

**Warsaw, 16 June 2008**  
**VIP Lounge, Belvedere Restaurant, 6:00 p.m. – 7:30 p.m.**

# Funding Mortgage Portfolios

## Change and Development Strategies for Covered Bonds

### - Focus on Poland

---

A consultation meeting for reformers of Polish infrastructure and business with participation of foreign guests – practitioners and regulators from leading covered bond markets in Europe.

*Dr. Agnieszka Tulodziecka*  
*President of the Polish Mortgage Credit Foundation*

**The meeting was a part of:**



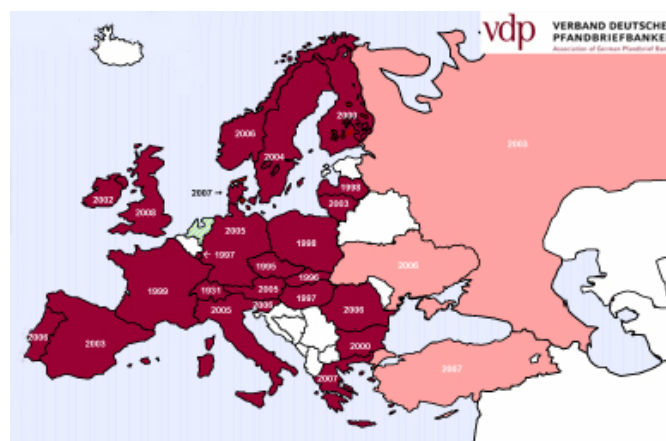
## Introduction:

The following publication presents the results of the discussion among the participants of the VIP Lounge "Funding Mortgage Portfolios – Change and Development Strategies for Covered Bonds: Focus on Poland", which accompanied the 12<sup>th</sup> Central European Covered Bonds Conference. Presenting the brochure, we would like to share the knowledge and opinions of the experts experienced in running covered bonds' business on different markets with the market participants from Poland and other CEE countries, as well as with the decisive and supervisory authorities.

In the 18<sup>th</sup> and 19<sup>th</sup> century Central Europe, and in particular Silesia, was the cradle of covered bonds, land credit societies, and later mortgage banks.



In the 90's of the 20<sup>th</sup> century covered bonds were re-introduced to the financial system of Central and Eastern Europe as a modern instrument for raising funds to finance construction. However the total outstanding volume of covered bonds in CEE amounts nowadays to only 1% of the whole European market.



The meeting on 16<sup>th</sup> -17<sup>th</sup> June 2008 is part of the twelve year tradition of the Central European Covered Bond Conference. The aim of those meetings is to answer the question: how to increase the importance of covered bonds as a funding tool in the CEE region. Since 15 years The Polish Mortgage Credit Foundation has assisted the introduction of covered bonds in Poland and the legislative works in this area. Nowadays we are facing the following challenge:

# Contents:

---

## **I. Covered Bond Markets – Poland and other CEE countries versus Europe - Differences**

- A. Volume
- B. Role in the Economy
- C. Prices of Covered Bonds – Differences

## **II. Challenge for Poland - Development**

- A. A Slow Evolution – Follow Small Niches in the Market
- B. Fiscal and System Support (Standard Development Incentive for Covered Bonds in Most Successful Markets).
- C. System Support of Regulatory and Investment Regulations (eligibility for repo - financing, risk weighting, notification).
- D. New Business Arrangements with Covered Bonds

## **III. A Key to Development (Assuming No Fiscal Support).**

- A. A product of European “covered bond” quality*
- B. Positive Calculations of Utilization of this Source of Funding – prerequisite for business decision.*
- C. Factors Compelling the Use of Covered Bonds*

## **IV. A solution under debate in Poland – moving from the specialist system to universal covered bond issues**

Predicted scope of necessary reform towards universal covered bond issuing principle.

## The current state of covered bonds' business in Poland



**Dr. Agnieszka Drewicz-Tułodziecka**, Doctor of Law; specialising in law, finance, banking and property collateral. After 5 year legislative experience in the Ministry of Finance, since 1995 she is a President of the Polish Mortgage Credit Foundation.

**Dr A. Tułodziecka:** “Introducing the covered bonds system in Poland in 1997, we followed the best European example on German and Danish legislation. We implemented their best achievements in order to ensure the proper quality of that instrument.

However, the system didn't work the way we've assumed in our optimistic presumptions. The first reason of that situation is **the low volume of issuance** – in 2006 all CEE countries produced not more than 1% of the whole European covered bonds market. As a consequence, the importance of covered bonds in Poland is relatively low - only about 6% of the mortgage portfolio is funded through covered bonds, whereas there're countries where covered bonds fund 100% of the loans, even Hungary and Czech Republic use that instrument in higher extent than Poland. Low popularity of covered bonds in Poland is also caused by their **relatively high price** – many basis points above the relevant instruments in Western Europe.

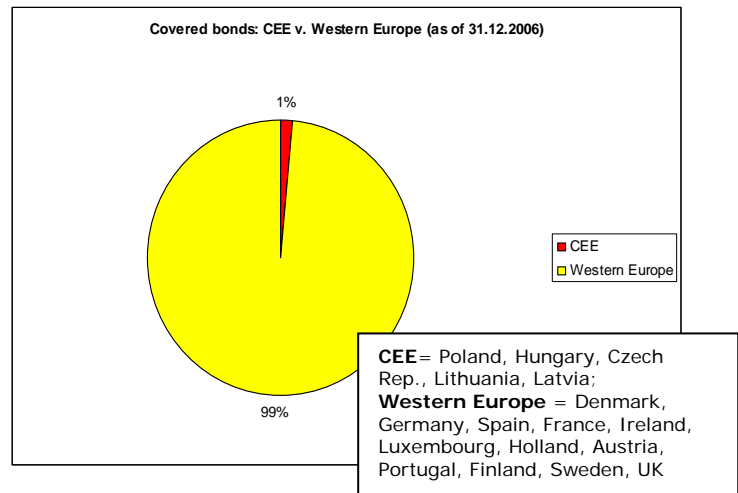
**In Poland only 5% of the mortgage portfolio totalling €40 billion is refinanced with covered bonds.**

However we have focused mainly on the Polish example, we believe that the addressed questions and experiences are of universal meaning for all developing markets. We would be grateful for all comments and remarks, and we hope to continue the forum of know-how exchange, in line with the statutory aims of the Polish Mortgage Credit Foundation.

# I. Covered Bond Markets – Poland and other CEE countries versus Europe

## - Differences

### A. Volume

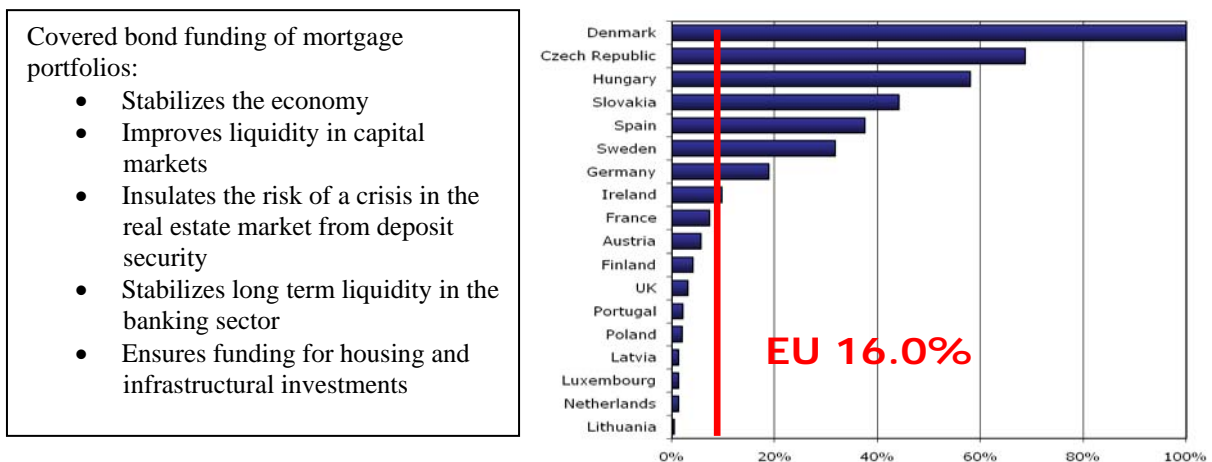


Source: EMF

All the issues of covered bonds in the new Member States of the European Union (i.e. Poland, Hungary, Czech Republic, Lithuania, and Latvia) account for only 1% of the European system of covered bonds, while their mortgage portfolios account for 10% of the EU volume (growth rate 5 times the rate in the old EU).

### B. Role in the Economy

Mortgage Covered Bonds as a % of residential outstanding (as of 31.12.2007) - Source: EMF



In Poland, only 5% of the mortgage portfolio is financed with covered bonds – on the contrary – the Hungarian and Czech markets fully take the advantages of the covered bonds system.

## Are the covered bonds an attractive funding alternative for the Polish banks?



**Tomasz Mironczuk**, Head of Treasury Department, Bank BPH S.A.

**T. Mironczuk:** *“In Poland the question of strategic competition model is extremely important. When the competition is so fierce the cost of funding counts even more than usually. The problem is: at what **yield** would the bank accept covered bonds as the funding source. Nowadays the **economic calculation is still against the covered bonds.**”*



**Piotr Cyburt** is a President of the Management Board of BRE Bank Hipoteczny S.A.

**P. Cyburt:** *“When issuing the covered bonds, we sometimes have to pay for the capital **more than for uncollateralized debt.** It means that the covered bonds are sold for higher prices than the quality of those instruments demands”.*



**Krzysztof Pietraszkiewicz**

**K. Pietraszkiewicz:** *“In that context it’s important to take into account the fact that the Polish banking system is in over 70% owned by the **foreign investors.** Therefore the funding strategies of the international conglomerates are also of great importance.”*

## *C. Prices of Covered Bonds - Differences*

<b>Issuer</b>	<b>Issue Date</b>	<b>Maturity</b>	<b>Coupon</b>
BRE Bank Hipoteczny - PL	12.03.2008	28.09.2010	6M Wibor + 0.80%
BRE Bank Hipoteczny – PL	25.04.2008	28.04.2011	6M Wibor + 0.89%
BHH - DE	2008	06.05.2010	4.50%
Caixa Catalunya - SP	2008	19.05.2010	5%
BNP Paribas - FR	2008	24.01.2001	4.13%
BHH - DE	2008	14.03.2011	3.75%

Data collected after a few years of observation and, in particular, the history of the most recent issues confirm that the cost of funding in developed covered bond markets (including Jumbo issues – over 1 million €) is much lower than the cost of Polish covered bonds, for example.

Taking into account conditions of issue in given markets, it appears that **price differences** above reference rates for German and Polish issues are higher than 10 b.ps. (more than 1%). And the same reference rate in Poland is higher than in Western Europe.

As a result, covered bonds are not an attractive source of mortgage funding in Poland - in terms of interest rates – contrary to analogical covered bonds used on developed markets.

## Pooling model as an alternative for the Polish market?



**Dr. Agnieszka Drewicz-Tułodziecka**, Doctor of Law; specialising in law, finance, banking and property collateral. After 5 year legislative experience in the Ministry of Finance, since 1995 she is a President of the Polish Mortgage Credit Foundation.

**Dr A. Tułodziecka:** “We may draw the conclusion that **the biggest challenge** for the Polish system of *list zastawny* is the development. The scenario we have followed so far is the low and stable evolution. In order to speed the development up, **the state support would help a lot** – e.g state guarantees or fiscal support. It’s worth noticing that Poland is the only country which does not and has never supported covered bond system. Poland is also the country fulfilling the European standard of covered bond (as indicated in the UCITS directive), unfortunately still the risk weighting of 10% is questioned and not clearly supported by the banking supervision.

In order to boost the covered bonds system in Poland different solutions are being considered. One option might be **introducing pooling model**, allowing mortgage banks to gather loans from different banks to create a bigger pool for the issuance. Another possibility is **abolishing the specialist banks principle** – but the question is: how the new legislation should look like? On the other hand, any new solution should take into account **the changed macro environment in Poland** – due to the fact that the pace of loans’ increase was much higher than of the deposits, the market is not so liquid as it used to be. That should turn more attention towards using the covered bonds as a funding instrument in Poland.”



**Irena Stocka**, President of the Board, BPH Bank Hipoteczny S.A.  
(\* currently Pekao Bank Hipoteczny)

**Irena Stocka:** “There’s an **economic justification** of a pooling model, which could be used also in Poland. The mortgage banks is a transparent issuer, but a key for success is a broad portfolio of mortgage loans, accessible from big universal banks. The cooperation on that field could ensure higher level of covered bonds funding – just as in Hungary.”

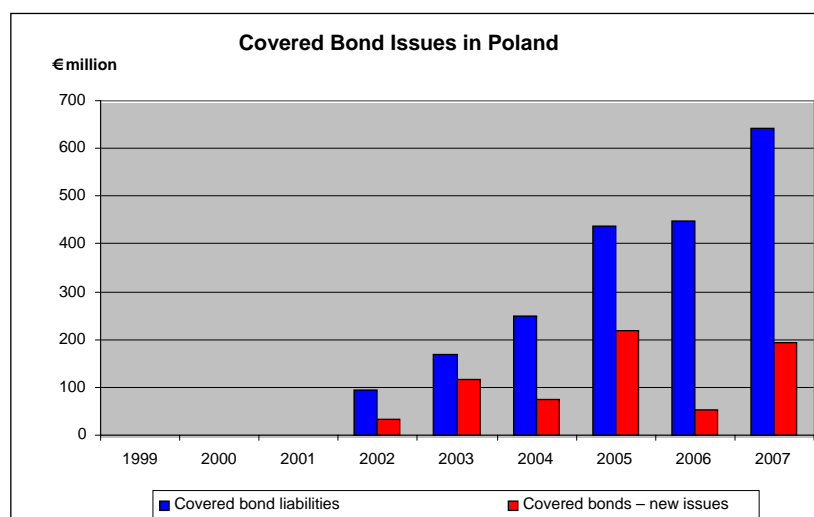
## II. Challenge for Poland - Development

In the light of the data presented in Section I, and in particular because of insignificant volumes, Poland has to face the following challenges:

- Increase the share in market funding
- Ensure funds for refunding to keep the growth rate in the mortgage market
- Optimize the price of covered bonds so that credit linked with that base offered at least equally attractive funding as deposit-based funding

### Development! But How?!

#### *A. A Slow Evolution – Follow Small Niches in the Market*



Source: Polish Mortgage Credit Foundation

There are 3 active mortgage banks in Poland:

- Commerzbank AG Group – BRE Bank Hipoteczny S.A.,
- HVB Group – BPH Bank Hipoteczny S.A. (\* currently Pekao Bank Hipoteczny)
- ING-affiliated Group – ING Bank Hipoteczny S.A.

As of the end of 2007, total liabilities from covered bond issues in Poland amounted to about €643 million.

Funding profile: mainly commercial mortgage loans, housing loans – an insignificant share, first projects in the public sector.

## How to ensure the situation when covered bonds would be an applicable funding instrument for the whole banking sector - same mortgage valuation and LTV standard?



**Dr. Otmar Stöcker** is Managing Director and Head of Department "Public Finance" in the Association of German Pfandbrief Banks. In addition he is responsible for German Pfandbrief law, cross-border mortgage finance in Europe and USA, comparison of covered bond legislation and vdp-consultancy to Central & Eastern Europe on covered bonds and mortgage finance.

**Dr. O. Stöcker:** "Although you have lots of mortgages in Poland, firstly you have to check the mortgages granted by universal banks, whether they're **eligible for the cover** of list zastawny. In Germany we had discussions with chairmen of the biggest banks and they said they'd ask for license. But their whole portfolio – due to some details – was not eligible. And – with mass production of loans – it's actually **impossible to check the portfolio** of loans granted within the last 20 years. That's why the 3 biggest German universal banks haven't asked for the license to issue covered bonds.

So there comes the question for the Polish system: is the mortgage business of universal banks eligible to the quality necessary according to the Act on covered bonds and mortgage banks? The answer is probably no – so the only solution would be **to revise the quality of collateral** eligible for covered bonds. Otherwise abolishing the specialized bank principle doesn't change anything in the next few years because only new credits will be eligible for covered bonds. Moreover, we see a big **difference in the costs** of producing mortgages which are eligible. Nevertheless – revising the quality may be done in good times and never in bad times. I really doubt that with abolishing the special banks principle you can achieve high volumes very quickly".



**Dr. Louis Hagen** - Executive Director, Association of German Pfandbrief Banks e. V., Berlin. Prior to assuming his present position as Executive Director of the Association of German Pfandbrief Banks in Berlin, Dr. Louis Hagen held several executive positions within the organization in the Bonn and Brussels offices. In addition he is Member of the Exchange Council of the Risk Management Exchange Hannover (RMX).

**Dr. L. Hagen:** "**Quality is the crucial thing.** We had that discussion in Germany **whether to loosen up some criteria** and raise the ratio of mortgage value eligible from 60 to 80%. We asked some investors and journalists about that, and when we saw big headlines in newspapers saying that Pfandbrief banks are loosening their standards for Pfandbrief we **stopped everything immediately**".

## Standards of mortgage lending – mortgage versus universal banks in Poland

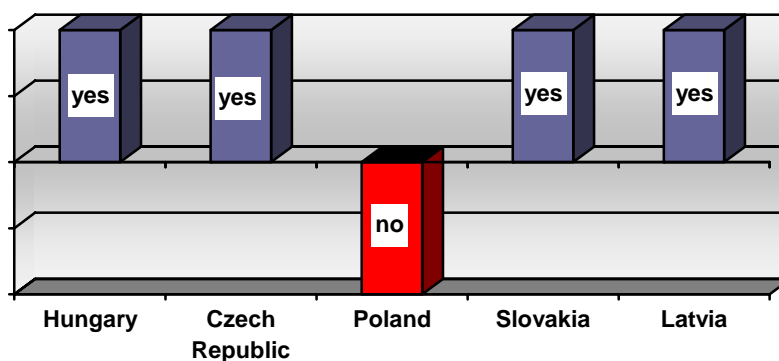
<i>Mortgage requirements for covered bonds</i>	<i>Mortgage requirements at universal banks</i>
Banking & mortgage value (mandatory), additional reporting duties and controlling of the quality of mortgages, valuations and limits	Market value (not mandatory)
- First mortgage with confirmed entry in the mortgage register (mandatory); - Additional mentions in mortgage registers	Mortgage is not mandatory in advance, as it takes time to register a mortgage, a loan is usually granted before the legal collateral is effectively established.
Limits or restrictions - developer financing or housing in progress	No limitations
LTV limit – mandatory by law	
Funding term congruence - mandatory	

For mortgage banks, the limits of offer and credit availability are the result of regime according to the Act on covered bonds and mortgage banks.

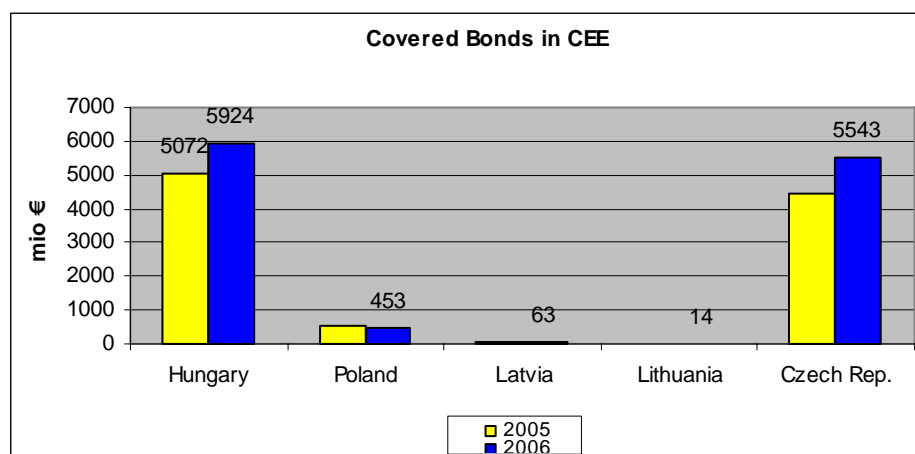
Mortgage credits offered by mortgage banks are characterized by requires troublesome for many clients, what together with higher funding costs – induces the fact that typical and standard offers of universal banks make mortgage credit more accessible. Therefore, the mortgage lending boom (the value of outstanding mortgage lending **has grown about 20 times in comparison to 2000**) is **mainly the result of activity of deposit-funded universal banks.**

## B. Fiscal and System Support (Standard Development Incentive for Covered Bonds in Most Successful Markets.

### System Support for Covered Bonds in CEE.



Source: Polish Mortgage Credit Foundation



Source: Polish Mortgage Credit Foundation

#### Standard support measures include:

- a) subventions to loans refinancing with covered bonds;
- b) tax credit for interest on covered bonds;
- c) ban on real estate funding from deposits of individuals;
- d) issuer: (wholly or partially) state-owned bank – high ratings

Poland has implemented no such measures as the only country that re-opened a covered bond market in the '80.

Before WWII, the covered bond market was significantly supported by state-owned banking capital (issuer: BGK).

## What is the real weight of advantages accompanying the covered bonds (they lack in Poland): eligibility for repo - financing, preferential risk weighting, EC notification?



**Reinolf Dibus** is currently Managing Director and Member of the Board of Directors of EUROHYPO Europäische Hypothekenbank S.A. ("Eurohypo") based in Luxembourg. He is Chairman of the Financial Markets Committee of the Luxembourg Bankers Association and a member of the Financial Markets Committee of the European Banking Federation. Furthermore he is a member of the Commission des Banques d'Émission de Lettres de Gage (COMBEL) originated by the Luxembourg

Banking Supervisory Authority (CSSF).

**R. Dibus:** "Some 1.5 years ago our bank thought about investing in Polish covered bonds. But finally we found out that it wouldn't make sense, because the Polish covered bonds **don't have privileged position and there's not enough liquidity on the market, and there's no repo market for the Polish covered bonds.** As long as you get enough liquidity on domestic market – it's fine. But that instrument should be prepared for **competition on the European market.** And to have more funding sources, you have to meet the requirements of the European investors, which are: preferential risk weighting, repo market, liquidity."

## C. System Support of Regulatory and Investment Regulations (eligibility for repo - financing, risk weighting, notification).

Country	Compliance with UCITS 22(4)	Special investment limits as notified to the EU	Risk weight for domestic CB	Risk weight for foreign CB
Austria	Yes	Yes	10%	10%
Belgium	No	Yes	---	10%
Czech Republic	Yes	Yes	10%	10%
Denmark	Yes	Yes	10%	10%
Finland	Yes	Yes	10%	10%
France	Yes	Yes	10%	10%
Germany	Yes	Yes	10%	10%
Greece	Yes	Yes	---	10%
Hungary	Yes	Yes	10%	10%
Ireland	Yes	Yes	10%	10%
Italy	No	Yes	20%	20%
Latvia	Yes	No notification	10%	10%
Lithuania	Yes	Yes	10%	10%
Luxembourg	Yes	Yes	10%	10%
Netherlands	No	No	20%	10%
Norway	No – not a Member State	No	10%	10%
Poland	Yes	Yes (since XII. 2008)		
Portugal	Yes	Yes	10%	10%
Slovakia	Yes	Yes	10%	10%
Spain	Yes	Yes	10%	10%
Sweden	Yes	Yes	10%	10%
Switzerland	No – not a Member State	---	10%	10%
U.K.	No	No	20%	20%

Source: European Covered Bond Fact Book 2007, ECBC.

Current situation – please check on: <http://ecbc.hypo.org>

In the practice, a covered bond is recognized as the covered bond not only by fulfilling the CRD criteria, but also by having such attributes as:

- preferential risk weights
- eligibility for repo-financing
- notification on the EC website

## What are the other countries' experiences in terms of advantages and barriers of using apex systems = pooling model for covered bond (Hungary)?



**Dr. András Gábor Botos** is Secretary General of the Association of Hungarian Mortgage Banks, comprising three specialised mortgage credit institutions.

**A. Botos:** “I must admit, that the initial reason for the success of covered bonds in Hungary was the **generous state subsidy system**. But on the other hand, when it was abolished, the system remained lucrative – so **apex worked also without support**, one of the Hungarian banks even managed to deliver a Jumbo issue. The key for success is **pooling** – in Hungary the mortgage banks are allowed to buy mortgages from universal banks and in this way they create a bigger covering pool, which enables them to maintain high issuance volumes and liquidity on the market. On the other hand, we’ve got a **solid legislation** for covered bonds – a German model was used as a benchmark - which makes that instrument reliable for investors.”



**Dr. Otmar Stöcker** is Managing Director and Head of Department “Public Finance” in the Association of German Pfandbrief Banks. In addition he is responsible for German Pfandbrief law, cross-border mortgage finance in Europe and USA, comparison of covered bond legislation and vdp-consultancy to Central & Eastern Europe on covered bonds and mortgage finance.

**Dr. O. Stöcker:** “Talking about success of pooling models, we have to notice, that there’re 7 countries in Europe using that solution: Hungary, Austria, Switzerland, Denmark, France, Spain, and recently – Germany. All those systems are different, they not always guarantee a success, much depends also on **economic framework**.”

## *D. New Business Arrangements with Covered Bonds*

### *Apex System - Austria, Switzerland, Hungary.*

#### **An optimized solution due to a medium size and the current stage of development of the market**

##### Advantages:

Expectations of investors can be met in the environment of a moderate base to generate covered bonds (mortgage loans that meet required standards).

Expectations of investors that affect an attractive pricing of covered bonds

- Credit quality (rating)
- Liquidity and frequency of issues
- Strategic fit (maturity, currency)
- High volumes

#### **Success of apex system for covered bonds on comparable Hungarian market**

Adaptation of apex system for covered bonds resulted in success on comparable markets. A spectacular example in this area is Hungarian market.

Taking into consideration the outstanding mortgage debt per capita, the Hungarian market is a bit bigger than the Polish one (about 1000 € vs. 700 € per capita). In both countries, the legal framework for covered bonds was introduced in 1997-1998, and both markets function according to specialization rule.

On the Hungarian market the level of outstanding covered bonds obligations is about 10 times higher than in Poland. Moreover in Hungary about 60% of mortgage portfolio is funded via covered bonds, whereas in Poland – about 5%.

Although apex system would be an ideal solution in Poland one can identify the following barriers the implementation of an apex system in Poland:

- Strategic management and Supervisory Boards responsible for development of mortgage lenders and issuers of covered bonds cannot reach an agreement.
- Psychological barriers of mortgage business resulting from a top priority assigned to financial results of particular units, even if they are financed under one corporate structure.

##### **Hungarian market's achievements:**

- a) Issue frequency
- b) Value of a single issue (Jumbo)
- c) Offer for foreign markets (better price)
- d) System support: land debt, revoked system support, risk weight of 10%, eligibility for repo - financing, notification
- e) Improved final competitiveness (doubled as compared with Polish covered bonds) and affordability as a way to refinance mortgage loans – see the last issue in Polish market.

## Developed markets' experiences – how to cope with a situation when the quality and security of covered bonds is not reflected in their price paid by investors?



**Dr. Louis Hagen** - Executive Director, Association of German Pfandbrief Banks e. V., Berlin. Prior to assuming his present position as Executive Director of the Association of German Pfandbrief Banks in Berlin, Dr. Louis Hagen held several executive positions within the organization in the Bonn and Brussels offices. In addition he is Member of the Exchange Council of the Risk Management Exchange Hannover (RMX).

**Dr. L. Hagen:** “We had situation when the German Pfandbrief cost too much in relation to other covered bonds. It was before subprime – it was **hard for Pfandbrief to differentiate** from other products of lower quality – for example in May/June 2007 the difference between Pfandbrief and other covered bonds was maybe 5-6 basis points. At that time we were of the opinion that the German product – with a strong legal basis, long history – wasn't identified by the market. But since July it has changed – for example **US covered bonds are now priced over 100 basis points over Pfandbrief or more.**

How can we cope with such a situation? The answer is: **work on quality.** When it comes to Pfandbrief: we're constantly working on how to change it so that it would suit the investors' needs more. When the market becomes tough, the quality will pay.”

## Abolishing the specialist bank principle – but on what conditions?



**Dr. Otmar Stöcker** is Managing Director and Head of Department “Public Finance” in the Association of German Pfandbrief Banks. In addition he is responsible for German Pfandbrief law, cross-border mortgage finance in Europe and USA, comparison of covered bond legislation and vdp-consultancy to Central & Eastern Europe on covered bonds and mortgage finance.

**Dr. O. Stöcker:** “In Germany the specialization principle was abolished after changing and **improving the insolvency law** (insolvency risk fencing). When we abolished specialization principle, we also introduced **means of compensation**, because while changing the legal framework for covered bonds, you have to be very careful in order not to frighten the investors – which is especially important in “bad times”.

Another question is depositors' protection which is the case with universal banks. It's especially important nowadays – until one year ago nobody was thinking about the scenario which happened to Northern Rock, where depositors were queuing in order to get their money back. Now that danger is more obvious. For example – in order to ensure the depositors' protection, in Australia any covered bonds are not allowed; whereas in the USA, Canada and UK there are limits of the volume of covered bonds issued by non-specialized banks. With specialized banks such problem doesn't exist.”

### Covered bond issues – Poland vs. Hungary

	Poland - BRE Bank Hipoteczny	Hungary – FHB
Coupon	6M Wibor + 89 p.b.	6M Wibor + 120 p.b.
Issue value	PLN250 million	...
Issue rating	A2	Aa3
Issuer rating	A3	BBB
Jumbo market	No	€0.75 billion
International issues	No	Issue Program for €3 billion

Source: Polish Mortgage Credit Foundation

It's worth stressing, that the issue planned by FHB has a higher rating than BRE Bank Hipoteczny's issue, despite the fact that the rating of Hungarian bank is lower in comparison to BRE Bank Hipoteczny. This situation is a consequence of notification of Hungarian covered bonds and their preferential risk treatment (weighting of 10%). In the same time it's worth noticing that the FHB's issue is more expensive – although it's higher rated.

#### Prognosis:

Applying the mechanism of Hungarian apex model to the Polish environment, it's estimated that on the basis of 50% of universal banks' mortgage portfolio, the annual covered bonds issuance could reach 6 billion € (assuming average credit portfolio growth ratio of 30%).

#### Condition:

- unification of valuation standards, LTV and mandatory mortgage collateral on the market – no matter what bank (universal/mortgage) grants mortgage credits,
- granting additional attributes of covered bonds (eligibility for repo - financing, risk weighting, notification).

### *The conversion from a specialized system to a universal principle of issue of covered bonds would also inspire new business arrangements*

- although – contrary to apex system – it would result in dispersion of an issue.

Both solutions indicated in section D share some problems: lack of common regime for mortgage credit parameters (valuation, LTV, required mortgage).

## European quality of the Polish list zastawny – needs to be confirmed!



**Dr. Otmar Stöcker** is Managing Director and Head of Department "Public Finance" in the Association of German Pfandbrief Banks. In addition he is responsible for German Pfandbrief law, cross-border mortgage finance in Europe and USA, comparison of covered bond legislation and vdp-consultancy to Central & Eastern Europe on covered bonds and mortgage finance.

**Dr. O. Stöcker:** "With the Polish covered bond, one thing is lacking: **the clear preferential risk weighting** for covered bonds. The question is: how does it affect the pricing of covered bonds?"

It has to be stressed that risk weighting matters mainly for the banks, as it's much more expensive for them to buy higher-risk instruments. But **the general perception** of covered bonds without 10% risk weighting isn't very good, so even the investors that do not have to comply with the new Capital Requirement Directive rules, **pay attention to that issue** – so the risk weighting has its major impact also on other investors.

The situation in Poland is very clear in that matter, as the Polish list zastawny **meets the criteria needed for the preferential risk weighting**. The only thing that needs to be done is sending a notification letter to the European Commission. After notification, it will be attractive for banks all over the Europe."

## III. A Key to Development (Assuming No Fiscal Support).

---

### *A. A product of European “covered bond” quality*

#### **Polish covered bonds meet European requirements**

- a top quality and rated product: “covered bond” is already implemented in the market.

The last issue of BRE Bank Hipoteczny was rated A2 by Moody’s – one level above the issuer’s rating.

- the product is recognized by investors – regulations that ensure higher investment limits – in compliance with the UCITS Directive

**The above are great advantages of Polish covered bonds.**

### *B. Positive Calculations of Utilization of Covered Bond Source of Funding – prerequisite for business decision.*

#### **Price of capital from different sources:**

	Covered bond	Deposit base <sup>1</sup>	Interbank market	Bank bonds
1.	6M Wibor + 80 p.b. <sup>2</sup> .	2.6%	6M EURIBOR + 60 p.b.	WIBOR 6M + 100 p.b. <sup>3</sup>

\* As of 30.04.2008

1. Households deposits over 2 years.

2. Covered bonds issued by BRE Bank Hipoteczny, 25.04.2008.

3. Bonds issued by PKO BP, 23.10.2007

The above calculation proves the price advantage of deposit as a credit funding source.



**Tomasz Mironczuk**, Head of Treasury Department, Bank BPH S.A. (\* currently the bank is named: Pekao Bank Hipoteczny S.A.)

**T. Mironczuk:** *“It should be decided whether we’d like our financial system to be open to the world or just we want the system to be domestically driven. Important in that matter is the question of liquidity.*

*If the banks have a very **limited capital**, it provides a boost for thinking. Having lot of capital – it’s a luxury of simply taking less care of whether I have enough funding, what is my risk – I can run higher and higher levels of risk and there’ll be no negative consequences (that’s potential thinking of well-capitalized banks). But **after the sub-prime crisis the situation has change**. Now the question is: how to achieve good structure of funding, how to use long-term unsecured funding, how to use mortgage backed funding or other structures which improve liquidity, which help to manage our business long-term.”*

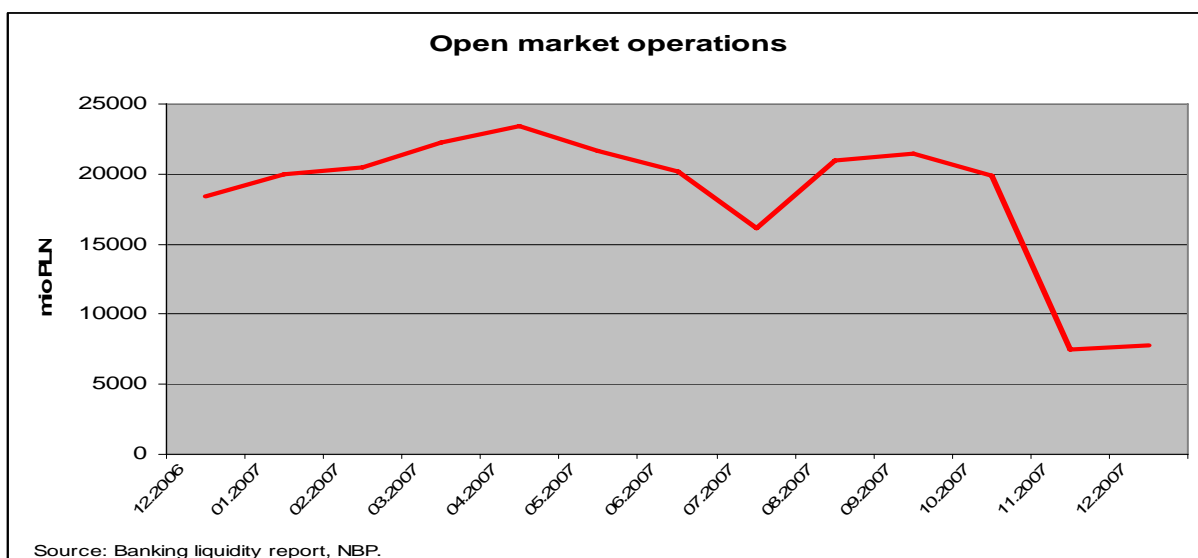
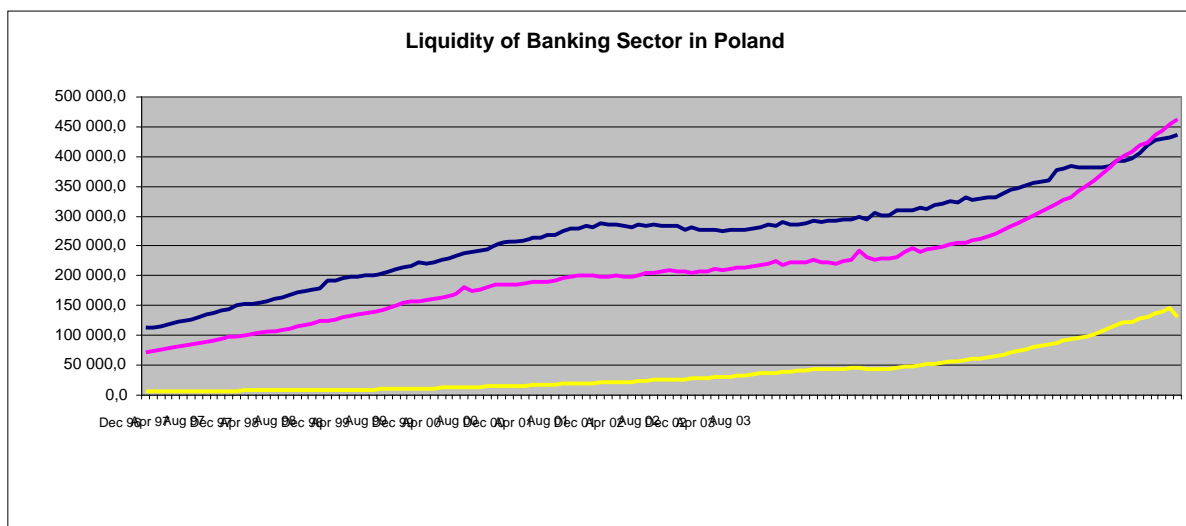
### The new reality

It has to be borne in mind however that in the previous months the deposit base has shrunken significantly, therefore alternative funding sources are needed. It's also worth mentioning that from the investor's perspective – more profitable were banking bonds (40 basis points). The price of banking bonds – a paper without qualified collateral like covered bond – influenced also the price of covered bonds. Furthermore, although the banking bonds' issue was not granted a rating (contrary to covered bonds), the status of the issuer - PKO BP – thus indirect guarantee of the Treasury – influenced the high assessment of the issue among the investors.

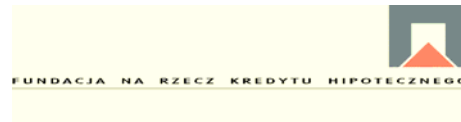
This is the market reality - high quality and administrative costs for banks resulting from the necessity to meet the requirements of covered bonds security – are not reflected in it's price.

## C. Factors Compelling the Use of Covered Bonds

- **Sector liquidity, liquidity of particular banks, deposit growth rate versus loans growth rate**



Funding Mortgage Portfolios - Focus on Poland  
VIP Lounge, 16.06.2008.



## Covered bonds system profitability now and then – how did it change after the sub-prime?



**Hans-Otto Hagemeister** – Regierungsdirektor, Bundesanstalt für Finanzdienstleistungsaufsicht BaFin, Leader of Competence Center for Pfandbriefe II – Special Audits of the Cover of Pfandbriefe

***O. Hagenmeister:** When the new legislation, abolishing the specialist bank principle, was introduced in Germany, the idea of applying for that license wasn't very popular due to market situation. Universal banks could have funded themselves by paying maybe **20 bps** premium above the Pfandbrief.*

*Now the difference between Pfandbrief and the senior unsecured lending is **80-90 bps** – **now it pays off** for them to issue Pfandbrief and the interest in getting the license has risen.”*

To the half of 2007, the high over-liquidity of the Polish banking sector discouraged from using other than deposit based methods of funding. Since then, the reality has changed – the subprime crisis caused serious liquidity problems on the Western markets. As a result, foreign banks reached for the capital on emerging markets and drained the liquidity from the Polish market.

- **Impact of regulations and limits (capital resolution and liquidity resolution of the KNB)**

Up from 01.07.2008, the new liquidity regulation will come into force in Poland. One of them is an obligation to hold long term assets or issue long term securities – adequate to the credits' maturity. On the one hand, it will impel the banks to issue long term debt securities, on the other one – it will boost competition on the market. As a result, the price of covered bonds may increase.

The year of 2007 brought significant difference when it comes to market demand for covered bonds, as well as the need for improvement of covered bonds legislation.

Firstly, the growth of deposit base doesn't follow the pace of credit portfolio increase.

Secondly, the sector liquidity – is limited as a result of subprime crisis and enforcement of new liquidity resolution.

It may reduce the residential market financing and slow down the pace of economic growth in Poland.

## Depositors vs. bond holders – conflict of interest?



**Hans-Otto Hagemeister** – Regierungsdirektor, Bundesanstalt für Finanzdienstleistungsaufsicht BaFin, Leader of Competence Center for Pfandbriefe II – Special Audits of the Cover of Pfandbriefe

**O. Hagenmeister:** “While abolishing the specialist system, there are three aspects that should be taken into consideration. Firstly, **cover pool audit** – not only at mortgage banks – as it used to be, but at all Pfandbrief banks. Secondly, we need to stress that abolishment of specialization principle wasn’t done because Pfandbrief was not attractive for the market – it was done to enable the banks **broader sources of funding**.

And last, but not least: it was important to **keep the same quality** of Pfandbrief for all banks (safeguarding measures) – not every bank may issue covered bonds – only the licensed ones and the license is granted by the supervisory authority. Bank must prove that it can conduct this business in a very secure way.”



**Tomasz Obal** - is the director of the Financial Assistance and Deposit Guarantee Department in Bankowy Fundusz Gwarancyjny (Bank Guarantee Fund).

**T. Obal:** “When talking about depositors’ protection it should be borne in mind that, according to the Directive 94/19 on Deposit Guarantee Schemes, there’s a list of depositors excluded from the insurance. These are the depositors, who are expected to be able to measure the risk on the market, for example State treasury, banks, brokerage companies, investment and pension funds, big enterprises. In Poland, the **deposits up to 1.000 € are guaranteed in 100%**, the amount over 1.000 € up to 22.500 € are guaranteed in 90%.”



**Dr. Louis Hagen** - Executive Director, Association of German Pfandbrief Banks e. V., Berlin. Prior to assuming his present position as Executive Director of the Association of German Pfandbrief Banks in Berlin, Dr. Louis Hagen held several executive positions within the organization in the Bonn and Brussels offices. In addition he is Member of the Exchange Council of the Risk Management Exchange Hannover (RMX).

**Dr. L. Hagen:** When the specialized bank principle was abolished in Germany, the question of potential conflict of interest between depositors and bond holders wasn’t really relevant. The reason for that was that Germany has had covered bonds for about 240 years, so the customers are used to that product. This question seems to be **more relevant in countries where covered bonds are new** instrument or will be introduced.

On the other hand, that issue should be also a subject of interest of the **supervisory authorities**. However it should be taken into consideration that the bank which funds its activity only through deposits, has a huge problem. Mortgages are mostly long term, whereas the deposits are usually long term, so there’s a maturity mismatch. Therefore, funding via covered bonds should be positively assessed by the supervisory authorities as it ensures more stability for the bank. The stability of banking system is the best protection for the depositors.

## IV. A solution under debate in Poland – moving from the specialist system to universal covered bond issues

### *Formal status:*

A complement, one-to-one, to the rights and obligations of the existing covered bond issuers and banks issuing covered bonds (the possibility for each universal bank without obtaining an additional license – resulting directly from the Law)

Sejm project – Within the package of construction financing facilities (form number 2092/07 and form number 461).

Supported by: The Ministry of Infrastructure, The Union of Polish Banks (MWy 212/1166/207).

Critical comments: The Ministry of Finance (indicating the threats to the quality of covered bonds).

The Polish Mortgage Credit Foundation (indicating the necessary application of the experience of other countries, especially with respect to laying down conditions).

Questions to guests and foreign experts based on their experience.

### *1. How to effectively and safely move to the universal covered bond issue system without distorting the main funding base – funding from deposits?*

- a) Trust in deposit holders
- b) Risk for the Bank Guarantee Fund (reflected in the level of contributions?)
- c) Foreclosure and bankruptcy privilege for covered bond issuers
- d) Importance for the Bank Guarantee Fund (the specific nature of Polish solutions) of the fact that the bankruptcy privilege of a covered bond issuer covers 100% of the loan value (although the covered bond only refinances up to 60% with the remaining 40% coming from deposits)

Opinions on the solutions used to-date:

- a) A ban on mortgage funding from deposits (Denmark until 2006)
- b) A ban on issuing covered bonds by banking institutions running deposit operations (Australia – as of 2005)
- c) Limits on issues of mortgage bonds/covered bonds vs. balance amount – a few percent – Great Britain (ca. 2000)
- d) German experience? Danish experience?

## How to ensure the situation when covered bonds would be an applicable funding instrument for the whole banking sector ?



**Dr. Louis Hagen** - Executive Director, Association of German Pfandbrief Banks e. V., Berlin. Prior to assuming his present position as Executive Director of the Association of German Pfandbrief Banks in Berlin, Dr. Louis Hagen held several executive positions within the organization in the Bonn and Brussels offices. In addition he is Member of the Exchange Council of the Risk Management Exchange Hannover (RMX).

**Dr. L. Hagen:** “There can be only one Pfandbrief. It’s important to have a **homogenous market** abroad, where all banks stick to the same rules. If something happens to the modified bond, it’s possible the investors would give up also traditional Pfandbrief. Therefore all covered bonds’ issuers should follow **one standard for all**. First of all: **security of collateral** – if you want to ensure high quality of security and investors’ confidence you have to maintain very **conservative standards** – also in terms of valuation – in Germany it means using the so called mortgage value. Before you use a mortgage loan as an collateral, the underlying property has to be appraised according to very specific regulation which was issued by supervisory authority. This accounts both for residential and commercial properties. That value is usually 10-15% under a market value. Moreover, only 60% of that value may be used as an eligible collateral in cover pool.”



**Piotr Bednarski**, MBA, is a Deputy Director of the Inspection Department in the Banking Supervision Division of the Polish Financial Supervision Authority. He is also Poland’s representative in the Groupe de Contact, a leading working group of the EU Committee of European Bank Supervisors (CEBS) and a member of International Liaison Group.

**P. Bednarski:** “The supervisory authority has done an empirical exercise comparing universal and mortgage banks. The general impression is that if you want to spoil the quality of list zastawny, go for abolishing of specialization principle. In this market, whit the sentiment we got now, we should really **treasure and protect** the value of mortgage covered bonds. If you want to confuse the market, create a “light” version of the mortgage banking valuation. That’s the core problem here: the universal banks don’t use mortgage banking valuation, they use market valuation, based sometimes on very poor data basis. We should stick to that principle: **let’s keep the quality of mortgage bonds valuation and covered bonds** as a special kind of instrument; at least at this stage. I’d rather abstain from making revolution. Especially now – when the fierce competition on the market sometimes results in loosening the lending standards. If we got a quality product with a brand on the market, why should we spoil it now? We should rather think how to **raise lending standards** in universal banks, how to make this pool eligible and why is the demand for covered bonds so low? The challenge is to make the market more vital.”

## ***2. How can the principle of the universal issue of a covered bond be implemented while protecting its integral character and current quality and without discriminating covered letter issuers operating in line with the current principle?***

- a) General or selected approval of covered bond issues by universal banks? Criteria? Threats?
- b) How to solve the issue of banking supervision (the existing specific supervision vs. operational capacity for such supervision with respect to an unlimited number of issuers)
- c) When deciding to adopt a new unified law, would it be rational to reduce the standard of a covered bond in relation to the currently binding norms given that the Polish legislation goes beyond the European “covered bond” standard as defined in the UCITS and CRD Directives?

## ***3. How to ensure the situation when covered bonds would be an actual funding instrument for the whole banking sector?***

### **Regulations in Poland in the background of the above questions and dilemmas.**

- If the covered bond is to be issued on the basis of universal banks' portfolio, one should take into consideration significant differences between credit regimes – resulting from the regulations or their lack:

These are the differences that so far have been a reason for higher competitiveness of mortgage credit offered by the banks operating without an additional regime:

- full credit offer for developer financing
- mortgage to be complemented after credit payoff
- valuation with a standard appraisal report or (by typical residential properties in a typical localization) – without appraisal report
- no special supervision for funding maturity congruence

Some of those regimes could be generally unified – that would enable creation of bigger base for funding via covered bonds by the specialist and universal banks.

## ***Conclusion:***



**Piotr Cyburt** is a President of the Management Board of BRE Bank Hipoteczny S.A.

***P. Cyburt:*** “Simple expansion of license to universal banks does not solve the quality problem and the quality means low price of capital. The given examples from Denmark, Portugal or Germany may make a good inspiration for the Polish market. The main conclusion is: it’s time to start hard work on legislation to create funding environment optimal for the Polish banking system.

*First of all we hope for fulfilling the Foundation’s postulates, such as:*

- eligibility for repo - financing***
- preferential risk weighting of 10% and the notification of the Polish covered bonds.***

*Recently the problem of withholding tax has been solved – also the foreign investors are exempted from this. It’s important that especially in times of liquidity tensions resulting from the sub-prime crisis – the covered bonds in Poland could to some extent solve that problem. The Polish Mortgage Credit Foundation works on pooling model for Poland. For that purpose, a relevant banking – governmental working group was set up by the Foundation.”*

Could the loosening of the local covered bonds regime (and maintaining the minimum European standard at the same time) result in different perception of that instrument (investors, rating agencies, chances to enter the European capital markets)?

The need for changes in order to achieve the above aims:

### **I. Rules disqualifying the use of covered bonds by universal banks:**

- Duty to maintain the limit: total of deposits, credits and issued bonds may not exceed the level of own capital of the bank issuing the covered bonds more than 10 times (article 15 of the Act) – postulated abolition
- Mandatory use of mortgage-banking value of a property – not used by universal banks as a standard (postulate of unified standard of mortgage sustainable value or market value for the whole sector)
- Banned granting mortgage credit outside Poland (postulated abolition).

### **II. Rules creating overregulation (over-standard for covered bonds)**

- Required mentions / registrations into mortgage register, that mortgage is to be added into covered poll register (additional time, costs)
- Lack of possibility of funding via covered bonds the cooperative residential properties and legal barriers for funding residential properties purchased from a developer (restricted scope of business, lack of available credits to met the market demand).

### **III. New rules need to be added to the Act on covered bonds and mortgage banks, adjusting the specialist system to the universal banks**

- Additional license for issuance of covered bonds by universal banks (conditions of granting and cancelling the license)
- Special supervision, reporting and monitoring of the quality of the covering pool
- System security – so that the banking risk wouldn't transfer on the covering poll risk
- Solution of the conflict between the depositors' claims and bankruptcy privilege of the covered bonds buyers.