mortgage	Ships	Others	Mixed Assets	TOTAL
Australia	-	46,021	-	-	-	46,021
Austria	23,682	18,854	-	-	-	42,536
Belgium	-	8,188	-	-	-	8,188
Canada	-	50,459	-	-	-	50,459
Cyprus	-	1,000	-	-	-	1,000
Czech Republic	-	10,355	-	-	-	10,355
Denmark	-	359,646	5,514	-	-	365,160
Finland	-	29,783	-	-	-	29,783
France	68,349	202,822	-	-	73,015	344,185
Germany	245,961	199,900	5,792	506	-	452,159
Greece	-	16,546	-	-	-	16,546
Hungary	-	4,016	-	-	-	4,016
Iceland	-	803	-	-	-	803
Ireland	22,154	20,827	-	-	-	42,981
Italy	6,945	122,099	-	-	-	129,044
Latvia	-	-	-	-	-	-
Luxembourg	21,708	-	-	-	-	21,708
The Netherlands	-	61,015	-	-	-	61,015
New Zealand	-	7,851	-	-	-	7,851
Norway	2,035	105,202	-	-	-	107,237
Panama	-	218	-	-	-	218
Poland	84	707	-	-	-	791
Portugal	1,200	34,199	-	-	-	35,399
Slovakia	-	4,015	-	-	-	4,015
South Korea	-	2,536	-	-	-	2,536
Spain	30,352	334,572	-	-	-	364,924
Sweden	-	217,854	-	-	-	217,854
Switzerland	-	89,064	-	-	-	89,064
United Kingdom	5,822	130,792	-	-	-	136,614
United States	-	6,000	-	-	-	6,000
Total	**428,292**	**2,085,345**	**11,306**	**506**	**73,015**	**2,598,464**

COVERED BONDS ISSUANCE 2013 in EUR million						
	Public Sector	Mortgage	Ships	Others	Mixed Assets	TOTAL
Australia	-	13,519	-	-	-	13,519
Austria	3,373	6,093	-	-	-	9,466
Belgium	-	5,598	-	-	-	5,598
Canada	-	9,354	-	-	-	9,354
Cyprus	-	-	-	-	-	-
Czech Republic	-	1,791	-	-	-	1,791
Denmark	-	149,989	458	-	-	150,447
Finland	-	3,771	-	-	-	3,771
France	4,179	19,637	-	-	3,498	27,314
Germany	15,611	33,583	303	-	-	49,497
Greece	-	-	-	-	-	-
Hungary	-	559	-	-	-	559
Iceland	-	51	-	-	-	51
Ireland	25	3,235	-	-	-	3,260
Italy	4,200	24,520	-	-	-	28,720
Latvia	-	-	-	-	-	-
Luxembourg	825	-	-	-	-	825
The Netherlands	-	4,478	-	-	-	4,478
New Zealand	-	1,122	-	-	-	1,122
Norway	239	18,339	-	-	-	18,578
Panama	-	73	-	-	-	73
Poland	-	116	-	-	-	116
Portugal	-	3,750	-	-	-	3,750
Slovakia	-	841	-	-	-	841
South Korea	-	466	-	-	-	466
Spain	5,895	22,919	-	-	-	28,814
Sweden	-	51,633	-	-	-	51,633
Switzerland	-	13,583	-	-	-	13,583
United Kingdom	-	1,480	-	-	-	1,480
United States	-	-	-	-	-	-
Total	**34,347**	**390,499**	**761**	**-**	**3,498**	**429,105**

Source: EMF/ECBC

5.2.3 AUSTRALIA

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	2,142	34,902	46,021
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	-	-	2,142	34,902	46,021
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	25,443	36,938
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	966	3,666	2,670
Others (below 500Mio)	-	-	-	-	-	-	-	1,176	2,150	1,118
Private Placement	-	-	-	-	-	-	-	-	3,643	5,295
Total	-	-	-	-	-	-	-	2,142	34,902	46,021
Denominated in EURO	-	-	-	-	-	-	-	-	10,242	14,355
Denominated in domestic currency	-	-	-	-	-	-	-	-	9,676	9,012
Denominated in other currencies	-	-	-	-	-	-	-	2,142	14,984	22,654
Total	-	-	-	-	-	-	-	2,142	34,902	46,021
Outstanding fixed coupon	-	-	-	-	-	-	-	2,142	27,640	38,198
Outstanding floating coupon	-	-	-	-	-	-	-	-	7,262	7,823
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	2,142	34,902	46,021
Number of Programmes	-	-	-	-	-	-	-	n.a.	n.a.	5
Number of Issuers	-	-	-	-	-	-	-	3	5	5

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	2,142	32,731	13,519
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	-	-	2,142	32,731	13,519
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	25,443	10,907
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	966	2,698	750
Others (below 500Mio)	-	-	-	-	-	-	-	1,176	947	-
Private Placement	-	-	-	-	-	-	-	-	3,643	1,863
Total	-	-	-	-	-	-	-	2,142	32,731	13,520
Denominated in EURO	-	-	-	-	-	-	-	-	10,242	4,112
Denominated in domestic currency	-	-	-	-	-	-	-	-	9,676	1,037
Denominated in other currencies	-	-	-	-	-	-	-	2,142	12,813	8,370
Total	-	-	-	-	-	-	-	2,142	32,731	13,519
Issuance fixed coupon	-	-	-	-	-	-	-	2,142	25,469	12,066
Issuance floating coupon	-	-	-	-	-	-	-	-	7,262	1,455
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	2,142	32,731	13,521
Number of New Issuers	-	-	-	-	-	-	-	3	2	-

5.2.4 AUSTRIA

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	6,750	13,038	15,615	15,200	17,326	19,617	19,555	25,116	25,831	23,682
Mortgage	4,000	4,000	3,880	4,125	4,973	5,317	7,645	17,174	17,010	18,854
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	10,750	17,038	19,495	19,325	22,299	24,934	27,200	42,290	42,841	42,536
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	6,000	7,087	5,000
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	9,915	11,328	12,870
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	5,821	5,897	87
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	20,554	18,529	24,579
Total	10,750	17,038	19,495	19,325	22,299	24,934	27,200	42,290	42,841	42,536
Denominated in EURO	n.a.	15,691	17,703	17,304	19,664	24,002	21,510	37,576	39,068	39,184
Denominated in domestic currency	n.a.	-	-	-	-	-	-	-	-	-
Denominated in other currencies	n.a.	1,347	1,792	2,021	2,634	932	5,690	4,714	3,773	3,352
Total	10,750	17,038	19,495	19,325	22,298	24,934	27,200	42,290	42,841	42,536
Outstanding fixed coupon	n.a.	13,497	17,207	18,111	19,189	16,593	17,900	32,275	32,696	34,793
Outstanding floating coupon	n.a.	3,324	2,062	1,029	3,110	6,309	6,600	7,650	7,750	7,342
Outstanding other	n.a.	217	226	185	-	2,032	2,700	2,364	2,395	402
Total	10,750	17,038	19,495	19,325	22,299	24,934	27,200	42,290	42,841	42,536
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	39
Number of Issuers	15	22	23	24	25	26	23	24	25	26

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	n.a.	3,591	3,110	3,131	9,361	2,501	8,125	7,114	6,882	3,373
Mortgage	n.a.	214	2,176	1,959	1,321	1,442	3,600	3,664	3,805	6,093
Ships	n.a.	-	-	-	-	-	-	-	-	-
Others	n.a.	-	-	-	-	-	-	-	-	-
Total Issuance	n.a.	3,805	5,286	5,090	10,682	3,943	11,725	10,778	10,687	9,466
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3,000	1,000	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,750	2,500	3,800
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	321	318	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4,707	6,869	5,666
Total	n.a.	3,805	5,286	5,090	10,682	3,943	11,725	10,778	10,687	9,466
Denominated in EURO	n.a.	n.a.	4,899	4,861	10,362	3,943	10,725	10,008	10,447	9,466
Denominated in domestic currency	n.a.	n.a.	-	-	-	-	-	-	-	-
Denominated in other currencies	n.a.	n.a.	387	229	320	-	1,000	770	240	-
Total	n.a.	3,805	5,286	5,090	10,682	3,943	11,725	10,778	10,687	9,466
Issuance fixed coupon	n.a.	n.a.	3,807	4,577	8,255	3,252	10,200	5,922	8,155	6,609
Issuance floating coupon	n.a.	n.a.	1,478	490	2,262	435	525	4,561	2,201	2,812
Issuance other	n.a.	n.a.	-	23	165	256	1,000	295	331	45
Total	n.a.	3,805	5,286	5,090	10,682	3,943	11,725	10,778	10,687	9,466
Number of New Issuers	3	7	1	1	1	1	2	1	1	1

5.2.5 BELGIUM

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	-	2,590	8,188
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	-	-	-	2,590	8,188
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	2,500	4,500
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	2,500
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	90	1,188
Total	-	-	-	-	-	-	-	-	2,590	8,188
Denominated in EURO	-	-	-	-	-	-	-	-	2,590	8,188
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	-	2,590	8,188
Outstanding fixed coupon	-	-	-	-	-	-	-	-	2,590	8,188
Outstanding floating coupon	-	-	-	-	-	-	-	-	-	-
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	-	2,590	8,188
Number of Programmes	-	-	-	-	-	-	-	-	2	3
Number of Issuers	-	-	-	-	-	-	-	-	2	3

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	-	2,590	5,598
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	-	-	-	2,590	5,598
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	2,500	2,000
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	2,500
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	90	1,098
Total	-	-	-	-	-	-	-	-	2,590	5,598
Denominated in EURO	-	-	-	-	-	-	-	-	2,590	5,598
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	-	2,590	5,598
Issuance fixed coupon	-	-	-	-	-	-	-	-	2,590	5,598
Issuance floating coupon	-	-	-	-	-	-	-	-	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	-	2,590	5,598
Number of New Issuers	-	-	-	-	-	-	-	-	2	1

5.2.6 CANADA

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	2,000	6,574	7,525	18,003	38,610	49,121	50,459
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	2,000	6,574	7,525	18,003	38,610	49,121	50,459
Public Placement										
Benchmark (1bn and above)	-	-	-	n.a.	6,280	6,238	14,600	34,009	43,495	45,372
Benchmark (500Mio - 999Mio)	-	-	-	n.a.	-	496	2,230	3,653	4,130	1,205
Others (below 500Mio)	-	-	-	n.a.	294	792	1,173	948	1,119	3,123
Private Placement	-	-	-	n.a.	-	-	-	-	378	759
Total	-	-	-	2,000	6,574	7,525	18,003	38,610	49,121	50,459
Denominated in EURO	-	-	-	2,000	6,574	6,574	4,250	4,250	2,576	6,750
Denominated in domestic currency	-	-	-	-	-	496	1,201	2,043	2,055	1,840
Denominated in other currencies	-	-	-	-	-	455	12,552	32,317	44,490	41,869
Total	-	-	-	2,000	6,574	7,525	18,003	38,610	49,121	50,459
Outstanding fixed coupon	-	-	-	2,000	6,250	6,999	17,763	38,610	48,743	48,962
Outstanding floating coupon	-	-	-	-	324	526	240	-	378	1,497
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	2,000	6,574	7,525	18,003	38,610	49,121	50,459
Number of Programmes	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	9
Number of Issuers	-	-	-	1	3	3	5	7	7	7

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	2,000	4,574	951	12,650	20,441	12,941	9,354
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	2,000	4,574	951	12,650	20,441	12,941	9,354
Public Placement										
Benchmark (1bn and above)	-	-	-	n.a.	4,280	-	10,334	19,036	11,942	9,030
Benchmark (500Mio - 999Mio)	-	-	-	n.a.	-	496	1,667	1,405	455	-
Others (below 500Mio)	-	-	-	n.a.	294	455	649	-	166	-
Private Placement	-	-	-	n.a.	-	-	-	-	378	324
Total	-	-	-	2,000	4,574	951	12,650	20,441	12,941	9,354
Denominated in EURO	-	-	-	2,000	4,250	-	-	-	-	5,500
Denominated in domestic currency	-	-	-	-	-	496	638	832	-	-
Denominated in other currencies	-	-	-	-	324	455	12,012	19,608	12,941	3,854
Total	-	-	-	2,000	4,574	951	12,650	20,440	12,941	9,354
Issuance fixed coupon	-	-	-	2,000	4,250	749	12,650	20,441	12,563	8,219
Issuance floating coupon	-	-	-	-	-	202	-	-	-	1,135
Issuance other	-	-	-	-	324	-	-	-	378	-
Total	-	-	-	2,000	4,574	951	12,650	20,441	12,941	9,354
Number of New Issuers	-	-	-	1	2	-	2	2	-	-

5.2.7 CYPRUS

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	5,200	4,550	1,000
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	-	-	5,200	4,550	1,000
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	5,200	4,550	1,000
Total	-	-	-	-	-	-	-	5,200	4,550	1,000
Denominated in EURO	-	-	-	-	-	-	-	5,200	4,550	1,000
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	5,200	4,550	1,000
Outstanding fixed coupon	-	-	-	-	-	-	-	-	-	-
Outstanding floating coupon	-	-	-	-	-	-	-	5,200	4,550	1,000
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	5,200	4,550	1,000
Number of Programmes	-	-	-	-	-	-	-	n.a.	n.a.	1
Number of Issuers	-	-	-	-	-	-	-	2	2	1

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	5,200	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	-	-	5,200	-	-
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	5,200	-	-
Total	-	-	-	-	-	-	-	5,200	-	-
Denominated in EURO	-	-	-	-	-	-	-	5,200	-	-
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	5,200	-	-
Issuance fixed coupon	-	-	-	-	-	-	-	-	-	-
Issuance floating coupon	-	-	-	-	-	-	-	5,200	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	5,200	-	-
Number of New Issuers	-	-	-	-	-	-	-	2	-	-

5.2.8 CZECH REPUBLIC

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	1,956	4,452	5,543	8,213	8,091	8,179	8,234	8,546	9,056	10,355
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	1,956	4,452	5,543	8,213	8,091	8,179	8,234	8,546	9,056	10,355
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	1,721	3,710	4,682	6,613	6,502	5,439	5,454	5,194	5,522	6,731
Private Placement	235	742	861	1,600	1,589	2,740	2,780	3,352	3,534	3,624
Total	1,956	4,452	5,543	8,213	8,091	8,179	8,234	8,546	9,056	10,355
Denominated in EURO	-	-	42	39	35	119	128	111	571	914
Denominated in domestic currency	1,956	4,452	5,501	8,174	8,056	8,060	8,106	8,435	8,485	9,441
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	1,956	4,452	5,543	8,213	8,091	8,179	8,234	8,546	9,056	10,355
Outstanding fixed coupon	1,796	3,619	4,615	5,871	5,752	3,756	3,608	3,740	3,280	6,110
Outstanding floating coupon	160	833	928	1,675	1,270	3,900	4,063	4,119	5,096	4,105
Outstanding other	-	-	-	667	1,069	523	563	687	680	140
Total	1,956	4,452	5,543	8,213	8,091	8,179	8,234	8,546	9,056	10,355
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	8
Number of Issuers	5	8	8	9	8	8	8	8	8	8

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	744	2,558	956	3,501	938	738	723	770	1,309	1,791
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	744	2,558	956	3,501	938	738	723	770	1,309	1,791
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	609	2,068	875	3,347	938	187	705	711	742	622
Private Placement	135	490	81	154	-	551	18	59	567	1,169
Total	744	2,558	956	3,501	938	738	723	770	1,309	1,791
Denominated in EURO	-	-	42	-	-	89	18	-	500	886
Denominated in domestic currency	744	2,558	914	3,501	938	649	705	770	809	905
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	744	2,558	956	3,501	938	738	723	770	1,309	1,791
Issuance fixed coupon	650	1,897	903	1,322	55	76	420	378	484	1,717
Issuance floating coupon	94	661	53	1,699	789	662	178	169	745	74
Issuance other	-	-	-	480	95	-	125	223	80	-
Total	744	2,558	956	3,501	938	738	723	770	1,309	1,791
Number of New Issuers	-	3	-	1	-	-	-	-	-	-

5.2.9 DENMARK

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	216,133	246,411	260,367	244,696	255,140	319,434	332,505	345,529	359,560	359,646
Ships	6,330	6,915	6,672	7,754	7,045	7,197	6,722	5,999	6,325	5,514
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	222,463	253,326	267,039	252,450	262,185	326,631	339,227	351,528	365,885	365,160
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	231,421	234,504
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	52,156	54,170
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	80,692	74,355
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,616	2,131
Total	222,463	253,326	267,039	252,450	262,185	326,631	339,227	351,528	365,885	365,160
Denominated in EURO	18,315	18,432	18,743	19,547	22,520	37,675	42,848	43,753	46,451	40,856
Denominated in domestic currency	204,148	234,894	248,296	232,903	238,324	287,317	294,019	302,938	312,065	316,603
Denominated in other currencies	-	-	-	-	1,341	1,639	2,360	4,837	7,368	7,701
Total	222,463	253,326	267,039	252,450	262,185	326,631	339,227	351,528	365,885	365,160
Outstanding fixed coupon	202,936	209,667	208,623	178,953	184,636	254,894	267,075	275,092	285,754	284,483
Outstanding floating coupon	7,877	32,729	48,232	73,497	77,549	71,737	72,152	76,436	80,131	80,677
Outstanding other	11,650	10,930	10,184	-	-	-	-	-	-	-
Total	222,463	253,326	267,039	252,450	262,185	326,631	339,227	351,528	365,885	365,160
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	24
Number of Issuers	8	8	8	9	9	9	9	9	9	9

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	95,009	149,708	114,014	70,955	103,230	125,484	148,475	145,147	185,845	149,989
Ships	139	1,837	960	2,515	235	935	136	121	1,474	458
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	95,148	151,545	114,974	73,470	103,465	126,419	148,611	145,268	187,319	150,447
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	140,705	112,880
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	18,339	17,573
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	27,843	19,657
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	432	337
Total	95,148	151,545	114,974	73,470	103,465	126,419	148,611	145,268	187,319	150,447
Denominated in EURO	5,556	8,850	8,844	14,415	13,186	22,255	24,833	25,415	25,074	23,553
Denominated in domestic currency	89,591	142,695	106,130	59,055	90,279	101,183	122,374	116,911	158,335	124,331
Denominated in other currencies	-	-	-	-	-	2,981	1,404	2,942	3,910	2,563
Total	95,148	151,545	114,974	73,470	103,465	126,419	148,611	145,268	187,319	150,447
Issuance fixed coupon	91,267	123,590	93,771	50,757	89,888	122,851	133,846	128,195	-	130,290
Issuance floating coupon	3,881	27,955	21,203	22,713	13,577	3,568	14,765	17,073	163,680	20,157
Issuance other	-	-	-	-	-	-	-	-	23,638	-
Total	95,148	151,545	114,974	73,470	103,465	126,419	148,611	145,268	187,319	150,447
Number of New Issuers	-	-	-	1	-	-	-	-	-	-

Note: Since a large share of Danish mortgage covered bonds are tap-issued over a period of typically 3 years, Benchmark (1bn and above) issues and outstanding are defined as covered bond with more than EUR 1 bn in the year, the bond reach EUR 1 bn. The same way, Benchmark (500Mio - 999Mio) issues and outstanding are defined as covered bond with 500Mio - 999Mio euro in the year, the bond reach EUR 500 Mio, and at the same time does not exceed EUR 999 Mio. The definition includes both covered bonds denominated in DKK and in EUR. Danish covered bonds denominated in euro and issued in a jurisdiction outside Denmark are included in the Danish data.

5.2.10 FINLAND

Outstanding (in EUR million)	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	250	1,500	3,000	4,500	5,750	7,625	10,125	18,839	26,684	29,783
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	250	1,500	3,000	4,500	5,750	7,625	10,125	18,839	26,684	29,783
Public Placement										
Benchmark (1bn and above)	-	1,000	2,000	3,000	4,000	5,250	7,250	14,750	20,750	22,500
Benchmark (500Mio - 999Mio)	-	-	-	-	-	600	1,600	2,200	2,200	2,200
Others (below 500Mio)	250	500	1,000	1,500	1,750	1,775	1,275	1,606	2,874	4,115
Private Placement	-	-	-	-	-	-	-	283	861	969
Total	250	1,500	3,000	4,500	5,750	7,625	10,125	18,839	26,684	29,783
Denominated in EURO	250	1,500	3,000	4,500	5,750	7,625	10,125	18,453	26,114	29,230
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	386	571	553
Total	250	1,500	3,000	4,500	5,750	7,625	10,125	18,839	26,684	29,783
Outstanding fixed coupon	-	1,000	2,250	3,750	4,750	6,500	9,250	17,863	23,247	26,425
Outstanding floating coupon	250	500	750	750	1,000	1,125	875	976	3,437	3,358
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	250	1,500	3,000	4,500	5,750	7,625	10,125	18,839	26,684	29,783
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	8
Number of Issuers	1	2	2	3	3	3	4	4	5	6

Issuance (in EUR million)	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	250	1,250	1,500	1,500	1,250	2,125	5,250	9,964	9,368	3,771
Ships	-	-	-	-	-	-	-	-	-	
Others	-	-	-	-	-	-	-	-	-	
Total Issuance	250	1,250	1,500	1,500	1,250	2,125	5,250	9,964	9,368	3,771
Public Placement										
Benchmark (1bn and above)	-	1,000	1,000	1,000	1,000	1,250	4,000	8,500	7,000	2,750
Benchmark (500Mio - 999Mio)	-	-	-	-	-	600	1,000	600	-	500
Others (below 500Mio)	250	250	500	500	250	275	250	581	1,790	370
Private Placement	-	-	-	-	-	-	-	283	578	151
Total	250	1,250	1,500	1,500	1,250	2,125	5,250	9,964	9,368	3,771
Denominated in EURO	250	1,250	1,500	1,500	1,250	2,125	5,250	9,578	9,186	3,771
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	386	182	-
Total	250	1,250	1,500	1,500	1,250	2,125	5,250	9,964	9,368	3,771
Issuance fixed coupon	-	1,000	1,250	1,500	1,000	2,000	5,000	9,613	6,783	3,621
Issuance floating coupon	250	250	250	-	250	125	250	351	2,585	150
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	250	1,250	1,500	1,500	1,250	2,125	5,250	9,964	9,368	3,771
Number of New Issuers	1	1	-	1	-	-	1	-	1	1

5.2.11 FRANCE

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	37,600	42,600	49,660	56,403	64,756	71,905	75,548	77,835	72,033	68,349
Mortgage	26,816	32,133	43,012	63,555	119,092	134,757	156,239	198,395	208,297	202,822
Mixed Assets	41,350	50,040	61,930	80,097	80,631	82,572	88,693	89,768	81,560	73,015
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	105,766	124,773	154,602	200,055	264,479	289,234	320,480	365,998	361,890	344,185
Public Placement										
Benchmark (Above 1bn)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	241,775	209,885
Benchmark (500Mio - 1bn)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4,949	23,992
Others	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	36,595	32,253
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	78,570	78,055
Total	105,766	124,773	154,602	200,055	264,479	289,234	320,480	365,998	361,890	344,186
Denominated in EURO	94,104	109,236	n.a.	165,779	226,922	256,798	285,501	327,874	331,212	316,562
Denominated in domestic currency	-	-	n.a.	-	-	-	-	-	-	-
Denominated in other currencies	11,662	15,537	n.a.	34,276	37,558	32,436	34,979	38,123	30,678	27,624
Total	105,766	124,773	154,602	200,055	264,480	289,234	320,480	365,998	361,890	344,186
Outstanding fixed coupon	26,333	30,465	n.a.	174,388	204,729	236,106	266,080	284,266	297,009	287,504
Outstanding floating coupon	n.a.	n.a.	n.a.	10,502	48,633	42,600	43,710	75,068	47,805	43,002
Outstanding other	n.a.	n.a.	n.a.	15,165	11,117	10,528	10,690	6,665	17,076	13,680
Total	105,766	124,773	154,602	200,055	264,479	289,234	320,480	365,998	361,890	344,186
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	23
Number of Issuers	5	5	6	7	10	14	16	19	20	21

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	8,600	9,070	12,134	15,271	11,354	13,915	12,508	8,851	1,150	4,179
Mortgage	5,737	6,397	12,637	21,670	59,734	29,373	42,895	84,416	49,260	19,637
Mixed Assets	11,150	13,150	17,263	23,682	8,549	15,824	17,261	8,719	8,101	3,498
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	25,487	28,617	42,034	60,623	79,637	59,112	72,664	101,986	58,511	27,314
Public Placement										
Benchmark (Above 1bn)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	25,672	12,250
Benchmark (500Mio - 1bn)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,185	5,550
Others	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4,830	1,755
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	26,824	7,759
Total	25,487	28,617	42,034	60,623	79,637	59,112	72,664	101,986	58,511	27,314
Denominated in EURO	21,369	20,637	34,172	50,700	73,930	56,155	64,375	96,020	55,851	26,596
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	4,119	7,980	7,862	9,923	5,708	2,957	8,289	5,967	2,660	718
Total	25,488	28,617	42,034	60,623	79,637	59,112	72,664	101,986	58,511	27,314
Issuance fixed coupon	12,279	14,904	n.a.	57,009	37,158	50,443	64,503	67,612	36,003	23,556
Issuance floating coupon	n.a.	n.a.	n.a.	2,614	42,224	8,519	7,953	34,286	22,368	3,558
Issuance other	n.a.	n.a.	n.a.	1,000	255	150	208	89	140	200
Total	25,488	28,617	42,034	60,623	79,637	59,112	72,664	101,986	58,511	27,314
Number of New Issuers	-	-	1	1	3	4	4	3	1	1

Note: The "Mixed assets" category refers to covered bonds that are backed by a mix of public sector assets, mortgage loans. The bonds (outstanding and issuance) have been allocated equally between mortgage and public sector categories in the total (5.2.1 section of the Fact Book).

5.2.12 GERMANY

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	760,264	734,713	720,835	677,656	578,974	486,406	412,090	355,673	301,125	245,961
Mortgage	246,636	237,547	223,306	206,489	217,367	225,100	219,947	223,676	215,999	199,900
Ships	3,212	3,670	4,669	4,413	9,282	7,954	7,805	6,641	7,246	5,792
Others	-	-	-	-	-	-	-	-	506	506
Total Outstanding	1,010,112	975,930	948,810	888,558	805,623	719,460	639,842	585,990	524,876	452,159
Public Placement										
Benchmark (1bn and above)	366,719	354,592	326,140	298,220	266,747	224,042	170,068	141,393	112,869	81,030
Benchmark (500Mio - 999Mio)	28,740	27,740	31,102	36,178	32,909	27,683	28,644	28,704	36,862	46,798
Others (below 500Mio)	181,004	185,578	155,379	92,675	62,805	66,030	46,344	43,634	75,244	63,864
Private Placement	433,649	408,020	436,189	461,485	443,162	401,705	394,786	372,259	299,901	260,467
Total	1,010,112	975,930	948,810	888,558	805,623	719,460	639,842	585,990	524,876	452,159
Denominated in EURO	985,370	952,485	922,878	863,594	778,623	690,510	620,420	565,529	506,639	437,737
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	24,742	23,445	25,932	24,964	27,000	28,950	19,422	20,461	18,237	14,422
Total	1,010,112	975,930	948,810	888,558	805,623	719,460	639,842	585,990	524,876	452,159
Outstanding fixed coupon	838,345	845,386	823,130	789,338	689,124	619,364	546,791	493,983	433,787	375,537
Outstanding floating coupon	160,693	120,681	121,754	90,552	107,522	90,136	78,105	74,340	76,840	59,170
Outstanding other	11,075	9,863	3,926	8,668	8,976	9,959	14,946	17,667	14,249	17,452
Total	1,010,112	975,930	948,810	888,558	805,623	719,460	639,842	585,990	524,876	452,159
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	118
Number of Issuers	48	54	57	58	59	61	63	66	70	72

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	131,506	137,235	129,452	107,913	89,522	52,251	41,574	30,990	14,341	15,611
Mortgage	40,773	33,722	35,336	26,834	57,345	56,852	42,216	40,911	38,540	33,583
Ships	1,646	1,742	2,374	628	6,054	1,286	3,189	895	3,169	303
Others	-	-	-	-	-	-	-	-	506	-
Total Issuance	173,925	172,699	167,162	135,375	152,921	110,389	86,979	72,796	56,556	49,497
Public Placement										
Benchmark (1bn and above)	42,325	48,450	45,210	32,980	26,285	17,125	16,853	21,406	4,008	2,125
Benchmark (500Mio - 999Mio)	4,250	9,050	7,200	12,556	10,880	7,650	10,297	5,319	11,879	15,725
Others (below 500Mio)	62,848	49,395	24,525	12,437	30,172	18,732	11,835	15,632	11,816	11,816
Private Placement	64,502	65,804	90,227	77,402	85,584	66,882	47,994	30,439	28,853	19,831
Total	173,925	172,699	167,162	135,375	152,921	110,389	86,979	72,796	56,556	49,497
Denominated in EURO	172,085	163,931	159,340	131,807	149,137	107,488	84,459	68,585	52,608	45,757
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	1,840	8,768	7,822	3,568	3,784	2,901	2,520	4,211	3,948	3,740
Total	173,925	172,699	167,162	135,375	152,921	110,389	86,979	72,796	56,556	49,497
Issuance fixed coupon	130,723	138,259	143,869	113,085	111,309	89,605	62,518	54,023	32,274	37,878
Issuance floating coupon	36,559	27,077	18,859	20,099	40,156	20,091	23,468	16,692	23,702	11,302
Issuance other	6,643	7,363	4,434	2,191	1,456	693	993	2,081	580	317
Total	173,925	172,699	167,162	135,375	152,921	110,389	86,979	72,796	56,556	49,497
Number of New Issuers	7	6	4	2	4	5	5	3	5	2

5.2.13 GREECE

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	5,000	6,500	19,750	19,750	18,046	16,546
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	5,000	6,500	19,750	19,750	18,046	16,546
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	1,500	1,500	1,500	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	846	846
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	5,000	5,000	18,250	18,250	17,200	15,700
Total	-	-	-	-	5,000	6,500	19,750	19,750	18,046	16,546
Denominated in EURO	-	-	-	-	5,000	6,500	19,750	19,750	18,046	16,546
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	5,000	6,500	19,750	19,750	18,046	16,546
Outstanding fixed coupon	-	-	-	-	-	1,500	1,500	1,500	846	846
Outstanding floating coupon	-	-	-	-	5,000	5,000	18,250	18,250	17,200	15,700
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	5,000	6,500	19,750	19,750	18,046	16,546
Number of Programmes	-	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	6
Number of Issuers	-	-	-	-	3	3	4	4	4	4

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	5,000	1,500	17,250	5,000	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	5,000	1,500	17,250	5,000	-	-
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	1,500	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	5,000	-	17,250	5,000	-	-
Total	-	-	-	-	5,000	1,500	17,250	5,000	-	-
Denominated in EURO	-	-	-	-	5,000	1,500	17,250	5,000	-	-
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	5,000	1,500	17,250	5,000	-	-
Issuance fixed coupon	-	-	-	-	-	1,500	-	-	-	-
Issuance floating coupon	-	-	-	-	5,000	-	17,250	5,000	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	5,000	1,500	17,250	5,000	-	-
Number of New Issuers	-	-	-	-	3	-	2	1	-	-

5.2.14 HUNGARY

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	4,962	5,072	5,924	5,987	7,105	7,375	6,323	5,175	4,958	4,016
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	4,962	5,072	5,924	5,987	7,105	7,375	6,323	5,175	4,958	4,016
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,290	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	865	20
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,803	3,996
Total	4,962	5,072	5,924	5,987	7,105	7,375	6,323	5,175	4,958	4,016
Denominated in EURO	350	540	1,547	1,784	2,879	3,799	2,904	2,167	1,863	1,616
Denominated in domestic currency	4,612	4,532	4,377	4,203	4,209	3,559	3,419	2,934	3,059	2,354
Denominated in other currencies	-	-	-	-	17	17		74	36	46
Total	4,962	5,072	5,924	5,987	7,105	7,375	6,323	5,175	4,958	4,016
Outstanding fixed coupon	4,556	4,587	5,214	5,080	4,086	6,737	5,713	3,195	3,318	2,650
Outstanding floating coupon	316	398	635	907	3,019	638	610	1,980	1,640	1,366
Outstanding other	90	87	75	-	-	-	-	-	-	-
Total	4,962	5,072	5,924	5,987	7,105	7,375	6,323	5,175	4,958	4,016
Number of Programmes	n,a	n,a	n,a	n,a	n,a	n,a	n,a	n,a	n,a	3
Number of Issuers	3	3	3	3	3	3	3	3	3	3

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	2,381	808	1,418	331	3,331	3,209	542	2,264	1,140	559
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	2,381	808	1,418	331	3,331	3,209	542	2,264	1,140	559
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	510	500
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	630	57
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	2
Total	2,381	808	1,418	331	3,331	3,209	542	2,264	1,140	559
Denominated in EURO	350	190	1,007	291	1,407	1,102	300	1,600	510	515
Denominated in domestic currency	2,031	618	411	40	1,907	2,107	242	565	630	42
Denominated in other currencies	-	-	-	-	17	-	-	99	-	2
Total	2,381	808	1,418	331	3,331	3,209	542	2,264	1,140	559
Issuance fixed coupon	2,377	718	1,168	116	2,275	3,200	477	538	630	57
Issuance floating coupon	-	90	250	215	1,056	9	65	1,726	510	502
Issuance other	4	-	-	-	-	-	-	-	-	-
Total	2,381	808	1,418	331	3,331	3,209	542	2,264	1,140	559
Number of New Issuers	-	-	-	-	-	-	-	-	-	-

5.2.15 ICELAND

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	467	478	492	685	807	808	893	803
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	467	478	492	685	807	808	893	803
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	467	478	492	685	807	808	893	803
Private Placement	-	-	-	-	-	-	-	-	-	-
Total	-	-	467	478	492	685	807	808	893	803
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	467	478	492	685	807	808	893	803
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	467	478	492	685	807	808	893	803
Outstanding fixed coupon	-	-	-	-	-	-	-	-	15	66
Outstanding floating coupon	-	-	-	-	-	-	-	-	-	-
Outstanding other	-	-	467	478	492	685	807	808	878	737
Total	-	-	467	478	492	685	807	808	893	803
Number of Programmes	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	1	3	4
Number of Issuers	-	-	2	2	1	1	1	1	2	3

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	467	-	321	-	-	25	113	51
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	467	-	321	-	-	25	113	51
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	467	-	321	-	-	25	113	-
Private Placement	-	-	-	-	-	-	-	-	-	51
Total	-	-	467	-	321	-	-	25	113	51
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	467	-	321	-	-	25	113	51
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	467	-	321	-	-	25	113	51
Issuance fixed coupon	-	-	-	-	-	-	-	-	15	23
Issuance floating coupon	-	-	-	-	-	-	-	-	-	-
Issuance other	-	-	467	-	321	-	-	25	98	28
Total	-	-	467	-	321	-	-	25	113	51
Number of New Issuers	-	-	2	-	-	-	-	-	1	1

5.2.16 IRELAND

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	27,204	40,965	49,914	51,204	52,613	50,951	36,492	31,760	27,546	22,154
Mortgage	2,000	4,140	11,900	13,575	23,075	29,725	29,037	30,007	25,099	20,827
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	29,204	45,105	61,814	64,779	75,688	80,676	65,529	61,767	52,645	42,981
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	26,402	23,079	17,169
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	500	500	2,500
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,092	868	239
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	33,773	28,198	23,073
Total	29,204	45,105	61,814	64,779	75,688	80,676	65,529	61,767	52,645	42,981
Denominated in EURO	26,696	37,452	52,800	52,328	60,056	67,626	54,940	53,054	44,725	36,360
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	2,508	7,654	9,014	12,451	15,632	13,050	10,589	8,713	7,920	6,621
Total	29,204	45,105	61,814	64,779	75,688	80,676	65,529	61,767	52,645	42,981
Outstanding fixed coupon	28,460	40,717	55,832	56,094	48,817	43,717	40,069	35,853	32,658	27,652
Outstanding floating coupon	631	2,095	3,028	5,299	23,294	33,607	22,507	22,919	17,008	12,730
Outstanding other	114	2,294	2,954	3,386	3,577	3,353	2,953	2,995	2,979	2,598
Total	29,204	45,105	61,814	64,779	75,688	80,676	65,529	61,767	52,645	42,981
Number of Programmes	3	3	4	4	5	6	6	6	5	5
Number of Issuers	3	3	4	4	5	6	6	6	5	5

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	15,047	13,576	9,722	9,533	12,665	3,174	60	-	-	25
Mortgage	2,000	2,000	7,753	1,675	9,506	14,801	6,000	9,290	5,500	3,235
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	17,047	15,576	17,475	11,208	22,171	17,975	6,060	9,290	5,500	3,260
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,000	1,000
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	500	2,000
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4,000	260
Total	17,047	15,576	17,475	11,208	22,171	17,975	6,060	9,290	5,500	3,260
Denominated in EURO	15,816	10,663	15,035	6,612	18,741	17,975	6,060	9,290	5,500	3,260
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	1,231	4,914	2,440	4,596	3,430	-	-	-	-	-
Total	17,047	15,576	17,475	11,208	22,171	17,975	6,060	9,290	5,500	3,260
Issuance fixed coupon	16,467	12,033	15,537	8,183	4,600	4,175	210	-	1,500	3,035
Issuance floating coupon	466	1,445	1,101	2,351	17,240	13,750	5,850	9,290	4,000	225
Issuance other	114	2,097	837	674	331	50	-	-	-	-
Total	17,047	15,576	17,475	11,208	22,171	17,975	6,060	9,290	5,500	3,260
Number of New Issuers	1	-	1	-	1	1	-	-	-	-

5.2.17 ITALY

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	4,000	8,063	8,063	8,063	9,063	10,092	12,999	10,300	6,945
Mortgage	-	-	-	-	6,500	14,000	26,925	50,768	116,405	122,099
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	4,000	8,063	8,063	14,563	23,063	37,017	63,767	126,705	129,044
Public Placement										
Benchmark (1bn and above)	-	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	37,927	39,602
Benchmark (500Mio - 999Mio)	-	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4,450	8,450
Others (below 500Mio)	-	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,783	1,170
Private Placement	-	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	82,544	79,822
Total	-	4,000	8,063	8,063	14,563	23,063	37,017	63,767	126,705	129,044
Denominated in EURO	-	4,000	8,000	8,000	14,500	23,000	36,925	63,668	126,705	129,044
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	63	63	63	63	92	99	-	-
Total	-	4,000	8,063	8,063	14,563	23,063	37,017	63,767	126,705	129,044
Outstanding fixed coupon	-	4,000	8,063	8,063	10,063	15,563	27,100	44,954	50,059	57,724
Outstanding floating coupon	-	-	-	-	500	500	2,825	18,814	76,646	71,320
Outstanding other	-	-	-	-	4,000	7,000	7,092	-	-	-
Total	-	4,000	8,063	8,063	14,563	23,063	37,017	63,767	126,705	129,044
Number of Programmes	-	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	19
Number of Issuers	-	1	1	1	4	7	11	12	14	13

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	4,000	4,063	-	-	3,000	2,000	5,900	-	4,200
Mortgage	-	-	-	-	6,500	7,500	12,925	29,261	70,768	24,520
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	4,000	4,063	-	6,500	10,500	14,925	35,161	70,768	28,720
Public Placement										
Benchmark (1bn and above)	-	n.a.	n.a.	-	n.a.	n.a.	n.a.	n.a.	6,304	5,250
Benchmark (500Mio - 999Mio)	-	n.a.	n.a.	-	n.a.	n.a.	n.a.	n.a.	1,700	3,500
Others (below 500Mio)	-	n.a.	n.a.	-	n.a.	n.a.	n.a.	n.a.	-	250
Private Placement	-	n.a.	n.a.	-	n.a.	n.a.	n.a.	n.a.	62,764	19,720
Total	-	4,000	4,063	-	6,500	10,500	14,925	35,161	70,768	28,720
Denominated in EURO	-	4,000	4,000	-	6,500	10,500	14,925	35,161	70,768	28,720
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	63	-	-	-	-	-	-	-
Total	-	4,000	4,063	-	6,500	10,500	14,925	35,161	70,768	28,720
Issuance fixed coupon	-	4,000	4,000	-	2,000	7,500	12,600	18,750	11,013	12,170
Issuance floating coupon	-	-	-	-	500	-	2,325	16,411	59,755	16,550
Issuance other	-	-	63	-	4,000	3,000	-	-	-	-
Total	-	4,000	4,063	-	6,500	10,500	14,925	35,161	70,768	28,720
Number of New Issuers	-	-	-	-	3	3	4	1	2	1

5.2.18 LATVIA

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	54	60	63	90	90	85	63	37	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	54	60	63	90	90	85	63	37	-	-
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	54	60	63	90	90	85	63	37	-	-
Private Placement	-	-	-	-	-	-	-	-	-	-
Total	54	60	63	90	90	85	63	37	-	-
Denominated in EURO	-	-	20	56	69	64	45	25	-	-
Denominated in domestic currency	36	38	34	28	17	17	14	12	-	-
Denominated in other currencies	18	21	8	6	4	4	4	-	-	-
Total	54	60	63	90	90	85	63	37	-	-
Outstanding fixed coupon	27	26	21	15	26	26	27	12	-	-
Outstanding floating coupon	27	34	41	75	64	59	36	25	-	-
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	54	60	63	90	90	85	63	37	-	-
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Number of Issuers	1	1	4	5	5	5	4	2	-	-

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	22	4	20	19	25	-	-	-	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	22	4	20	19	25	-	-	-	-	-
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	22	4	20	19	25	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	-	-
Total	22	4	20	19	25	-	-	-	-	-
Denominated in EURO	-	-	20	19	25	-	-	-	-	-
Denominated in domestic currency	3	4	-	-	-	-	-	-	-	-
Denominated in other currencies	18		-	-	-	-	-	-	-	-
Total	22	4	20	19	25	-	-	-	-	-
Issuance fixed coupon	3	-	-	-	25	-	-	-	-	-
Issuance floating coupon	18	4	20	19	-	-	-	-	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	22	4	20	19	25	-	-	-	-	-
Number of New Issuers	-	-	3	1	-	-	-	-	-	-

5.2.19 LUXEMBOURG

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	19,627	24,968	28,360	33,741	35,467	31,645	28,889	26,700	24,859	21,708
Mortgage	-	-	150	150	150	-	-	-	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	19,627	24,968	28,510	33,891	35,617	31,645	28,889	26,700	24,859	21,708
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,768	1,000
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	9,696	10,052
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	13,395	10,656
Total	19,627	24,968	28,510	33,891	35,617	31,645	28,889	26,700	24,859	21,708
Denominated in EURO	11,032	10,909	12,319	16,172	18,147	16,592	15,826	15,496	14,994	12,925
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	8,595	14,059	16,191	17,719	17,470	15,053	13,063	11,204	9,864	8,783
Total	19,627	24,968	28,510	33,891	35,617	31,645	28,889	26,700	24,859	21,708
Outstanding fixed coupon	12,236	15,427	19,077	22,573	22,267	21,126	20,390	16,547	14,766	13,182
Outstanding floating coupon	5,489	7,376	7,217	9,210	11,270	9,355	7,710	9,377	8,507	7,080
Outstanding other	1,902	2,165	2,216	2,108	2,080	1,164	789	776	1,585	1,445
Total	19,627	24,968	28,510	33,891	35,617	31,645	28,889	26,700	24,859	21,708
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	6
Number of Issuers	3	3	3	5	5	5	5	5	6	6

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	5,516	9,611	9,730	10,052	3,967	3,083	3,524	2,788	2,660	825
Mortgage	-	-	150	-	-	-	-	-	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	5,516	9,611	9,880	10,052	3,967	3,083	3,524	2,788	2,660	825
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,660	825
Total	5,516	9,611	9,880	10,052	3,967	3,083	3,524	2,788	2,660	825
Denominated in EURO	3,589	2,468	3,628	5,773	2,639	2,661	3,260	2,422	2,587	825
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	1,927	7,143	6,252	4,279	1,328	422	264	366	73	-
Total	5,516	9,611	9,880	10,052	3,967	3,083	3,524	2,788	2,660	825
Issuance fixed coupon	3,516	7,511	8,092	5,425	1,423	1,526	1,213	336	187	-
Issuance floating coupon	1,600	1,700	1,601	4,448	2,471	1,530	2,289	2,452	2,473	825
Issuance other	400	400	187	178	73	27	22	-	-	-
Total	5,516	9,611	9,880	10,051	3,967	3,083	3,524	2,788	2,660	825
Number of New Issuers	-	-	-	2	-	-	-	-	1	-

5.2.20 THE NETHERLANDS

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	2,000	7,477	15,093	20,534	27,664	40,180	51,970	59,822	61,015
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	2,000	7,477	15,093	20,534	27,664	40,180	51,970	59,822	61,015
Public Placement										
Benchmark (1bn and above)	-	2,000	5,500	11,000	14,275	20,650	29,898	39,623	45,245	44,913
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	500	500	1,000
Others (below 500Mio)	-	-	685	937	1,279	1,281	1,819	2,345	2,319	2,281
Private Placement	-	-	1,292	3,156	4,979	5,633	8,463	9,503	11,758	12,822
Total	-	2,000	7,477	15,093	20,534	27,564	40,180	51,970	59,822	61,015
Denominated in EURO	-	2,000	6,437	13,777	18,715	25,822	36,854	47,795	53,884	55,362
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	1,040	1,316	1,819	1,842	3,326	4,175	5,938	5,653
Total	-	2,000	7,477	15,093	20,534	27,664	40,180	51,970	59,822	61,015
Outstanding fixed coupon	-	2,000	7,182	13,697	17,804	25,558	37,954	51,230	58,902	60,016
Outstanding floating coupon	-	-	255	1,336	2,670	1,956	2,176	700	880	959
Outstanding other	-	-	40	60	60	50	50	40	40	40
Total	-	2,000	7,477	15,093	20,534	27,564	40,180	51,970	59,822	61,015
Number of Programmes	-	1	1	2	5	5	5	5	5	6
Number of Issuers	-	1	1	2	5	5	5	5	5	5

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	2,000	5,477	7,648	5,355	7,725	13,660	14,143	10,738	4,478
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	2,000	5,477	7,648	5,355	7,725	13,660	14,143	10,738	4,478
Public Placement										
Benchmark (1bn and above)	-	2,000	3,500	5,500	3,275	6,375	10,498	9,700	8,387	2,750
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	500	-	500
Others (below 500Mio)	-	-	685	272	236	-	300	473	290	-
Private Placement	-	-	1,292	1,876	1,845	1,350	2,862	3,470	2,062	1,228
Total	-	2,000	5,477	7,648	5,355	7,725	13,660	14,143	10,738	4,478
Denominated in EURO	-	2,000	4,437	7,340	4,938	7,725	12,337	13,207	8,859	4,478
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	1,040	308	418	-	1,324	937	1,879	-
Total	-	2,000	5,477	7,648	5,355	7,725	13,660	14,143	10,738	4,478
Issuance fixed coupon	-	2,000	5,182	6,529	4,030	7,725	13,603	14,013	10,558	4,398
Issuance floating coupon	-	-	255	1,099	1,325	-	57	130	180	80
Issuance other	-	-	40	20	-	-	-	-	-	-
Total	-	2,000	5,477	7,648	5,355	7,725	13,660	14,143	10,738	4,478
Number of New Issuers	-	1	-	1	3	-	-	-	-	-

5.2.21 NEW ZEALAND

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	1,247	3,656	6,881	7,851
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	-	1,247	3,656	6,881	7,851
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	1,000	2,000	2,000	2,000
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	1,050	3,051	3,954
Others (below 500Mio)	-	-	-	-	-	-	247	427	1,353	1,436
Private Placement	-	-	-	-	-	-	-	179	477	461
Total	-	-	-	-	-	-	1,247	3,656	6,881	7,851
Denominated in EURO	-	-	-	-	-	-	1,000	2,500	4,500	5,500
Denominated in domestic currency	-	-	-	-	-	-	247	606	982	940
Denominated in other currencies	-	-	-	-	-	-	-	550	1,399	1,411
Total	-	-	-	-	-	-	1,247	3,656	6,881	7,851
Outstanding fixed coupon	-	-	-	-	-	-	1,247	3,477	6,259	7,244
Outstanding floating coupon	-	-	-	-	-	-	-	179	622	607
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	1,247	3,656	6,881	7,851
Number of Programmes	-	-	-	-	-	-	1	4	4	5
Number of Issuers	-	-	-	-	-	-	1	4	4	5

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	1,247	2,409	3,192	1,122
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	-	1,247	2,409	3,192	1,122
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	1,000	1,000	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	1,050	2,000	1,000
Others (below 500Mio)	-	-	-	-	-	-	247	179	902	122
Private Placement	-	-	-	-	-	-	-	179	290	-
Total	-	-	-	-	-	-	1,247	2,409	3,192	1,122
Denominated in EURO	-	-	-	-	-	-	1,000	1,500	2,000	1,000
Denominated in domestic currency	-	-	-	-	-	-	247	358	343	-
Denominated in other currencies	-	-	-	-	-	-	-	550	849	122
Total	-	-	-	-	-	-	1,247	2,409	3,192	1,122
Issuance fixed coupon	-	-	-	-	-	-	1,247	2,229	2,757	1,122
Issuance floating coupon	-	-	-	-	-	-	-	179	435	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	1,247	2,409	3,192	1,122
Number of New Issuers	-	-	-	-	-	-	1	3	-	1

5.2.22 NORWAY

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	751	1,837	3,759	2,742	2,035
Mortgage	-	-	-	6,371	21,924	53,582	70,401	91,852	107,242	105,202
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	6,371	21,924	54,333	72,238	95,611	109,984	107,237
Public Placement										
Benchmark (1bn and above)	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	51,179	47,342
Benchmark (500Mio - 999Mio)	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	20,125	18,471
Others (below 500Mio)	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	32,354	31,763
Private Placement	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	6,327	9,661
Total	-	-	-	6,371	21,924	54,333	72,238	95,611	109,985	107,237
Denominated in EURO	-	-	-	4,500	12,847	14,522	22,022	29,953	38,597	44,510
Denominated in domestic currency	-	-	-	1,433	8,351	39,022	45,803	55,325	59,533	49,965
Denominated in other currencies	-	-	-	438	725	789	4,413	10,333	11,854	12,762
Total	-	-	-	6,371	21,924	54,333	72,238	95,611	109,984	107,237
Outstanding fixed coupon	-	-	-	5,718	14,750	17,064	28,809	44,813	56,918	63,088
Outstanding floating coupon	-	-	-	653	7,174	37,269	43,429	50,798	53,066	44,148
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	6,371	21,924	54,333	72,238	95,611	109,984	107,236
Number of Programmes	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	23
Number of Issuers	-	-	-	3	7	22	22	23	22	22

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	751	1,421	2,374	943	239
Mortgage	-	-	-	6,458	15,660	30,105	21,062	28,135	22,946	18,339
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	6,458	15,660	30,856	22,483	30,509	23,888	18,578
Public Placement										
Benchmark (1bn and above)	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	10,916	7,441
Benchmark (500Mio - 999Mio)	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	4,748	1,458
Others (below 500Mio)	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	7,664	8,267
Private Placement	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	560	1,412
Total	-	-	-	6,458	15,660	30,856	22,483	30,509	23,888	18,578
Denominated in EURO	-	-	-	4,500	8,346	2,044	11,232	8,800	12,431	8,382
Denominated in domestic currency	-	-	-	1,521	7,042	28,745	7,777	15,808	9,463	7,546
Denominated in other currencies	-	-	-	438	272	67	3,474	5,901	1,994	2,651
Total	-	-	-	6,458	15,660	30,856	22,483	30,509	23,888	18,578
Issuance fixed coupon	-	-	-	5,754	9,020	2,207	16,074	15,961	15,462	11,423
Issuance floating coupon	-	-	-	704	6,640	28,649	6,409	14,548	8,427	7,155
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	6,458	15,660	30,856	22,483	30,509	23,888	18,578
Number of New Issuers	-	-	-	3	4	15	-	1	-	-

5.2.23 PANAMA

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	-	152	218
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	-	-	-	152	218
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	152	218
Private Placement	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	-	152	218
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	152	218
Total	-	-	-	-	-	-	-	-	152	218
Outstanding fixed coupon	-	-	-	-	-	-	-	-	152	218
Outstanding floating coupon	-	-	-	-	-	-	-	-	-	-
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	-	152	218
Number of Programmes	-	-	-	-	-	-	-	-	n.a.	1
Number of Issuers	-	-	-	-	-	-	-	-	1	1

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	-	152	73
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	-	-	-	152	73
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	152	73
Private Placement	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	-	152	73
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	152	73
Total	-	-	-	-	-	-	-	-	152	73
Issuance fixed coupon	-	-	-	-	-	-	-	-	152	73
Issuance floating coupon	-	-	-	-	-	-	-	-	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	-	152	73
Number of New Issuers	-	-	-	-	-	-	-	-	1	-

5.2.24 POLAND

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	131	137	139	126	112	110	84
Mortgage	220	558	453	676	561	583	511	527	657	707
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	220	558	453	807	698	722	636	639	768	791
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	768	791
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Total	220	558	453	807	698	722	636	639	768	791
Denominated in EURO	62	62	62	56	56	4	-	-	20	117
Denominated in domestic currency	115	440	357	726	617	711	636	639	748	674
Denominated in other currencies	43	56	34	25	25	7	-	-	-	-
Total	220	558	453	807	698	722	636	639	768	791
Outstanding fixed coupon	4	4	4	1	1	4	-	-	-	30
Outstanding floating coupon	216	554	450	806	697	718	636	639	768	761
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	220	558	453	807	698	722	636	639	768	791
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3	3
Number of Issuers	1	2	2	2	3	3	3	2	2	2

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	131	24	-	25	-	61	-
Mortgage	63	224	52	206	197	88	138	269	228	116
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	63	224	52	337	222	88	164	269	289	116
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	289	116
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Total	63	224	52	337	222	88	164	269	289	116
Denominated in EURO	25	-	-	-	-	-	-	-	20	96
Denominated in domestic currency	7	211	52	337	222	88	164	269	269	20
Denominated in other currencies	31	12	-	-	-	-	-	-	-	-
Total	63	223	52	337	222	88	164	269	289	116
Issuance fixed coupon	-	-	-	-	-	-	-	-	-	30
Issuance floating coupon	63	224	52	337	222	88	164	269	289	86
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	63	224	52	337	222	88	164	269	289	116
Number of New Issuers	-	1	-	-	1	-	-	-	-	-

5.2.25 PORTUGAL

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	150	1,150	1,400	1,400	1,300	1,200
Mortgage	-	-	2,000	7,850	14,870	22,120	28,840	34,347	34,570	34,199
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	2,000	7,850	15,020	23,270	30,240	35,747	35,870	35,399
Public Placement										
Benchmark (1bn and above)	-	-	2,000	6,500	12,150	18,150	17,900	15,358	8,183	8,788
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	2,449	500
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	1,350	2,870	5,120	12,340	20,389	25,238	26,111
Total	-	-	2,000	7,850	15,020	23,270	30,240	35,747	35,870	35,399
Denominated in EURO	-	-	2,000	7,850	15,020	23,270	30,240	35,747	35,870	35,399
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	2,000	7,850	15,020	23,270	30,240	35,747	35,870	35,399
Outstanding fixed coupon	-	-	2,000	6,500	12,170	18,170	17,960	15,418	10,691	9,348
Outstanding floating coupon	-	-	-	1,350	2,850	5,100	12,280	20,329	25,179	26,051
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	2,000	7,850	15,020	23,270	30,240	35,747	35,870	35,399
Number of Programmes	-	-	1	2	6	8	9	11	11	11
Number of Issuers	-	-	1	2	5	6	7	9	9	9

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	150	1,000	250	-	-	-
Mortgage	-	-	2,000	5,850	7,020	7,250	11,870	9,300	4,850	3,750
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	2,000	5,850	7,170	8,250	12,120	9,300	4,850	3,750
Public Placement										
Benchmark (1bn and above)	-	-	2,000	4,500	5,650	6,000	3,000	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	500
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	1,350	1,520	2,250	9,120	9,300	4,850	3,250
Total	-	-	2,000	5,850	7,170	8,250	12,120	9,300	4,850	3,750
Denominated in EURO	-	-	2,000	5,850	7,170	8,250	12,120	9,300	4,850	3,750
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	2,000	5,850	7,170	8,250	12,120	9,300	4,850	3,750
Issuance fixed coupon	-	-	2,000	4,500	5,650	6,000	3,040	-	-	500
Issuance floating coupon	-	-	-	1,350	1,520	2,250	9,080	9,300	4,850	3,250
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	2,000	5,850	7,170	8,250	12,120	9,300	4,850	3,750
Number of New Issuers	-	-	1	1	3	1	1	2	-	-

5.2.26 SLOVAKIA

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	1,052	1,583	2,214	2,738	3,576	3,608	3,442	3,768	3,835	4,015
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	1,052	1,583	2,214	2,738	3,576	3,608	3,442	3,768	3,835	4,015
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,606	1,407
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,229	2,608
Total	1,052	1,583	2,214	2,738	3,576	3,608	3,442	3,768	3,835	4,015
Denominated in EURO	-	-	280	510	1,189	3,516	3,350	3,625	3,680	3,917
Denominated in domestic currency	1,052	1,583	1,934	2,161	2,296	-	-	-	-	-
Denominated in other currencies	-	-	-	68	92	92	92	143	155	98
Total	1,052	1,583	2,214	2,738	3,576	3,608	3,442	3,768	3,835	4,015
Outstanding fixed coupon	1,052	1,223	1,405	1,666	1,992	1,845	1,571	1,886	2,224	2,511
Outstanding floating coupon	-	360	809	1,073	1,584	1,762	1,871	1,882	1,606	1,499
Outstanding other	-	-	-	-	-	-	-	-	5	5
Total	1,052	1,583	2,214	2,738	3,576	3,608	3,442	3,768	3,835	4,015
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	8
Number of Issuers	8	9	9	8	8	8	8	8	8	8

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	549	584	676	803	1,414	707	1,179	867	785	841
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	549	584	676	803	1,414	707	1,179	867	785	841
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	248	97
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	537	744
Total	549	584	676	803	1,414	707	1,179	867	785	841
Denominated in EURO	-	-	280	230	679	707	1,179	820	735	815
Denominated in domestic currency	549	584	396	505	711	-	-	-	-	-
Denominated in other currencies	-	-	-	68	24	-	-	47	50	26
Total	549	584	676	803	1,414	707	1,179	867	785	841
Issuance fixed coupon	549	223	227	539	902	529	349	414	703	757
Issuance floating coupon	-	360	449	264	512	178	830	452	77	84
Issuance other	-	-	-	-	-	-	-	-	5	-
Total	549	584	676	803	1,414	707	1,179	867	785	841
Number of New Issuers	2	1	-	-	-	-	-	-	-	-

5.2.27 SOUTH KOREA

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	773	1,120	2,171	2,407	2,536
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	773	1,120	2,171	2,407	2,536
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	773	773	773	758	725
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	347	721	758	1,088
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	677	891	723
Total	-	-	-	-	-	773	1,120	2,171	2,407	2,536
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	-	-	-	-	-	527	740	723
Denominated in other currencies	-	-	-	-	-	773	1,120	1,644	1,667	1,813
Total	-	-	-	-	-	773	1,120	2,171	2,407	2,536
Outstanding fixed coupon	-	-	-	-	-	773	1,120	2,021	2,255	2,536
Outstanding floating coupon	-	-	-	-	-	-	-	150	152	-
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	773	1,120	2,171	2,407	2,536
Number of Programmes	-	-	-	-	-	1	2	2	2	2
Number of Issuers	-	-	-	-	-	1	2	2	2	2

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	773	347	1,051	178	466
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	773	347	1,051	178	466
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	773	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	347	374	-	363
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	677	178	103
Total	-	-	-	-	-	773	347	1,051	178	466
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	-	-	-	-	-	527	178	466
Denominated in other currencies	-	-	-	-	-	773	347	524	-	-
Total	-	-	-	-	-	773	347	1,051	178	466
Issuance fixed coupon	-	-	-	-	-	773	347	901	178	466
Issuance floating coupon	-	-	-	-	-	-	-	150	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	773	347	1,051	178	466
Number of New Issuers	-	-	-	-	-	1	1	-	-	-

5.2.28 SPAIN

Outstanding (in EUR million)	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Total Covered Bonds Outstanding										
Public Sector	7,200	9,640	11,590	17,054	17,749	16,724	19,098	32,657	33,609	30,352
Mortgage	94,707	150,213	214,768	266,959	315,055	336,750	343,401	369,208	406,736	334,572
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	101,907	159,853	226,358	284,013	332,804	353,474	362,499	401,865	440,345	364,924
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	243,207	211,343
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	11,850	14,098
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	200	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	185,088	139,483
Total	101,907	159,853	226,358	284,013	332,804	353,474	362,499	401,865	440,345	364,924
Denominated in EURO	101,907	159,853	226,358	283,334	332,085	352,780	361,751	401,092	438,641	363,731
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	679	719	694	748	773	1,703	1,193
Total	101,907	159,853	226,358	284,013	332,804	353,474	362,499	401,865	440,345	364,924
Outstanding fixed coupon	100,417	153,588	212,878	238,952	262,198	291,929	310,499	343,067	311,719	260,831
Outstanding floating coupon	1,490	6,265	13,480	45,061	70,606	61,545	52,000	58,797	128,625	103,631
Outstanding other	-	-	-	-	-	-	-	-	-	462
Total	101,907	159,853	226,358	284,013	332,804	353,474	362,499	401,865	440,345	364,924
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	40
Number of Issuers	61	65	67	69	66	68	59	64	38	32

Issuance (in EUR million)	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Total Covered Bonds Issuance										
Public Sector	1,600	2,440	5,150	5,739	1,670	500	5,900	20,334	6,407	5,895
Mortgage	37,835	57,780	69,890	51,801	54,187	43,580	51,916	72,077	98,846	22,919
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	39,435	60,220	75,040	57,540	55,857	44,080	57,816	92,411	105,253	28,814
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7,200	7,000
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3,600	4,840
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	94,453	16,974
Total	39,435	60,220	75,040	57,540	55,857	44,080	57,816	92,411	105,253	28,814
Denominated in EURO	39,435	60,220	75,040	56,861	55,857	44,080	57,816	92,411	105,253	28,814
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	679	-	-	-	-	-	-
Total	39,435	60,220	75,040	57,540	55,857	44,080	57,816	92,411	105,253	28,814
Issuance fixed coupon	38,635	55,545	66,125	36,549	21,957	37,480	50,891	52,507	27,559	16,169
Issuance floating coupon	800	4,675	8,915	20,991	33,900	6,600	6,925	39,904	77,694	12,445
Issuance other	-	-	-	-	-	-	-	-	-	200
Total	39,435	60,220	75,040	57,540	55,857	44,080	57,816	92,411	105,253	28,814
Number of New Issuers	3	7	1	1	1	1	2	1	3	-

Source: AIAF, Bloomberg, Reuters, Moody's, Fitch, S&P, ECBC

Note: Please note that the breakdown public vs private placements is an estimation made by the ECBC.

Please also note that the methodology used for counting the number of issuers has changed this year. Until 2011, the number of new issuers included the new financial institutions established as part of the restructuring of the Spanish banking sector whose inaugural issue occurred during the year of reporting. The number of issuers also included all the former financial institutions with outstanding covered bonds at the end of each year - even if, as a consequence of the aforementioned restructuring, they were integrated into a new one - along with the new institutions. From 2012 onwards, however, only the new entities will be reported as active issuers.

5.2.29 SWEDEN

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	n.a.	n.a.	-	-	-	-	-	-	-	-
Mortgage	n.a.	n.a.	55,267	92,254	117,628	133,903	188,750	208,894	220,374	217,854
Ships	n.a.	n.a.	-	-	-	-	-	-	-	-
Others	n.a.	n.a.	-	-	-	-	-	-	-	-
Total Outstanding	n.a.	n.a.	55,267	92,254	117,628	133,903	188,750	208,894	220,374	217,854
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	175,163	173,333
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	8,234	10,775
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	29,055	26,071
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7,921	7,676
Total	n.a.	n.a.	55,267	92,254	117,628	133,903	188,750	208,894	220,374	217,854
Denominated in EURO	n.a.	n.a.	5,283	13,171	21,126	25,787	35,697	37,554	39,995	39,423
Denominated in domestic currency	n.a.	n.a.	49,474	77,436	93,374	103,809	144,969	159,628	164,501	161,651
Denominated in other currencies	n.a.	n.a.	510	1,648	3,128	4,308	8,085	11,712	15,878	16,780
Total	n.a.	n.a.	55,267	92,254	117,628	133,903	188,750	208,894	220,374	217,854
Outstanding fixed coupon	n.a.	n.a.	55,029	88,944	112,648	126,116	172,693	191,013	198,372	195,770
Outstanding floating coupon	n.a.	n.a.	21	3,046	4,259	7,169	16,013	17,659	21,778	22,055
Outstanding other	n.a.	n.a.	217	265	721	619	45	222	224	29
Total	n.a.	n.a.	55,267	92,254	117,628	133,903	188,750	208,894	220,374	217,854
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	10
Number of Issuers	n.a.	n.a.	3	6	7	7	7	7	7	8

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	n.a.	n.a.	-	-	-	-	-	-	-	-
Mortgage	n.a.	n.a.	17,569	36,638	43,488	53,106	79,910	69,800	48,936	51,633
Ships	n.a.	n.a.	-	-	-	-	-	-	-	-
Others	n.a.	n.a.	-	-	-	-	-	-	-	-
Total Issuance	n.a.	n.a.	17,569	36,638	43,488	53,106	79,910	69,800	48,936	51,633
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	37,148	35,519
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	92	6,753
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	10,078	8,276
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,620	1,086
Total	n.a.	n.a.	17,569	36,638	43,488	53,106	79,910	69,800	48,936	51,633
Denominated in EURO	n.a.	n.a.	5,283	7,085	10,975	6,705	20,797	13,263	2,485	5,745
Denominated in domestic currency	n.a.	n.a.	11,794	28,417	31,490	44,354	55,117	52,118	41,971	41,220
Denominated in other currencies	n.a.	n.a.	492	1,135	1,023	2,047	3,997	4,419	4,481	4,668
Total	n.a.	n.a.	17,569	36,638	43,488	53,106	79,910	69,800	48,936	51,633
Issuance fixed coupon	n.a.	n.a.	17,560	35,779	39,135	47,375	68,023	53,137	38,294	42,949
Issuance floating coupon	n.a.	n.a.	2	752	4,353	5,376	11,888	16,562	10,642	8,684
Issuance other	n.a.	n.a.	7	107	-	354	-	102	-	-
Total	n.a.	n.a.	17,569	36,638	43,488	53,106	79,910	69,800	48,936	51,633
Number of New Issuers	n.a.	n.a.	3	3	1	-	-	-	-	1

5.2.30 SWITZERLAND

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Outstanding CBs - Pfandbriefe	29,941	29,010	29,395	29,013	36,180	43,283	58,046	60,729	67,652	71,716
Outstanding CBs - Structured	-	-	-	-	-	3,000	4,000	11,152	18,062	17,348
Total Outstanding	29,941	29,010	29,395	29,013	36,180	46,283	62,046	71,881	85,714	89,064
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	17,926	15,488
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	23,839	6,218
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	35,986	61,351
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7,963	6,008
Total	29,941	29,010	29,395	29,013	36,180	46,283	62,046	71,881	85,714	89,064
Denominated in EURO	-	-	-	-	-	3,000	7,000	10,250	13,000	11,500
Denominated in domestic currency	29,941	29,010	29,395	29,013	36,180	43,283	55,046	60,729	67,652	71,716
Denominated in other currencies	-	-	-	-	-	-	-	902	5,063	5,848
Total	29,941	29,010	29,395	29,013	36,180	46,283	62,046	71,881	85,714	89,064
Outstanding fixed coupon	29,941	29,010	29,395	29,013	36,180	46,283	62,046	71,752	85,714	89,064
Outstanding floating coupon	-	-	-	-	-	-	-	-	-	-
Outstanding other	-	-	-	-	-	-	-	129	-	-
Total	29,941	29,010	29,395	29,013	36,180	46,283	62,046	71,881	85,714	89,064
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4
Number of Issuers	2	2	2	2	2	3	4	4	4	4

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
New Issues of CBs - Pfandbriefe	2,755	4,171	4,967	4,559	5,316	9,414	10,834	11,227	12,804	12,568
New Issues of CBs - Structured	-	-	-	-	-	3,000	4,000	4,152	6,919	1,015
Total Issuance	2,755	4,171	4,967	4,559	5,316	12,414	14,834	15,379	19,723	13,583
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	6,919	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,394	3,077
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	10,410	10,397
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	109
Total	2,755	4,171	4,967	4,559	5,316	12,414	14,834	15,379	19,723	13,583
Denominated in EURO	-	-	-	-	-	3,000	4,000	3,250	2,750	-
Denominated in domestic currency	2,755	4,171	4,967	4,559	5,316	9,414	10,834	11,227	12,804	12,568
Denominated in other currencies	-	-	-	-	-	-	-	902	4,169	1,015
Total	2,755	4,171	4,967	4,559	5,316	12,414	14,834	15,379	19,723	13,583
Issuance fixed coupon	2,755	4,171	4,967	4,559	5,316	12,414	14,834	15,250	19,723	13,474
Issuance floating coupon	-	-	-	-	-	-	-	-	-	109
Issuance other	-	-	-	-	-	-	-	129	-	-
Total	2,755	4,171	4,967	4,559	5,316	12,414	14,834	15,379	19,723	13,583
Number of New Issuers	-	-	-	-	-	1	1	-	-	-

Note: from 2008 only Limmat bonds are considered as "Private Placements"

5.2.31 UNITED KINGDOM

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Regulated - Mortgages	-	-	-	-	125,764	109,473	125,250	121,623	147,425	112,715
Regulated - Public Sector	-	-	-	-	-	-	-	-	-	-
Non-regulated - Mortgages	15,668	28,384	54,265	84,874	78,092	90,993	77,965	63,429	37,818	18,077
Non-regulated - Public Sector	-	-	-	-	-	3,439	3,548	3,656	3,742	5,822
Total Outstanding	15,668	28,384	54,265	84,874	203,856	203,905	206,763	188,707	188,985	136,614

Public Placement										
Benchmark (1bn and above)	14,250	23,250	45,269	72,274	179,076	174,036	171,202	147,473	148,608	109,416
Benchmark (500Mio - 999Mio)	1,418	3,709	6,602	8,909	19,789	24,555	27,738	29,424	27,127	9,002
Others (below 500Mio)	-	1,425	2,395	3,691	4,981	5,304	6,643	9,231	9,137	13,984
Private Placement	-	-	-	-	10	10	1,180	2,580	4,113	4,213
Total	15,668	28,384	54,265	84,874	203,856	203,905	206,763	188,707	188,985	136,614

Denominated in EURO	14,250	24,676	45,176	69,776	79,338	73,324	81,475	102,084	118,667	84,633
Denominated in domestic currency	1,418	3,648	6,552	7,023	116,049	122,395	115,625	76,905	61,012	43,316
Denominated in other currencies	-	60	2,536	8,075	8,469	8,186	9,663	9,718	9,306	8,665
Total	15,668	28,384	54,265	84,874	203,856	203,905	206,763	188,707	188,985	136,614

Outstanding fixed coupon	15,668	25,439	49,956	76,236	78,287	71,342	83,820	111,426	123,888	106,995
Outstanding floating coupon	-	2,945	4,309	8,638	125,410	132,563	122,943	77,282	65,097	29,619
Outstanding other	-	-	-	-	160	-	-	-	-	-
Total	15,668	28,384	54,265	84,874	203,856	203,905	206,763	188,707	188,985	136,614

Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	18
Number of Issuers	3	5	7	8	19	21	20	16	15	14

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Regulated - Mortgages	-	-	-	-	10,145	8,254	25,000	36,983	37,109	1,480
Regulated - Public Sector	-	-	-	-	-	-	-	-	-	-
Non-regulated - Mortgages	10,668	12,675	25,813	31,673	110,761	22,177	900	-	-	-
Non-regulated - Public Sector	-	-	-	-	-	3,439	-	-	-	-
Total Issuance	10,668	12,675	25,813	31,673	120,906	33,870	25,900	36,983	37,109	1,480

Public Placement										
Benchmark (1bn and above)	9,250	9,000	22,019	27,165	106,620	27,407	15,412	20,190	22,921	1,000
Benchmark (500Mio - 999Mio)	1,418	2,250	2,829	2,809	13,211	6,001	6,603	9,659	9,432	-
Others (below 500Mio)	-	1,425	965	1,698	1,064	462	2,706	5,734	3,222	380
Private Placement	-	-	-	-	10	-	1,180	1,400	1,534	100
Total	10,668	12,675	25,813	31,673	120,906	33,870	25,900	36,983	37,109	1,480

Denominated in EURO	9,250	10,426	20,500	24,900	10,263	5,535	22,095	27,211	20,024	1,480
Denominated in domestic currency	1,418	2,189	2,829	1,023	110,643	28,335	2,788	8,290	15,041	-
Denominated in other currencies	-	60	2,483	5,750	-	-	1,018	1,482	2,044	-
Total	10,668	12,675	25,813	31,673	120,906	33,870	25,900	36,983	37,109	1,480

Issuance fixed coupon	10,668	9,730	24,472	26,800	2,618	3,750	20,542	35,102	17,991	1,200
Issuance floating coupon	-	2,945	1,340	4,873	118,128	30,120	5,359	1,881	19,118	280
Issuance other	-	-	-	-	160	-	-	-	-	-
Total	10,668	12,675	25,813	31,673	120,906	33,870	25,900	36,983	37,109	1,480

Number of New Issuers	2	2	2	1	11	3	1	-	-	-

Note: There are 12 regulated issuers each with one regulated mortgage programme (some regulated issuers also have unregulated programmes). For more details, please refer to the FCA's website (http://www.fca.org.uk/firms/systems-reporting/register/use/other-registers/rcb-register).

5.2.32 UNITED STATES

Outstanding (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000	6,000
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000	6,000
Public Placement										
Benchmark (1bn and above)	-	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000	6,000
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	-	-
Total	-	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000	6,000
Denominated in EURO	-	-	4,000	11,500	11,500	11,500	10,000	8,000	6,000	6,000
Denominated in domestic currency	-	-	-	1,359	1,437	1,388	1,497	1,546	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000	6,000
Outstanding fixed coupon	-	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000	6,000
Outstanding floating coupon	-	-	-	-	-	-	-	-	-	-
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000	6,000
Number of Programmes	-	-	1	2	2	2	2	2	2	2
Number of Issuers	-	-	1	2	2	2	2	2	2	2

Issuance (in EUR million)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	4,000	8,859	-	-	-	-	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	4,000	8,859	-	-	-	-	-	-
Public Placement										
Benchmark (1bn and above)	-	-	4,000	8,859	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	-	-
Total	-	-	4,000	8,859	-	-	-	-	-	-
Denominated in EURO	-	-	4,000	7,500	-	-	-	-	-	-
Denominated in domestic currency	-	-	-	1,359	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	4,000	8,859	-	-	-	-	-	-
Issuance fixed coupon	-	-	4,000	8,859	-	-	-	-	-	-
Issuance floating coupon	-	-	-	-	-	-	-	-	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	4,000	8,859	-	-	-	-	-	-
Number of New Issuers	-	-	1	1	-	-	-	-	-	-

5.2.33 ANNEX: EUROPEAN CENTRAL BANK EXCHANGE RATES WITH THE EURO, YEAR END

	Australian dollar	Brazilian real	Canadian dollar	Swiss franc	Czech koruna	Danish krone	UK pound sterling
2004	1.7459	3.6201	1.6416	1.5429	30.464	7.4388	0.70505
2005	1.6109	2.7462	1.3725	1.5551	29	7.4605	0.6853
2006	1.6691	2.8141	1.5281	1.6069	27.485	7.456	0.6715
2007	1.6757	2.5914	1.4449	1.6547	26.628	7.4583	0.73335
2008	2.0274	3.2436	1.6998	1.485	26.875	7.4506	0.9525
2009	1.6008	2.5113	1.5128	1.4836	26.473	7.4418	0.8881
2010	1.3136	2.2177	1.3322	1.2504	25.061	7.4535	0.86075
2011	1.2723	2.4159	1.3215	1.2156	25.787	7.4342	0.8353
2012	1.2712	2.7036	1.3137	1.2072	25.151	7.461	0.8161
2013	**1.5423**	**3.2576**	**1.4671**	**1.2276**	**27.427**	**7.4593**	**0.8337**

	Hong Kong dollar	Hungarian forint	Iceland krona	Japanese yen	Korean won (Republic)	Lithuanian litas	Latvian lats
2004	10.5881	245.97	83.6	139.65	1410.05	3.4528	0.6979
2005	9.1474	252.87	74.57	138.9	1184.42	3.4528	0.6962
2006	10.2409	251.77	93.13	156.93	1224.81	3.4528	0.6972
2007	11.48	253.73	91.9	164.93	1377.96	3.4528	0.6964
2008	10.7858	266.7	250*	126.14	1839.13	3.4528	0.7083
2009	11.1709	270.42	179.48*	133.16	1666.97	3.4528	0.7093
2010	10.3856	277.95	153.78*	108.65	1499.06	3.4528	0.7094
2011	10.051	314.58	159*	100.2	1498.69	3.4528	0.6995
2012	10.226	292.3	168.91*	113.61	1406.23	3.4528	0.6977
2013	**10.6933**	**297.04**	**158.29****	**144.72**	**1450.93**	**3.4528**	**0.7025**

* Bloomberg "Compound New York" Rates, ** Bloomberg "Bloomberg Generic Pricing (BGN)" Rates (On December 10, 2008, the European Central Bank has stopped publishing foreign exchange reference rates of the Icelandic Króna)

	Norwegian krone	New Zealand dollar	Polish zloty	Swedish krona	Singapore dollar	Turkish lira	US dollar
2004	8.2365	1.8871	4.0845	9.0206	2.2262	1836200	1.3621
2005	7.985	1.727	3.86	9.3885	1.9628	1.5924	1.1797
2006	8.238	1.8725	3.831	9.0404	2.0202	1.864	1.317
2007	7.958	1.9024	3.5935	9.4415	2.1163	1.717	1.4721
2008	9.75	2.4191	4.1535	10.87	2.004	2.1488	1.3917
2009	8.3	1.9803	4.1045	10.252	2.0194	2.1547	1.4406
2010	7.8	1.72	3.975	8.9655	1.7136	2.0694	1.3362
2011	7.754	1.6737	4.458	8.912	1.6819	2.4432	1.2939
2012	7.3483	1.6045	4.074	8.582	1.6111	2.3551	1.3194
2013	**8.363**	**1.6762**	**4.1543**	**8.8591**	**1.7414**	**2.9605**	**1.3791**

Source: ECB, Statistics Data Warehouse.
Note: The Euro is the denominator.
Note: The exchange rate protocol used for ECBC covered bond statistics is to take the ECB bilateral exchange rate on the last business day of the year.

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The Covered Bond Voice of the European Mortgage Federation

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