ECBC

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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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FOREWORD

Against a backdrop of ongoing turbulence in capital markets, the covered bond market continues to expand: in 2009, total outstanding covered bonds grew 5% to €2.4 trillion, over 30 new issuers joined the market in 2009 to bring the total number of issuers to more than 300 and, today, at least 10 countries are considering the introduction of covered bonds.

There are many reasons for this continued expansion of the covered bond market. These include the fact that the asset class has demonstrated itself to be a solid and reliable long-term funding tool which enables banks to access capital markets and maintain lending to the real economy. Furthermore, the safety features and resilient performance of covered bonds, particularly relative to other asset classes, has continued to attract a broad, stable investor base.

Nevertheless, the crisis bought into focus areas which need further improvement. Therefore, in order to protect, and further improve on the features of covered bonds, the industry as a whole has been working together on market initiatives to improve transparency, quality and liquidity. Market participants recognise that further work still needs to be undertaken, and in this light, are keen to press ahead in order to further underline the value of covered bonds not only from the perspective of the banking industry but also in terms of their general impact on financial stability. Indeed, their increased recognition by policymakers and regulators emphasises the need to ensure an appropriate regulatory framework for covered bonds at European and international levels.

The Fifth Edition of the ECBC European Covered Bond Fact Book aims to build on the success of the first four editions, as the benchmark and a comprehensive source of information on the asset class. Chapter I presents an analysis of six of the key themes of the year, including a review of the European Central Bank's covered bond purchase programme, before investigating the work being undertaken by the Basel Committee to address the capital and liquidity provisions in the Basel III framework and how these relate to covered bonds. There are articles on the role of ratings for the asset class, an evaluation of covered bond performance relative to sovereigns, an overview of secondary market liquidity and finally an article on covered bonds from the viewpoint of investors. Chapter II provides a detailed explanation of covered bond fundamentals. Chapter III presents an overview of the legislation and markets in 29 jurisdictions. Chapter IV sets out the rating agencies covered bond methodologies. Finally, Chapter V gives 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 a special thank you must also be extended to Mr Wolfgang Kaelberer, the Chairman of the ECBC Fact Book Working Group for guiding the Fact Book so expertly towards completion, as well as to the members of the "Fact Book" and "Statistics & Data" Working Groups, whose enthusiasm and dedication resulted in this 2010 edition of the ECBC European Covered Bond Fact Book.

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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 which brings together 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 2010, the Council has over 100 members across 25 active covered bonds jurisdictions and many different market segments. ECBC members represent over 95% of covered bonds outstanding.

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

ECBC STRUCTURE

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

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

ECBC WORKING GROUPS

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

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

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

> **The Working Group on Statistics and Data,** chaired by Mr Horst Bertram, is responsible for collecting and publishing complete and up-to-date information on issuing activities and volumes outstanding of covered bonds in all market segments. With 25 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 Reinolf Dibus, examines the rating approaches applied by rating agencies and has been active over the past year monitoring, analysing and reacting to the changes underway in covered bond rating methodologies.

Membership of the ECBC continues to grow and its agenda for the coming year is already filled with numerous activities. The ECBC's objective now is to press ahead in its work with a view to further strengthening its role in facilitating the communication among the different covered bonds stakeholders, working as a catalyst in defining the common features that characterise the asset class and in facilitating improvements in market practices, transparency and liquidity.

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

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August 2010

CHAPTER 1 - KEY THEMES OF THE YEAR

1.1 INTRODUCTION

By Ralf Burmeister, LBBW

The year 2010 has been a remarkable year so far – following last year which was also characterised by exceptional circumstances. It is also not difficult to assume that during the remainder of this year as well looking towards 2011 that the progress towards a return to normality will continue to be a long and slow, for the economy in general and accordingly also for the covered bond market. Nevertheless, it is fair to state that covered bonds demonstrated an ongoing positive performance throughout the crisis and are also expected to do so in the future. This statement should not be seen in pure spread terms but in terms of the safety of the product and investor's appetite for the asset class. Investors haven't withdrawn from the market and issuers have made increased use of the covered bond funding tool. We detect two major arguments for this positive market perception. Firstly, the industry remains committed to the market and is working on further improvements. The labelling of covered bonds, further steps with regard to transparency of cover pool data as well as progress in the liquidity and trading issue of covered bonds, steps being undertaken under the umbrella of the ECBC can be cited here. Furthermore, the market has been strongly supported by, for example, the European Central Bank. The support we are referring to surely has not come to an end with the end of the purchasing programme (see Article 1.2 on the ECB Covered Bond Purchase by Frank Will) as Central Banks throughout the globe continue to be investors in covered bonds. In addition, the ECB remains committed to the market, e.g. commenting on proposed changes in the CRD as well as arguing in favour of covered bonds when compared to MBS (see Article 2.4 by Ralf Burmeister and Frank Will on the macro-economic dimension of covered bonds).

The covered bond market has not been primarily driven by intrinsic factors such as new legislation, amendments to covered bond laws or rating changes. Nevertheless, the latter topic is still of great importance and is discussed in Article 1.4, by Florian Hillenbrand, Jan King and Franz Rudolf.

A major source of influence has of course been the uncertainty and volatility in European government markets, impacting, of course, on the covered bond market (see Article 1.5 on covered bond performance and sovereign spreads by José Sarafana) as well as all other major fixed income market segments. The concept of a sovereign ceiling is no longer a theoretical one but has become a real phenomenon in the European banking sector. The trading and liquidity situation therefore remains difficult (see Article 1.6 on secondary market liquidity by Richard Kemmish and Sebastian Sachs), but the overall market situation with regard to government spreads in various European jurisdictions compared to covered bond spreads in general create relative value opportunities (see Article 1.7 by Fritz Engelhard and John Maskell).

Issuers as well as investors are being confronted with various changes in the regulatory environment of banks in the years to come which will also affect covered bonds directly and indirectly. Although the major tone has become friendlier towards covered bonds in the forthcoming pieces of regulation, there is still a significant body of work to be done in order to increase the understanding of market characteristics in the covered bond universe and to avoid negative effects due to a one-size-fits-all regulatory approach. A particular challenge consists of strengthening covered bonds as long term funding instruments in order to reduce mismatched funding structures of banks and avoid future liquidity crises.

The improvements between the consultative document on liquidity issued by the Basel Committee in December 2009 compared to the latest clarification issued in late July 2010 can be named here as a positive example, however, an overly sharp definition of technical parameters within the Basel framework for liquid assets might exclude a segment of covered bonds for no or very little apparent reason. Until the calibration of the Basel III liquidity rules have been finalised, regulation will continue to have its influence on volatility and uncertainty in the market (see Article 1.3 by Ralf Burmeister, Fritz Engelhard and Frank Will).

After a difficult period, this is not the time for complacency as the projects outlined above need to be completed. The loyalty of investors in covered bonds as well as the constructive dialogue we have with regulators make us believe that we will achieve a positive outcome for all market participants when looking at all the changes to come.

1.2 WAS THE ECB COVERED BOND PURCHASE PROGRAMME A SUCCESS?

By Frank Will and Sophia Kwon, RBS

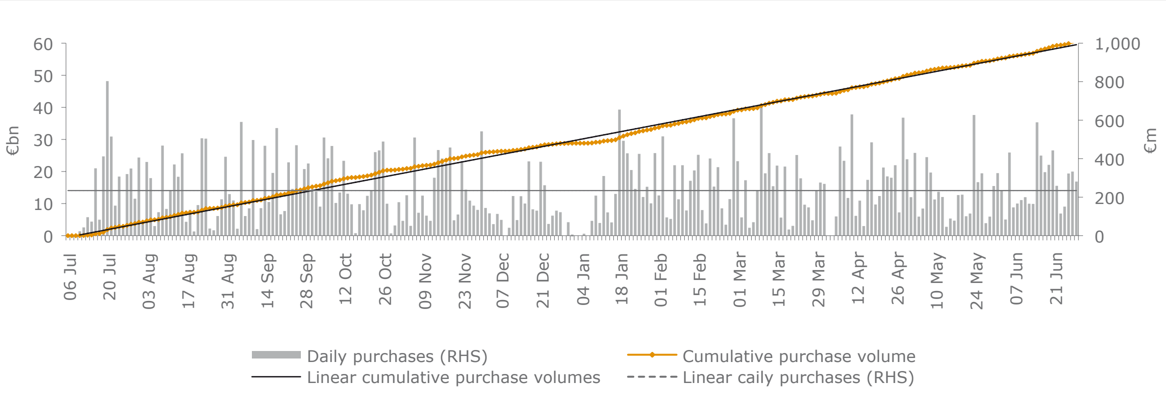
On 7 May 2009, the ECB surprised the market with its announcement to buy €60bn of euro-denominated covered bonds issued within the euro area. The mere announcement of the so-called Covered Bond Purchase Programme (CBPP) had an unprecedented market impact; it revived the lethargic covered bond primary market and triggered a massive tightening of secondary market spreads across the curve and across covered bond categories. The ECB set the major guidelines but left the individual national central banks (NCB) some room to manoeuvre within these boundaries. The ECB and NCBs started to buy covered bonds on 6 July 2009 and purchased €60bn of covered bonds over a 12-month period until the end of June 2010.

The ECB disclosed daily the purchase volume under its programme. In addition, monthly reports on the purchases were published disclosing the amount purchased in the primary and secondary market. However, the ECB did not disclose any additional information regarding the breakdown by currency or country, not even in the final report. We only know that "in total, 422 different bonds were purchased, 27% in the primary market and the remaining 73% in the secondary market. The Eurosystem mainly purchased covered bonds with maturities of three to seven years, which resulted in an average modified duration of 4.12 for the portfolio, as of June 2010". We also know that the "Eurosystem intends to hold the purchased covered bonds until maturity".

ECB Covered Bond Purchase Programme	Details
Total size	€60bn
Total number of purchased bonds	422
Primary market purchases Secondary market purchases	27% / €16.2bn 73% / €43.8bn
Maturities	3-10 years, with strong focus on maturities up to 7 years
Duration	4.12 (as of June 2010)
Holding period	ECB intends to hold bonds until maturity

In order to achieve the €60bn within 12 months, the average daily purchase volume had to be about €234m or €5bn per month. The actual daily purchase volumes varied substantially. The cumulative actual purchase volumes had remained close to the target rate until mid-September 2009 (the chart on the next page shows the cumulative volume (orange line) compared to the target volume (black line)). Amid the supply waves in September and October the ECB increased its daily purchase volumes pushing the actual cumulative volume over the target volume. It dropped briefly below the target volume in January 2010 but since then had remained close to the target until the programme ended.

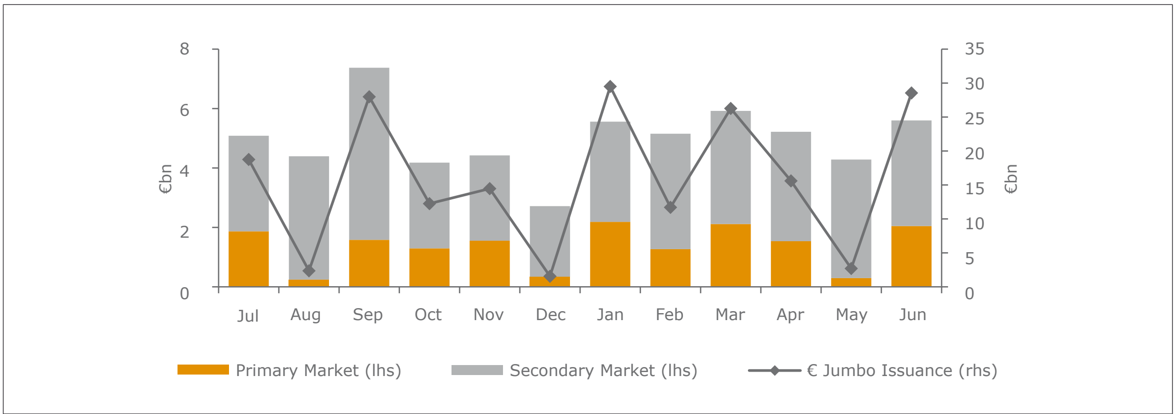
> Chart 1: Eurosystem Covered Bond Purchases – Actual Volumes vs. Targets



Source: ECB, RBS

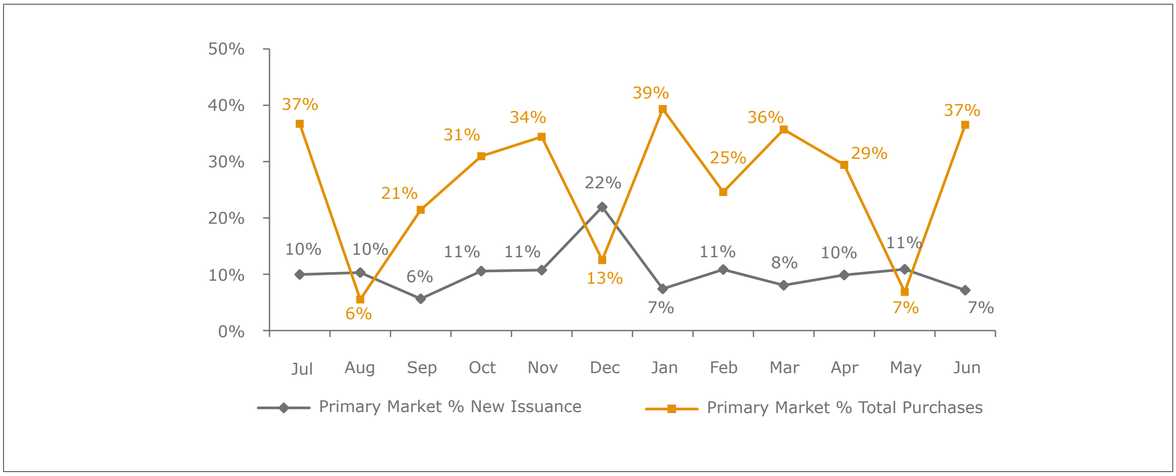
A clear linkage of Jumbo issuance and the ECB purchases in the primary market could not be established. Theoretically, the monthly ECB purchase volume was €5bn representing some kind of soft ceiling on the total amount to be spend each month. Moreover, the primary market share was likely to be lower the higher the new issue volume was. This held true for September last year as well as January and June which had been characterised by exceptionally high new issue volumes. The ratio of ECB primary market purchases to new issue volume were 5.6%, 7.4% and 7.2% respectively compared to an average of 10.2%. However, in absolute terms these figures translated into amounts that were among the highest absolute volumes allocated to the primary market.

> Chart 2: ECB Covered Bond Purchases



Source: ECB, RBS

> Chart 3: ECB Primary Market Allocation vs. Covered Bonds Issuance



Source: ECB, RBS

THE ECB CBPP - KEY FACTS

The ECB conducted the purchase programme primarily through the 16 national central banks (NCBs) of the euro area and bought only 8% of the €60bn amount directly. The ECB set the major guidelines of the programme but the individual national central banks had some room to manoeuvre within these boundaries. The ECB and NCBs started to buy covered bonds on 6 July and purchased covered bonds over a 12-month period until the end of June 2010.

> **ECB Objectives:** The ECB wanted to achieve four main objectives with its CBPP. The first was to promote the ongoing decline in money market term rates, the second was easing funding conditions for credit institutions and corporates, the third was encouraging credit institutions to maintain and expand their lending activities, and last but not least to improve market liquidity in the covered bond market.

> **Eligibility criteria for Covered Bonds:** In general only covered bonds issued in accordance with the criteria set out in Article 52(4)[1] of the UCITS Directive were eligible. However, structured covered bonds that a Eurosystem central bank at its sole discretion considers as offering safeguards similar to UCITS-compliant covered bonds could be included as well.

In order to qualify for the purchase programme, the covered bonds had to be eligible for the monetary policy operations of the Eurosystem, be denominated in euro and issued under covered bond legislation within the euro area. This has been interpreted by the market to exclude covered bonds out of the UK, Sweden, Denmark, Norway, Switzerland, Iceland, the US and Canada. Moreover, the purchases were limited to bonds with remaining maturities of 3 to 10 years. Generally, the minimum size for covered bonds was an outstanding volume of €500m and as a rule, covered bonds needed at least one double-A rating by Fitch, Moody's, S&P or DBRS.

1 Following the recast of EU Directive 85/611 under Directive 2009/65 on 13 July 2009, UCITS Article 22(4) will become UCITS Article 52(4) in July 2011 (http://ec.europa.eu/internal_market/investment/ucits_directive_en.htm).

> **Allocation key:** The ECB said it would buy 8% (or €4.8bn) of covered bonds directly under the €60bn purchase programme. The national central banks of the Euro area were to purchase the remaining €55.2bn of covered bonds. The share of each NCB in the programme was primarily allocated according to the percentage of ECB capital stock held (though there were other undisclosed factors affecting the individual share of each NCB). While the final allocation levels were not made public, taking the share of paid up capital as an indicator, the top-5 central banks in terms of allocated amounts were the Bundesbank, the Banque de France, the Bank of Italy, the Bank of Spain and De Nederlandsche Bank which together make up 58% of the ECB capital stock (see column c in table below).

However, putting the absolute amounts in relation to the size of the outstanding covered bonds eligible under the CBPP in each market shows (see column e) the real winners were Italy (495%) and Finland (165%), followed by Austria (31%), the Netherlands (24%) and Portugal (21%) while Spain and Ireland were least supported with 5% each.

> ECB Capital Shares of National Central Banks and Assumed Allocation of the €60bn Covered Bond Programme

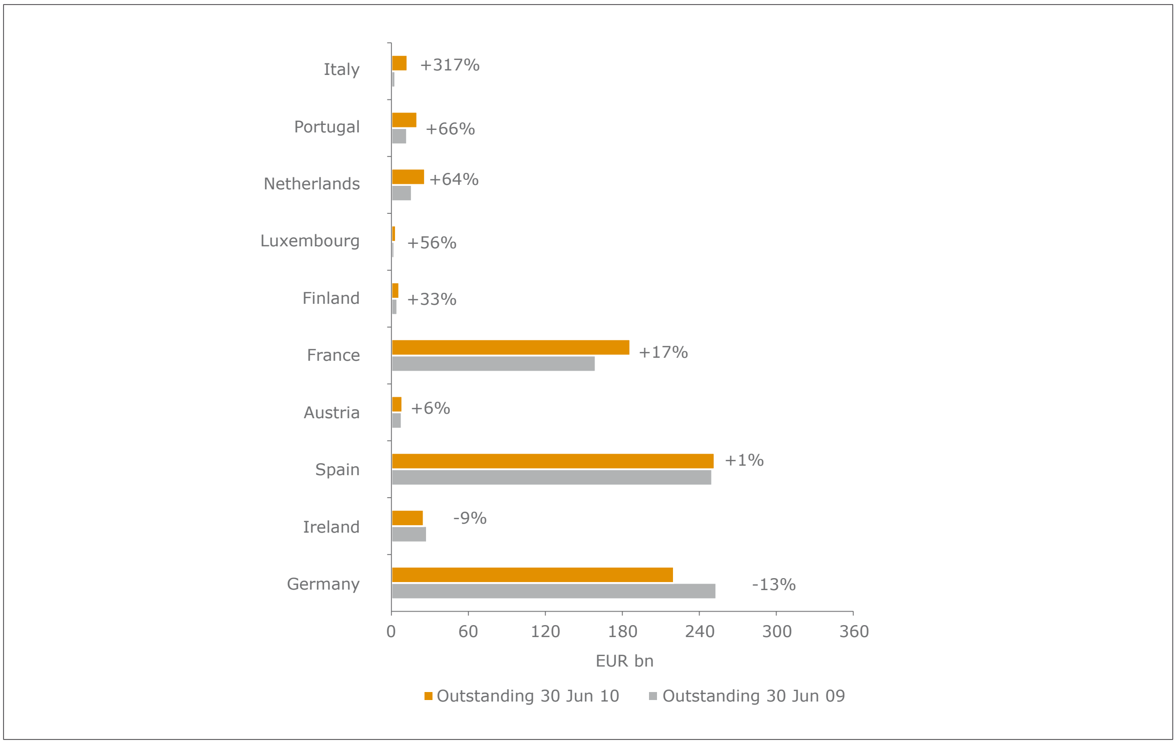
	Capital key % (only euro area) (a)	Portion of the €60bn (€bn) (b)	Portion of the €60bn (%) (c)	Only 3-10yr maturity Jumbo bracket in June 2009 (€bn) (d)	Portion of the €60bn vs. 3-10yrJumbos in June 2009 (%) (e)
ECB	-	4.8	8.000%	-	-
Deutsche Bundesbank	27.134%	15.0	24.963%	88.72	17%
Banque de France	20.377%	11.2	18.747%	91.58	12%
Banca d'Italia	17.906%	9.9	16.473%	2.00*	495%
Banco de España	11.898%	6.6	10.946%	142.03	5%
De Nederlandsche Bank	5.714%	3.2	5.257%	12.90	24%
Banque Nationale de Belgique	3.475%	1.9	3.197%	-	-
Bank of Greece	2.815%	1.6	2.590%	-	-
Oesterreichische Nationalbank	2.782%	1.5	2.560%	5.00	31%
Banco de Portugal	2.508%	1.4	2.307%	6.65	21%
Suomen Pankki - Finlands Bank	1.797%	1.0	1.653%	0.60	165%
Central Bank of Ireland	1.591%	0.9	1.464%	17.68	5%
Národná banka Slovenska	0.994%	0.5	0.914%	-	-
Banka Slovenije	0.471%	0.3	0.433%	-	-
Banque centrale du Luxembourg	0.250%	0.1	0.230%	1	14%
Central Bank of Cyprus	0.196%	0.1	0.180%	-	-
Central Bank of Malta	0.091%	0.0	0.083%	-	-
Total euro area	**100.0%**	**60.0**	**100.0%**	**-**	**-**

Source: RBS

*excluding CDP issues

Taking a look at the size of the individual markets in each country at the start and at the end of the CBPP reveals that the Italian, Portuguese and Dutch covered bond markets benefited the most on a relative basis. The Italian covered bond market (excluding CDP issues) has taken off growing by 317% from a mere €3bn to €12.5bn within the 12 months (including all maturities). The Portuguese and Dutch covered bond markets grew by 66% and 64% respectively; the highest gross supply within that period came out of France which led the market to grow by 17%, while the impact could not be felt in the Spanish market as the gross supply was offset by redemptions. High redemption volumes in the Pfandbrief market caused the German covered bond market to shrink by 13%.

> CHART 4: CHANGE OF AMOUNT OUTSTANDING COVERED BONDS BY COUNTRY EUR BENCHMARK ISSUES ONLY

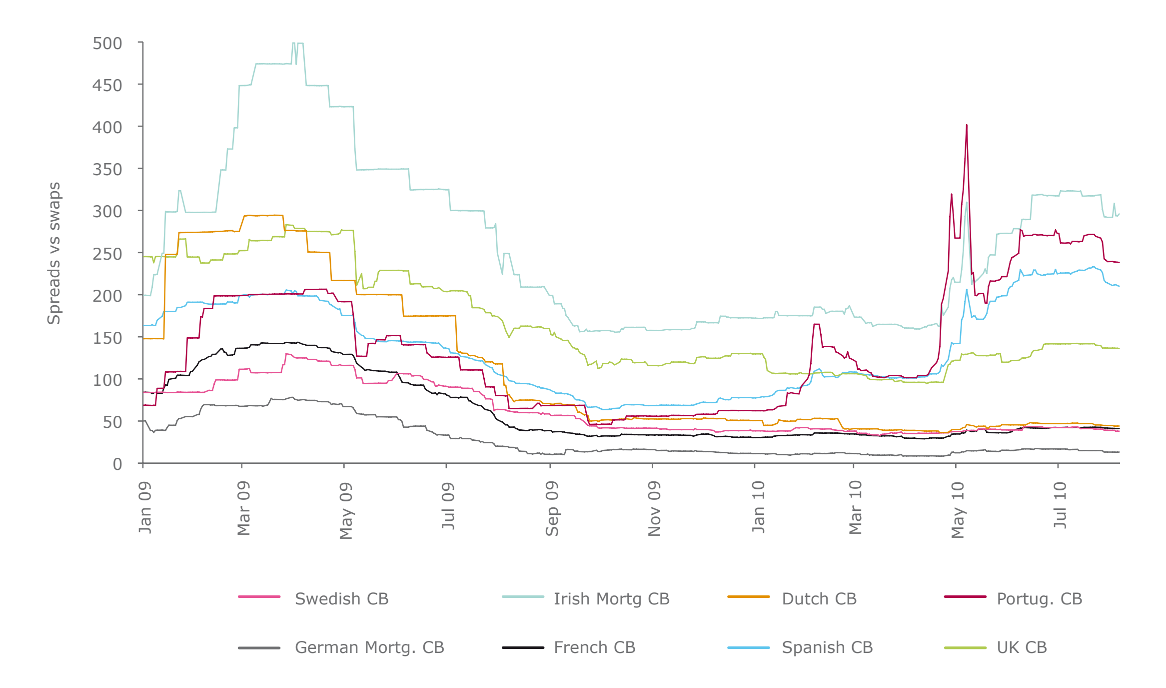


Source: RBS

HAS THE ECB ACHIEVED ITS OBJECTIVES?

Even prior the ECB announcement of its purchase programme, covered bonds spreads had already begun to tighten. However, the mere announcement on 7 May 2009 instantly lowered the quoted spreads of covered bonds across all jurisdictions by a margin, even though details on which bonds would be included in the CBPP were not known. With the actual start of the purchases in July 2009 covered bonds inside to the CBPP started to outperform covered bonds that were not included in the programme. Secondary market spreads of Pfandbriefe – the most expensive market segment before the crisis - tightened by close to 40bp, Obligations Foncières by around 70bp, whilst other covered bonds such as the Dutch and Irish outperformed swaps by more than 130bp and 160bp respectively from May to December 2009. Overall, covered bonds outside of the CBPP also performed impressively with UK covered bonds coming in by 100bp and the Swedish close to 60bp.

> CHART 5: SPREAD DEVELOPMENT OF SELECTED 5-YEAR COVERED BONDS AGAINST SWAPS



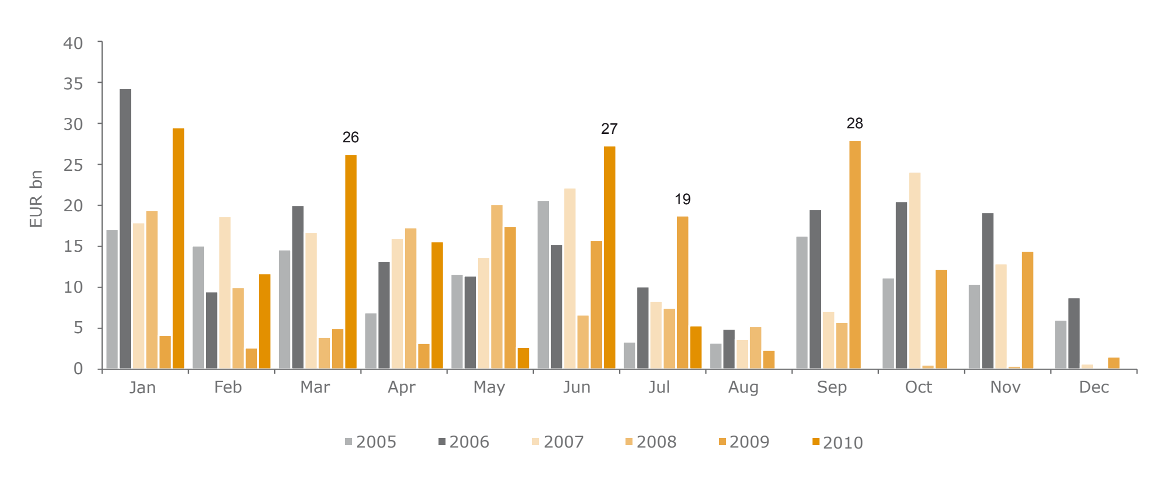
Source: RBS

The primary market impact was exceptional. The first four months of 2009 were dominated by government guaranteed bank bonds (GGBs) and negligible covered bond issuance. In May, the CBPP announcement accelerated the recovery of the covered bond market while general market conditions had begun to improve in April. GGB supply petered out as demand for non-guaranteed debt returned. Benchmark covered bond issuance jumped to record levels for four of the 13 months since the announcement in May 2009. Moreover, the first quarter and the first half of 2010 achieved new record supply volumes.

The immediate success achieved by the ECB in the primary market and secondary markets took a while to feed into turnover volumes. While the lack of liquidity before May 2009 stemmed from more sellers than buyers in covered bond market - which was mirrored in the massive spread widening we had witnessed - the tide turned the other way after the CBPP announcement. Spreads in the secondary market rallied attracting even more buyers. This means that the new state of affairs was liquidity being absent due to the lack of sellers.

As the year progressed the situation eased a little and the number of two-way flows increased as investors started to take profits at the tight levels and switched into bonds offering higher pick-ups, both in the secondary market as well primary markets. Due to the bias of the CBPP towards German and French names in particular, some of them seemed to have tightened more than fundamentally justified while other covered bonds have not felt much of the benefit in the secondary market. Markets were shaken up by the sovereign crisis in the first half of 2010 and liquidity dried up again only returning slowly as spreads started to rally on the back of the publication of the bank stress test results and particular due to the watering down of the Basel III requirements in the Basel Committee paper released in July 2010.

> Chart 6: Historic covered bond supply by month four record months since the CBPP was announced



Source: RBS

CONCLUSION

So was the ECB's covered bond purchase programme a success?

Measured by its own four objectives as stated at the beginning of the CBPP, the ECB was certainly successful in achieving three of them. Firstly, the funding conditions for credit institutions and corporates were undoubtedly eased as shown by the record covered bond supply volumes driven by the initial spread rally which, secondly, lead to improved liquidity conditions in the covered bond market as discussed above. The achievement of 'the ongoing decline in money market term rates' is undisputed. Whether credit institutions did maintain and expand their lending activities is hard to gauge from the outside in an environment where banks are rather looking to downsize their balance sheets, though we believe that the retracement would have been worse without the programme.

Finally, the CBPP was certainly a success with regards to the covered bond market. We believe that it would have recovered without the help of the ECB but neither in such a short amount of time, nor to the same extent. The impact of the CBPP purchases was two-fold.

Firstly, the actual buying of covered bond paper in the primary and secondary market had the aforementioned positive effects on spreads and supply volumes. Secondly, it helped to improve and/or reinstall the confidence in the covered bond product following the massive spread widening (which was partly driven by concerns about the issuers and the collateral pools but also to a large extent by the crowding out through government guaranteed bank debt). Following the ECB announcement in May 2009, covered bonds once again became an attractive funding channel for banks allowing many of them to cease their government guaranteed issuance, which in turn helped to alleviate the crowing out effects. Moreover, during the current sovereign debt crisis, the covered bond market was among the first markets to reopen allowing banks to fund at attractive levels, whilst the unsecured market remained more or less closed during June 2010.

The only caveat has been the domestic bias of the purchases by the national central banks which   based on the flow we saw and other anecdotal evidence   bought primarily paper from issuers out of their own countries. Hence, the German, French and Italian issuers benefited disproportionally whilst the Greek, Spanish and Portuguese markets, despite having arguably the highest needs, received less support due to their lower outstanding covered bond volumes.

The end of the covered bond purchase programme has not resulted in a significant spread widening. The market had plenty of time to adjust to a world without a covered bond purchase programme and the ECB statement that they will hold the bonds until maturity has removed market concerns that at some stage the market will be swamped by the ECB paper. It seems that the covered bond market has recovered and can now function without the help of the ECB. However, we believe that many European banks will continue to rely on the ECB for its wholesale funding over the coming years and that the ECB support in terms of repo facilities can only be withdrawn gradually.

1.3 COVERED BONDS AND THE ERA OF REGULATION: SPOTLIGHT ON LIQUIDITY

By Ralf Burmeister, LBBW, Fritz Engelhard, Barclays Capital and Frank Will, RBS

Regulation is without doubt a major topic these days in financial markets. One of the many challenges within this topic is to produce a statement on regulation which fits into an annual Fact Book without being outdated by the time the book is printed. We therefore chose to shed some light on the process around liquid assets and the liquidity banks will be required to hold as a consequence of the Basel III process as we believe it is a good example of how regulation evolves over time. In addition, looking at the replies from the industry to the consultative paper on liquidity, it is also a good example for problems that might arise within a one-size-fits-all regulation approach.

Liquidity rules

In December 2009, the Basel Committee on Banking Supervision (BCBS) published a consultation paper on the 'International framework for liquidity risk measurement, standards and monitoring'. The consultation period closed mid-April 2010. The Basel Committee received plenty of feedback from various market participants and interest groups such as the ECBC, the ACI, the European Banking Federation, and numerous other national banking associations. The tenor of the responses was often critical, questioning the reasoning behind the classification of liquid assets and the suggested haircuts as well as assumed roll-off rates of certain assets. The BCBS took some of the criticism on board and published in mid-July several amendments which lowered the requirements for banks. The final rules are expected to be published before year-end 2010.

The consultation paper defines minimum short-term and long-term liquidity levels for banks by introducing a liquidity coverage ratio and a net stable funding ratio (see box 1). The liquidity coverage ratio requires banks to hold a stock of unencumbered[1] 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. The standard requires a minimum amount of funding that is expected to be stable over a one year time horizon. This required amount varies by the quality and maturity of the assets in question and each asset class is assigned a Required Stable Funding (RSF) Factor. This RSF factor defines the minimum amount of stable funding for each particular asset class, which is naturally higher for riskier assets.

> Box 1: Proposed New Liquidity Rules

Liquidity Coverage Ratio:

$$\frac{\text{Stock of high quality liquid assets}}{\text{Net cas outlflows over a 30-day time period}} \geq 100\%$$

Net Stable Funding Requirement:

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} > 100\%$$

1 "Unencumbered" is defined as "not pledged wither explicitly or implicitly in any way to secure, collateralise or credit enhance any transaction and not held as a hedge for any other exposure".

Initially the Basel Committee suggested two definitions of high quality liquid assets. The narrow definition included cash and central bank reserves, as well as "marketable securities representing claims on, or claims guaranteed by, sovereigns, central banks, non-central government public sector entities (PSEs), the European Commission, and multilateral development banks" subject to the following criteria being fulfilled:

(a) they are assigned a 0% risk weight under the Basel II standardised approach;

(b) deep repo markets exist for the securities; and

(c) the securities are not issued by banks or other financial services entities.

Under the wider definition, the range of assets included both corporate and covered bonds. These would have received substantial haircuts of 20% for bonds rated at least AA and 40% for those at least A- and notably against the market value of the assets. The portfolio would also have to have been diversified and not comprise more than 50% of the overall stock.

With regards the net stable asset ratio, the assessment is broadly similar. Sovereign debt and cash would receive a 0% RSF factor. For multilateral development bank debt (rated at least AA), European Commission debt and debt from PSEs the RSF factor would be 5% if the assets have a 0% risk weighting under the Basel II standardised approach and are traded in active repo markets. Covered bonds and corporate debt rated at least AA and fulfilling certain other requirements such as being a reliable source of liquidity and are traded in large, deep and active markets would get a RSF factor of 20%. Lower rated covered bonds and corporate debt (rated A- or higher) would face a higher haircut.

The Basel Committee defined the fundamental characteristics of high quality liquid assets. Based on the criteria set out in Section 29 of the consultative document, the below table was created with the criteria applied to the covered bond market.

Table 1: Fundamental characteristics of section 29 consultative documents applied to the covered bond market

Criterion	Applies to Covered Bonds
1) Low credit and market risk	
> High credit standing of the issue	> Yes, covered bonds are usually rated AA or higher
> Low degree of subordination	> Yes, preferential claim on cover pool assets plusrecourse against the issuer ranking pari passu tosenior unsecured investors
> Low duration, low volatility, low inflation risk, convertible currency	> Yes, in line and partly better than government bonds from Eurozone periphery
2) Ease and certainty of valuation	
> Wrong-way risk	> No, as insolvency remoteness and special law ensure credit quality of cover pool. In contrast, correlation of 91% with government bonds (Source: iBoxx index data between July 2006 and March 2010)
> Exotic product	> No, track record since the late 18th century

3) Low correlation with risky assets > Wrong-way risk	> No, as insolvency remoteness and special law ensure credit quality of cover pool. In contrast, correlation of 91% with government bonds (Source: iBoxx index data between July 2006 and March 2010)
4) Listed on exchange market	> Yes, although the majority of trading turnover does not necessarily take place there
5) Active and sizeable market > Outright sale and repo > Market breadth and market depth	 > Yes, there are deep repo market for covered bonds > Yes, is given, simply looking at involvement of central banks as market participants
6) Committed Market Makers	> Yes, although market making is not enforceable
7) Low market concentration	> Yes, investor base ranges from large accounts to small asset managers, see e.g. granularity of order books
8) Committed Market Makers	> Yes, see high correlation with government bonds

Source: Basel Committee, ECBC

As mentioned above, in response to the negative feedback the Basel Committee received after publishing its consultation paper in December 2009, the proposed liquidity buffer rules were recalibrated in July 2010 by the Committee. The amendments included revisions to the definition of qualifying liquid assets and adjustments of the recognition assumptions on the liability side. Under the liquidity coverage ratio (LCR) rules, roll-off rates for retail and SME deposits were lowered as well as those for senior unsecured funding. On the asset side, the Committee introduced a two-tier structure of liquid assets. The narrow definition of liquid assets remains in line with the December 2009 proposal including sovereign debt and explicitly guaranteed agencies as well as supranationals (though non-0% risk-weighted domestic sovereign debt issued in foreign currency can be included under certain circumstance). In addition, there is a new group of 'Level 2' liquid assets which can make up 40% of the total liquid assets. The original proposal had a 50% limit in place. These 'Level 2' assets can comprise 20% risk-weighted debt from government and other public sector entities as well as high quality covered bonds and corporate debt rated AA- or higher. All 'Level 2' assets would be subject to a 15% haircut. The original proposal suggested a 20% haircut for AA or higher rated bonds and a 40% haircut for lower rated bonds. These amendments are therefore positive for the banks as the rating limit for high quality bonds was lowered by one notch and the haircut reduced by 5 percentage points. However, the removal of the eligibility of the lower rated assets is partly offsetting this positive impact (see table below for an overview on the major amendments). Furthermore, we note that within Level 2 assets, triple-A and double-A rated covered bonds will compete with single-A rated 20% risk-weighted public sector debt, which does not need to fulfil the additional eligibility criteria applied to covered bonds. As these public sector exposures regularly offer a higher yield than many covered bonds, they might be the preferred investments, although from a liquidity perspective they should not be in the same liquidity bucket. Table 1: Fundamental characteristics of section 29 consultative documents applied to the Covered Bond market

Table 2: Overview of selected amendments of the initial proposal

Revised Definition of Liquid Assets		
Criteria	**Original Proposal (17 December 2009)**	**Amendments (26 July 2010)**
Assets Side		
Definition of Liquid Assets	Corporate and covered bonds are not part of the narrow definition of liquid assts. Wider definition includes corporate and covered bonds rated at least A-.	Narrow definition comprises only cash, central bank reserves government debt, and supras & agency paper but neither corporate nor covered bonds. However, 'Level 2' assets are corporate and covered bonds rated at least AA-
Cap for certain liquid assets	50% cap on corporate and covered bonds; portfolio needs to be diversified	40% limit for 'Level 2' assets; no explicit mentioning of any diversification requirement (but final rules will likely include such a requirement)
Haircut for assets	> 20% for corporate and covered bonds rated AA or better > 40% for corporate and covered bonds rated A or better	15% for 'Level 2' assets, i.e. corporate and covered bonds rated at least AA-
Large, deep, active markets	Covered bonds: bid-ask yield spread has not exceeded 50bp during the last 10 years	Unchanged
Reliable source of liquidity	Maximum decline in price or haircut over a 30-day period during the last 10 year (or during period of significant liquidity stress) not exceeding 10%	Unchanged
Liability Side		
Retail & SME deposits	Run-off rate floor or retail and SME deposits of 7.5% (stable) and 15% (less stable)	Run-off rate floor or retail and SME deposits of 5% (stable) and 10% (less stable)
Unsecured funding	For unsecured funding, sovereigns, central banks and PSEs have the same roll-off rate as financial institutions of 100%	For unsecured funding, all sovereigns, central banks and PSEs have the same roll-off rate as corporates of 75
Secured funding	For secured funding backed by assets (excluding government debt and supra & agency paper) assume a 100% roll-off rate.	For secured funding backed by assets that would not be included in the stock of liquid assets, assume a 25% roll-off of funding.

Source: Basel Committee

Surprisingly, the Basel Committee still intends to introduce the Net Stable Funding Ratio (NSFR) despite heavy criticism from various market participants (and market rumours that the NSFR will be skipped completely). Though the Committee admitted that the initial proposal needed to be modified, in particular regarding the calibration of the standard and the relative incentives across certain business models. They also plan to publish a more detail set of proposals on the NFSR by the end of 2010. More importantly they introduced an "observation phase to address unintended consequences" and postponed the introduction of the NFSR until the beginning of 2018. This would gives banks plenty of time to adjust their balance sheets to the new regulation and maybe more importantly leaves the door open for the Committee to drop this controversial ratio altogether if it proves to be ineffective.

Table 3: Overview of potential changes to the Net Stable Funding Ratio

Potential changes of the Net Stable Funding Ratio		
Criteria	**Original Proposal (17 December 2009)**	**Amendments (26 July 2010)**
Transition phase	Rules to be finalised by the end of 2010 with the aim of implementation by end-2012	Observation phase to address unintended consequences" and postpone the introduction of the NFSR to the beginning of 2018
Retail and SME deposits	Available Stable Funding (ASF) factor for stable and less stable retail and SME deposits of 85% and 70%	Available Stable Funding (ASF) factor for stable and less stable retail and SME deposits of 90% and 80%
Mortgages	Required Stable Funding (RSF) factor of 100% for residential mortgages (and other loans that qualify for the 35% or better risk weight under Basel II standardised approach)	Required Stable Funding (RSF) factor of 65% for residential mortgages (and other loans that qualify for the 35% or better risk weight under Basel II standardised approach)
Commitments	RSF of 10% for off-balance sheet commitments	RSF of 5% for off-balance sheet commitments
Additional aspects		Partly recognition of matched funding within the one-year time frame and other structural changes possible
Liability Side		
Retail & SME deposits	Run-off rate floor or retail and SME deposits of 7.5% (stable) and 15% (less stable)	Run-off rate floor or retail and SME deposits of 5% (stable) and 10% (less stable)
Unsecured funding	For unsecured funding, sovereigns, central banks and PSEs have the same roll-off rate as financial institutions of 100%	For unsecured funding, all sovereigns, central banks and PSEs have the same roll-off rate as corporates of 75
Secured funding	For secured funding backed by assets (excluding government debt and supra & agency paper) assume a 100% roll-off rate.	For secured funding backed by assets that would not be included in the stock of liquid assets, assume a 25% roll-off of funding.

Source: Basel Committee

Level 2 Assets

In order to qualify as 'Level 2' assets under the amended Liquidity Cover Ratio rules, covered bonds must satisfy all of the following conditions:

> Central bank eligibility for intraday liquidity needs or overnight liquidity shortages in relevant jurisdictions.

> Not issued by the bank itself.

> Low credit risk with a minimum rating of AA-.[2]
> Traded in large, deep and active markets characterised by a low level of concentration. The bid-ask yield spread has not exceeded 50 bps during the last 10 years or during a relevant period of significant liquidity stress.
> Proven record as a reliable source of liquidity in the markets even during stressed market conditions: i.e., maximum decline of price or increase in haircut over a 30-day period during the last 10 years or during a relevant period of significant liquidity stress not exceeding 10%.

In particular the last two requirements are problematic in our view. First, there is a fundamental conceptual problem when trying to assess the liquidity of any kind of bond by its bid/ask spread. As the majority of bonds especially in the credit universe are still traded by so-called phone trading and not on electronic platforms, it is by no means a trivial task to determine the pricing source on which to base the assessment of bid/ask spreads. It is common business practice to quote different prices for bonds to different customers at the very same point in time which depends e.g. on the size of the trade requested. Therefore, the fair and objective observability of executable bond prices is questionable per se. In other words: it will almost be impossible to capture consistent and coherent bond prices for a market driven approach to determine the liquidity of a bond (i.e. the tradability of that particular bond) without a clear guidance of which pricing source to use.

Moreover, the wording of the consultation paper is ambiguous whether this set of rules shall apply to a single bond (i.e. each individual bond has to fulfil the criteria in terms of rating, bid/ask yield spread price stability), the issuer or the whole segment of the covered bond market. However, wording of the consultation paper could be interpreted that an issuer (or even the entire market segment) would not qualify anymore as soon as one covered bond surpasses the 50bp bid/ask spread threshold. As many countries have supported banks in Europe, thereby also supporting covered bond issuing institutions, a reference from one issuer to the national market as a whole would more or less lead to the exclusion of covered bonds as highly liquid asset as there are cases of troubled issuers in almost all relevant markets.

Tracking the bid/ask spreads for various bonds is very difficult as the majority of trading activity particularly during a crisis situation is via the phone. Using the data provided by iBoxx as of mid-August 2010, bid-ask spread of 70 covered bonds out of 458 have had bid-offer spreads of more than 50bp at one stage over the last five years3. This would represent about 15.3% of the covered bonds included in the iBoxx index. However, the actual bid-offer is most likely much lower than these figures indicated as it is only based on an average of quoted prices. The range of bonds with bid/ask spreads beyond the threshold includes several Spanish, Irish, UK and US covered bonds but also a few German and French names. Some of the bonds exceeded the 50bp limit on only one or two days.

Using the price history of a bond as proof for its reliability as a funding source is equally problematic. Firstly, the availability of such long historic spreads is often limited and secondly, it ignores that – particularly in a stress scenario   the price of a bond often depends on the actual trading size and the relationship status of the client.

2 The original proposal had different rating floors and haircuts. Covered bonds with a rating from by a recognised rating agency of at least AA would have been assigned a 20% haircut, whilst those with a rating of at least A- would have been assigned a 40% haircut. Bonds not rated by a recognised rating agency and are internally rated as having a PD corresponding to a credit assessment of at least AA or A-, respectively.

Based on iBoxx data (issue level, average of more or less accurate prices) as of mid-August 2010, the (mid) price of only 19 bonds out of the 458 covered bonds being part of the iBoxx € Covered Bond index declined by more than 10% over a 30-day period during the last five years.[3] That means that only 4.1% of the analysed bonds would not satisfy the proven track record required for 'Level 2' assets. Unsurprisingly, most of the bonds were issued by troubled issuers such as Northern Rock, Washington Mutual, and Hypo Real Estate Group, as well as National Bank of Greece's covered bond and a few Spanish and Portuguese names. The list includes several very long-dated Cédulas as well as CFF 3.875 Apr 2055 highlighting the problem of just focusing on the price as indicator. In the case of the ultra-long CFF bond, a relative small yield increase of just over 50bp would result in a price drop of more than 10% given the remaining maturity of 45 years. Changes of this magnitude happen often at the ultra-long end of the curve.[4]

Where to from here?

Given the aforementioned problems, we expect that the final rules will take some of the criticism from the various industry groups on board and will further improve the liquidity rules. The ECBC in its response to the consultation paper argued for a broad range of changes such as a closer link between central bank eligibility and recognition within liquidity standards in particular regarding the maturities of underlying assets. Within the consultative document, a haircut on highly liquid assets would be applied to all covered bonds irrespective of the remaining maturity of the respective bonds. This approach seems too static and too simplistic, because of potentially huge differences in pricing volatility with regard to the maturity of the various bonds under consideration. Also by referring to central banks' repo policy, it is evident that the haircuts on shorter maturities should be lower than on longer term maturities. Moreover, the requirements of the new liquidity rules are not only inappropriate, in our view, but also are not in practice either measurable or available over the required time frame as highlighted above. We therefore hope that final liquidity rules will be a more workable regarding the covered bond requirements.

3 Please note that the liquidity rules require a price and yield history of 10 years.

4 Based on Bloomberg data, the generic 30-year Bund yield dropped by more than 50bp during the 18 trading days between 12 May 2010 and 8 June 2010.

1.4 COVERED BOND RATINGS – MARKET VIEWS

By Franz Rudolf and Florian Hillenbrand, UniCredit and Jan King, LBBW

I. INVESTOR POINT OF VIEW

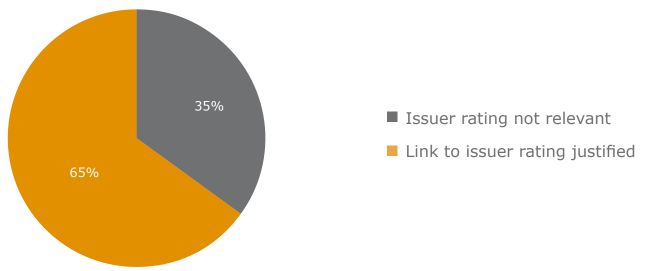
Back at the turn of the century, the covered bond market was far from being a triple-AAA market. However, the broadening of the issuer base and the competition of legal frameworks in particular in the years between 2005 and 2007 led to massive peer-pressure among issuers. The result was an almost purely triple-AAA market. Along with the issuer base, the investor base also increased. In particular for many of the new investors, but also for the old ones that in the meantime became accustomed to the champions' league rating situation, it was quite an experience that triple-AAA ratings for covered bonds were not written in concrete. This situation was aggravated when rating agencies started implementing liquidity stresses into their methodologies, which – in particular in combination with lower senior ratings for the issuer –resulted in stretched Aaa/AAA ratings or even multi-notch downgrades. This, in turn, had some knock-on effects on the choice of rating agencies. As indicated in the previous chapter, in particular the 2009 performance of S&P and also the results of changed methodology led many issuers to drop one agency and continue business with the two remaining or even replace one agency with another.

At the end of the day, many investors had to cope with questions of how to deal with (multi-notch) downgrades, how to deal with a changed rating setup and how to deal with structural solutions to keep higher ratings (such as soft bullet structures). As demonstrated in the next sub-chapter, the spread impact on covered bonds triggered by rating changes was quite limited, which reflects a very sober attitude which investors already had towards covered bonds in general. However, in order to gain a precise idea of how market participants think, LBBW conducted a survey of German and international covered bond players in Q1 2010. The following analysis is based on 60 questionnaires which LBBW received.

"Is the issuer rating relevant for covered bond ratings?"

All three agencies now use the issuer rating as a basis for rating covered bonds. Depending on the legal structure and significance of the national covered bond product, the rating may be capped at a level below AAA. The majority, namely two thirds, of the market players whom LBBW surveyed considered this approach to be reasonable. Only one third did not take account of issuer ratings in the analysis of covered bonds and therefore rejected the high degree of importance attached to them in the agencies' covered bond rating methodologies.

> Figure 1: Is the issuer rating relevant for covered bond ratings?



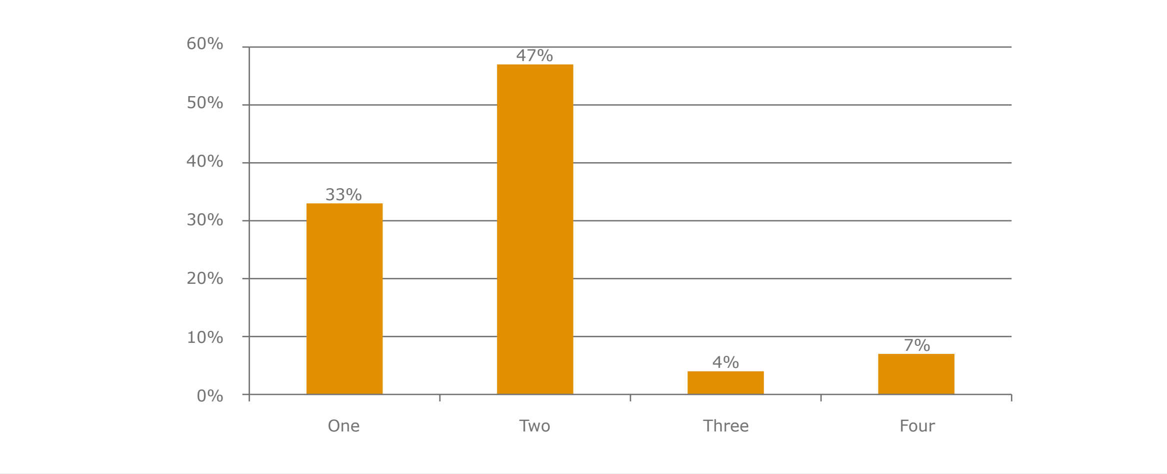
Source: LBBW Credit Research

"How many ratings are necessary - do all good things come in threes, twos or ones?"

Issuers only pay the agencies with a view to reaching a maximum number of investors with their issues. Prior to considering which agency should be preferred, it is first necessary to explore the question as to whether the three agencies' covered bond ratings are even comparable from market participants' point of view. If they are, then there is hardly any need for multiple ratings as this merely results in added expense for issuers without providing investors with any additional information.

Slightly more than three quarters of the investors LBBW asked felt that the agencies' covered bond ratings were not comparable. Therefore, it makes sense for issuers to select a combination of several agencies. That said, the vast majority of investors do not require ratings from all three agencies. LBBW's survey revealed that only 4% of investors expected ratings from all three agencies. More than 50% consider two to be the preferred number of ratings for covered bonds.

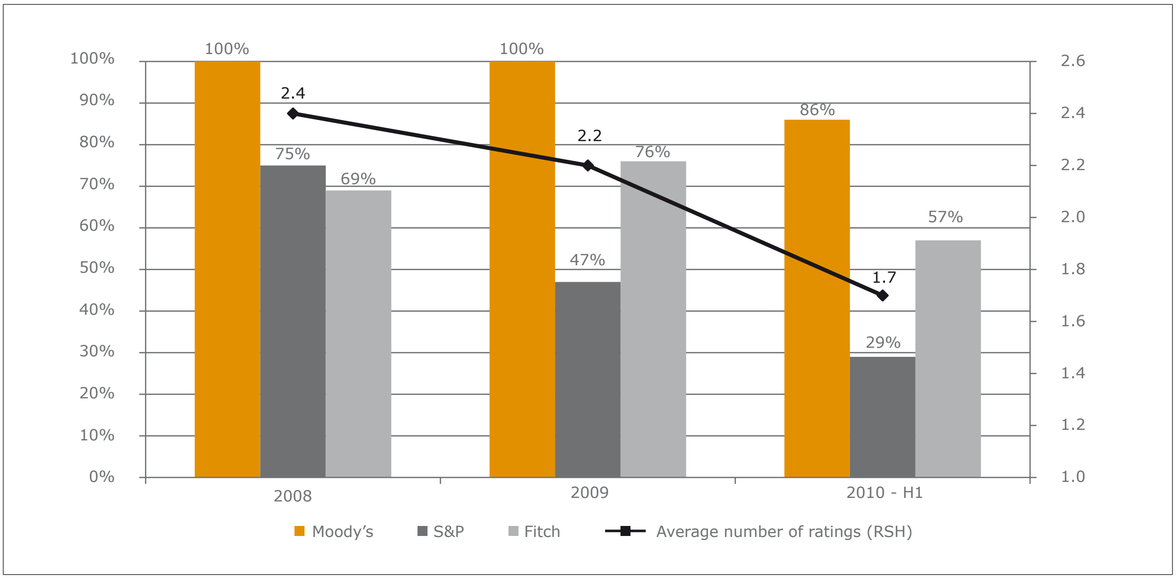
> Figure 2: How many ratings are required for covered bonds these days?



Source: LBBW Credit Research

Of the debut jumbo covered bond issues in 2009, only 42% had three covered bond ratings, down from 56% in 2008. In the first half of 2010, none of the debut jumbo covered bond issues was rated by all three agencies.

> FIGURE 3: MARKET SHARE IN COVERED BOND RATINGS FOR DEBUT JUMBO ISSUES (PUBLICLY SOLD TO THE MARKET) AND AVERAGE NUMBER OF RATINGS (RHS)

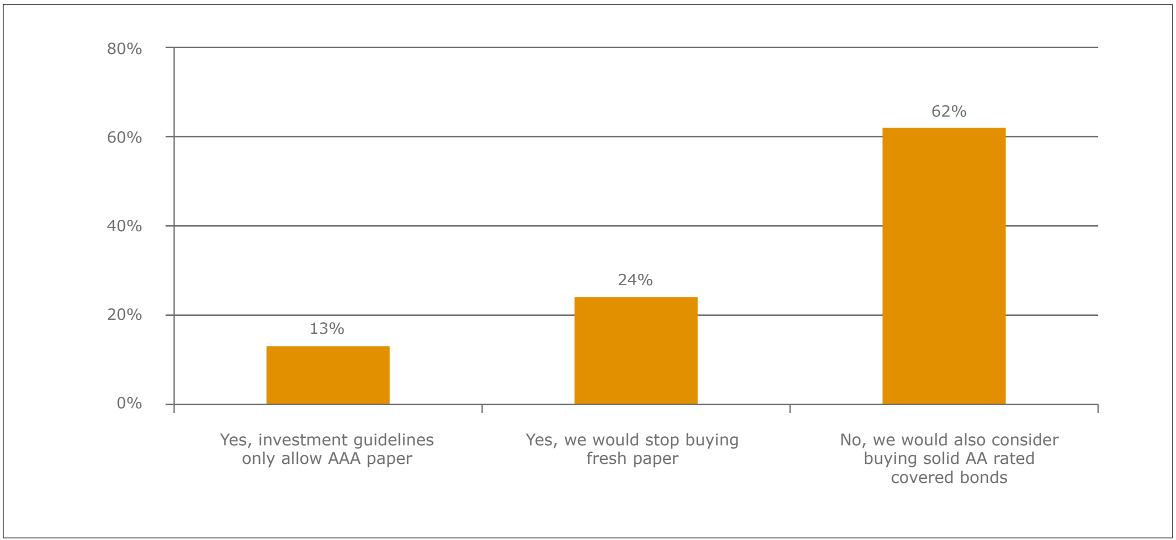


Source: Bloomberg, LBBW DCM, LBBW Credit Research.

Is it a concern if a covered bond loses its AAA rating?

The new or adjusted covered bond rating methodologies in conjunction with weaker issuer ratings have resulted in a number of rating downgrades for covered bonds over the past two years. This trend is likely to continue. What impact does this have on investors? Will this trigger a whole series of forced selling in the market in the future?

> FIGURE 4: IS IT A CONCERN TO YOU IF A COVERED BOND LOSES ITS AAA RATING?



Source: LBBW Credit Research

Of the surveyed investors, 13% stated that they have to dump non-AAA covered bonds. A further 24% said that, while they did not have to actively sell, they were not able to buy any new covered bonds with a sub-AAA rating. The majority (62%) said that they were fundamentally not affected by agencies' activities. As long as their own analyses do not identify any problems with a specific bond, these investors will also buy AA-rated covered bonds.

We feel that the covered bond rating tends to be relevant as a factor in cases in which there is already a high risk perception with respect to the particular sub segment of the market and fairly small issuers are concerned. Accordingly, there is a connection between spreads and ratings possibly caused by the 13% of those investors whom LBBW's survey found were required to actively sell in the event of any rating downgrade to below AAA. The greater risk which it is possible to identify from the responses in LBBW's survey stems from the just one quarter of the interviewees who are unable to engage in any new buying if the rating of the covered bond is below AAA. Together with the 13% who in any case are no longer permitted to engage in any activities with these instruments, this means that just over one third of LBBW's interviewees are no longer active in the primary market for these issuers' instruments. The likely upshot of this is that their new issues will be more difficult to place in the market or will result in wider spreads.

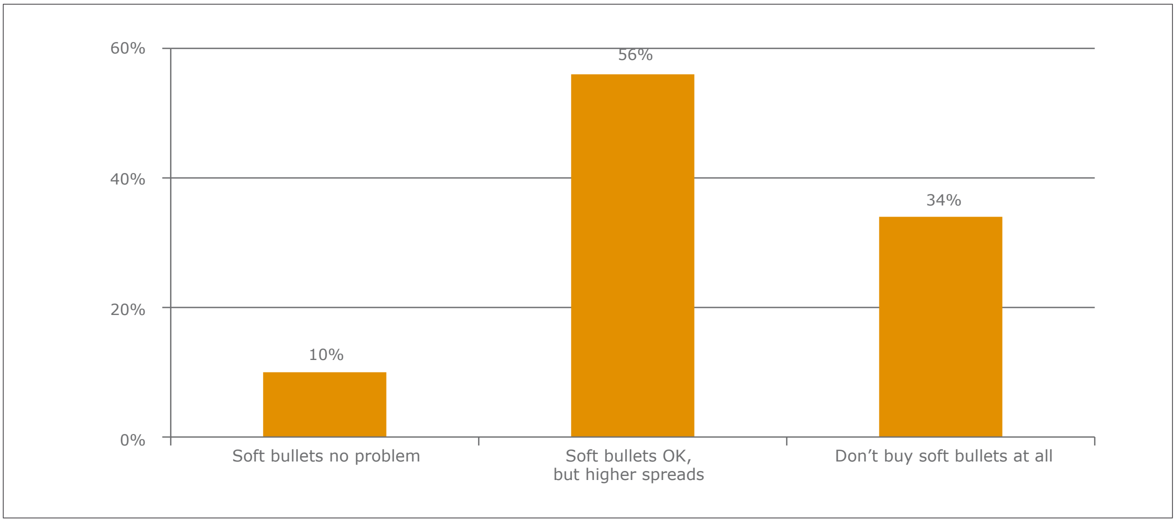
Soft bullets as the last resort - good or bad...?

In the medium term at least, ratings could thus make a difference in parts of the covered bond market. It therefore comes as no surprise to see that issuers are going to great lengths to preserve their AAA ratings. As long as the issuer ratings remain correspondingly high, this can generally be achieved by means of additional overcollateralization. As of a certain threshold, however (it generally becomes critical if the issuer rating gets close to the BBB range), this is no longer sufficient as the covered bond rating is limited by the issuer rating. The only option available in such a case is to improve the D-Factor in the case of a Fitch rating, to move into a higher timeliness payment indicator (TPI) category in the case of Moody's or to lower the ALMM risk in the case of S&P.

One key way of achieving this is to utilize a soft bullet structure or, if already in place, to prolong the period during which the maturity date can be extended. The likely result is the same with all three rating agencies, namely the possibility of a higher uplift of the covered bond rating above the issuer rating. From the investor's point of view, however, these rating-optimization efforts may be somewhat problematic. Thus, although the risk of default of the covered bond is lowered, at the same time, there is a heightened risk that repayment of the invested capital may be delayed (in contrast to using hard-bullet maturities with a pre-maturity test). In the case of insurance companies or pension funds, which synchronize their investments with their liabilities, this may give rise to a critical situation.

Thus, only 10% of the market participants admitted that they did not have any problems whatsoever with soft bullets and evidently do not demand any wider spreads for this additional risk. At 56%, the large majority of the investors whom LBBW questioned do not consider soft bullets to be problematic, although they do demand correspondingly higher risk premiums. 34% generally do not buy covered bonds with soft-bullet structures. The negative responses can be seen across all investor types, i.e. banks and fund managers as well as the aforementioned insurance companies and pension funds.

> FIGURE 5: HOW DO YOU VIEW SOFT-BULLET STRUCTURES FOR COVERED BONDS?



Source: LBBW Credit Research

Conclusion

Despite all the criticism levelled at them, rating agencies continue to play a crucial role for investors in the covered bond market. Thus, LBBW's survey showed that no market participant was willing to entirely dispense with agencies. Since more than three quarters of the investors LBBW asked find that each covered bond rating among the three rating agencies has its individual message, the majority of the polled market participants consequently require at least two ratings, albeit only 4% expect issues to be rated by all three rating agencies. The trend from three towards two ratings could be observed for debut jumbo issues, especially over the last year.

Soft-bullet structures are a way of avoiding a downgrade and have since become very common for covered bonds. Some of the market players LBBW questioned are critical of this development. On the other hand, the majority are not overly concerned, although they do demand higher spreads in such cases. One alternative which would doubtless meet with greater acceptance would, for example, be the availability of external liquidity facilities or cash funds with the issuer.

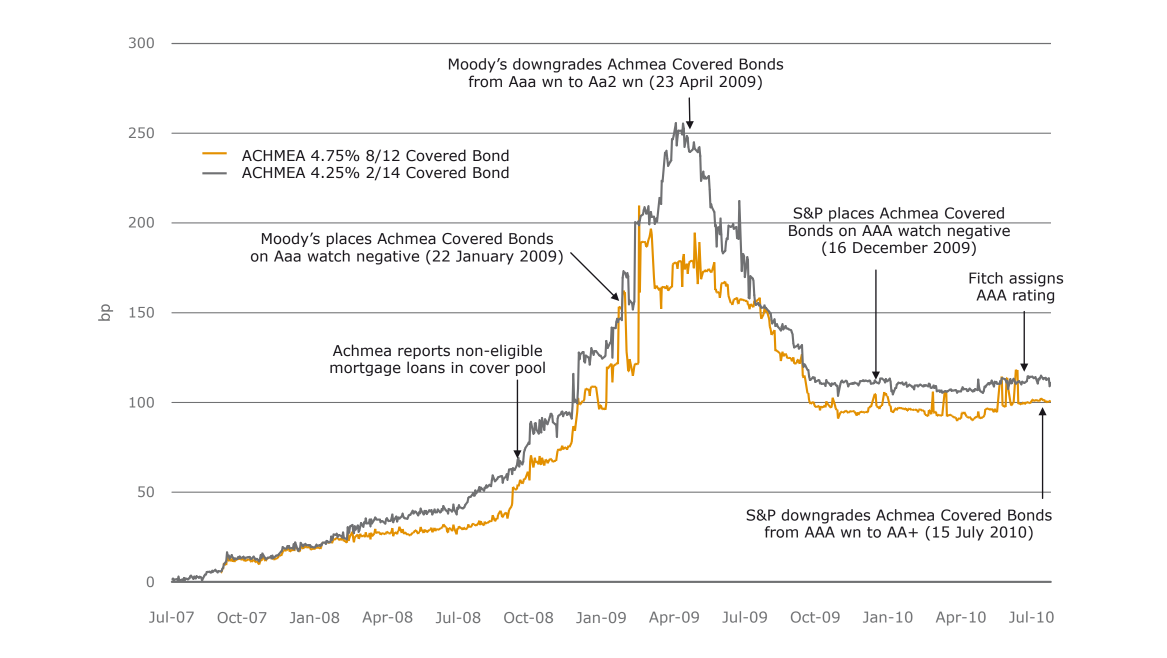
II. MARKET IMPACT OF RATINGS

In previous sections, we have shed some light on the possible impacts on, and reactions of investors and issuers to changes of rating agencies actions. In this section, we will analyze the quantitative effects of rating actions on spreads.

What is the market impact of rating actions? When taking a look at swap spread histories of covered bonds, the impact of rating actions actually seems limited. As a starting point, we identified covered bonds that were downgraded by S&P following the rating methodology change. We then considered rating actions of Moody's and Fitch with regards to these bonds, and analyzed spread movements in conjunction with relevant newsflow. The analysis showed that spread movements were not directly correlated to the announcement of rating actions. While a direct impact was not observable, factors such as a deterioration of the underlying credit quality, go hand in hand with spread movements and eventually rating actions – in many cases not directly attributable to a specific date. It was found that more directly assignable influences on spread movements were either sovereign related, sentiment driven, or fundamentally impacted.

Consider the example of Achmea covered bonds (Aa2s/---/AAAn), which saw significant spread widening (stronger than the Dutch covered bond index) in late 2008. Although the overall sentiment at that time (Lehman default 15 September 2008) was negative, the above average widening of Achmea's covered bonds was, in our view, largely driven by topics surrounding non-eligible mortgage loans in its cover pool. The downgrade of Achmea covered bonds from Aaa to Aa2 on 23 April 2009, actually came at the peak of spread widening. So the subsequent spread movements were positive and not negative as the rating action might have suggested. The independence of spread widening from ratings action is further demonstrated by the negative rating actions of S&P on December 2009 and on July 2010 and the first time rating by Fitch assigning a AAA. These actions were not followed by any spread reaction.

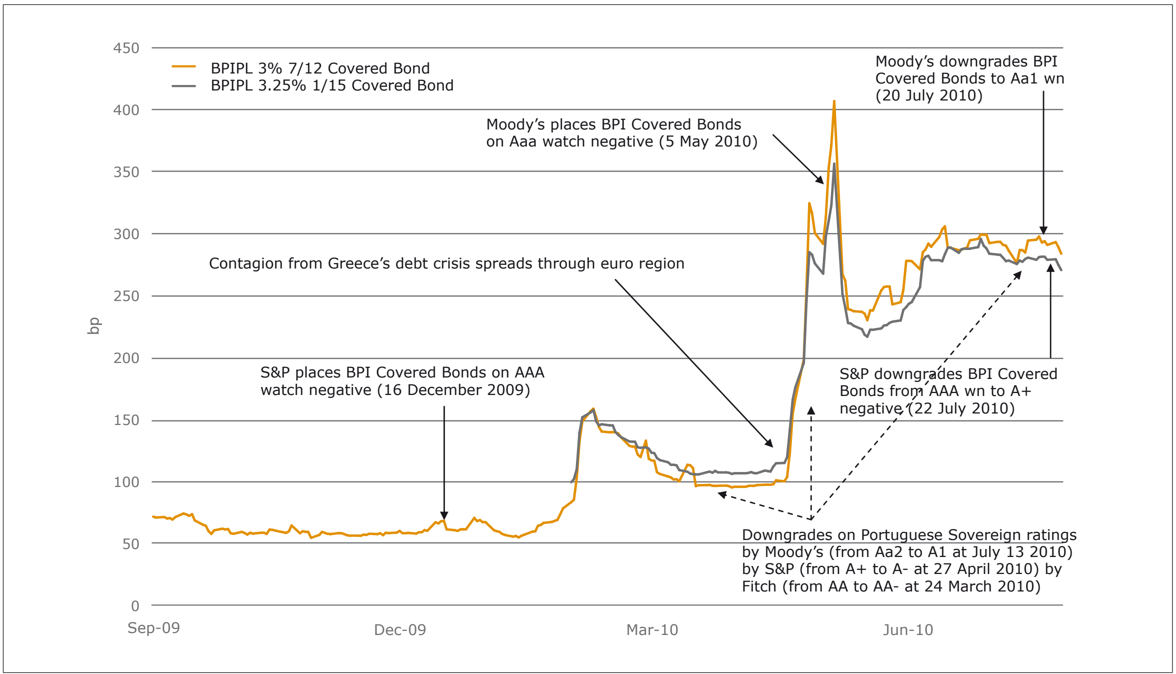
> FIGURE 6: SPREAD MOVEMENTS VS. RATING ACTIONS - ACHMEA COVERED BONDS



Taking a look at the covered bonds of the Portuguese BPI (Aa1n/A+n), correlation of spread movement to covered bond or issuer specific rating events is negligible. While the lack of spread reaction resulting from S&P's methodology change seems understandable (as it also applied to 97 other covered bond programs), spreads had no reaction to the downgrades by Moody's and S&P in July 2010. Only S&P's rating action on the Portuguese sovereign falls within the period of strong spread widening at the end of April. However, this does not apply for the rating actions by Moody's and Fitch on the Sovereign. The main spread driver for BPI's covered bonds were concerns on the overall sovereign debt crisis, which created a very negative sentiment for covered bonds in most periphery countries. Spreads of periphery countries and all the asset classes within Greece widened significantly in April 2010 as a result of the contagion risk from Greece's debt crisis gaining momentum. Consequently, BPI's covered bonds jumped from around 100bp over asset swap to almost 400bp within a few weeks.

Rating actions on covered bonds are not usually the product of a single event, but are more an outcome of a large number of factors and developments. Thus, the fact that a direct link between rating actions and spread movements is missing is not really surprising. This does not mean that ratings are irrelevant, however. It is just that the actual announcement of rating changes is usually not significant for bond prices.

> Figure 7: Spread movements vs. rating actions - BPI covered bonds

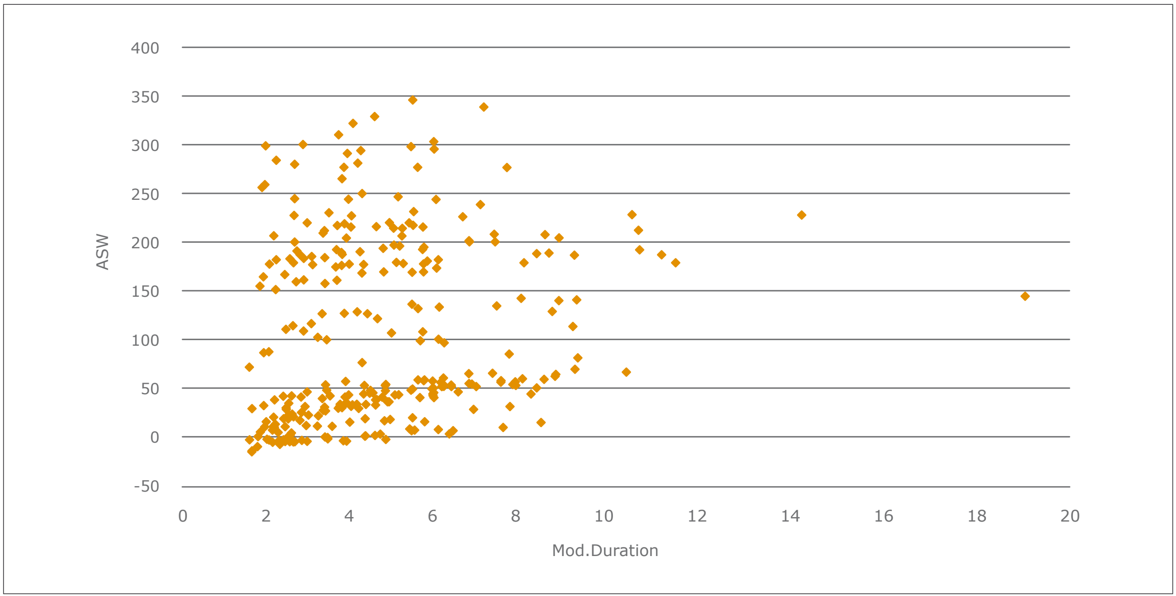


Apart from possible short-term reactions on rating changes, the long-term impact can also be assessed. The most suitable way to investigate this is using a regression analysis. Using a cross-sectional analysis, we analyzed the valuation of all Jumbo covered bonds of the twelve largest European Jumbo covered bond countries (Spain, Germany, France, UK, Sweden, Netherlands, Ireland, Portugal, Italy, Norway, Denmark and Austria) with a modified duration of at least 1.5 years. The asset swap spread is explained by way of a multivariate analysis using duration (actually the natural logarithm thereof), the country and the covered bond rating as explanatory variables. The collateral type (public vs. mortgage) was deliberately not considered as inclusion causes colinearity problems.

Using the natural logarithm of the modified duration has proven to be quite reliable in numerous estimations in the past and also finds a good reflection in the practice since the marginal damage of taking on more interest rate change risk should be diminishing.

An ASW (Asset Swap) plot of a hypothetical Aaa/AAA covered bond segment, demonstrates that investors no longer have an isolated view on ratings, if they ever had one. Consequently, a meaningful analysis also has to capture country specific information, which is achieved in the analysis by definition of a further set of country-related dummy variables.

> Figure 8: Aaa Segment



The "Aaa-segment" shows spreads between swaps -15 bp and +300 bp in the short end and +15 bp and also around +300 bp at the longer end of the cloud. Concerning ratings, the steps defined were Aaa/AAA, Aa1/AA+, Aa2/AA, Aa3/AA- and below Aa3/AA-.

Working with dummy variables always requires the definition of a reference group. In this case, German Pfandbriefe and the Aaa/AAA rating category were taken as references. The outcome was as follows:

The natural logarithm of the modified duration is a highly significant element explaining spread differentials. Taking account of all country specific dummies and also including rating differentials, a 1% extension of the duration leads on average to a 0.33 bp increase in the spread.

The impacts of country specific aspects are highly diverse. Using German Pfandbriefe as a reference, a Spanish covered bond with the same rating and the same duration offers an average pickup of 146 bp, UK covered bonds offer a 79 bp pickup while Swedish bonds only provide 8.38 bp more. The beta values for all country specific aspects meet the 95% confidence criterion by a large margin – with two exceptions: for Denmark and Norway, the statistical significance of the pickup offered over German Pfandbriefe is spot-on to meet the 95% confidence interval.

> Table of regression analysis with respect to countries

	Sweden	Spain	Portugal	Norway	Netherlands	Italy	Ireland	France	UK	Denmark	Austria
β	8.38	146.44	152.84	3.23	20.38	39.62	215.2	19.59	79.58	13	22.47
δ	3.9	3.74	7.22	1.63	6.57	8.3	8.1	3.82	5.12	6.52	10.09
t-statistic	2.15	39.16	21.17	1.98	3.1	4.77	26.57	5.13	15.54	1.99	2.23

Note: the R2 of the estimation is at 0.95. The F-Statistic of 331.07 at 314 degrees of freedom is also in an acceptable range.

With our reference category being Aaa/AAA, the beta values of the estimation define the pickup necessary to compensate for the respectively lower category.

In comparison to the Aaa/AAA covered bond and in combination with the country specific aspects, a duration neutral Aa1/AA+ rated covered bond does not show a statistically different spread differential. However, a gap of 42 bp opens up in case of a downgrade to Aa2/AA. The fact that the gap for a Aa3/AA- rated institution is 58 bp and therefore, a non-linear increase as compared to the pickup from Aa1/AA+ to Aa2/AA is of minor importance. On the one hand one might argue that rating downgrades also have a declining marginal impact, in the other hand, from a statistical point of view, the betas are not significantly different from each other. The same is true for the sub Aa3/AA- category. From this we can conclude that a two-class society exists: the Aaa/AAA and Aa1/AA+ club on the one side and everything else below.

> Table of regression analysis with respect to rating categories

	Aa1/AA+	Aa2/AA	Aa3/AA-	below Aa3/AA-
β	-0.3	42.27	57.94	49.34
δ	6.67	9.02	9.449	22.82
t-statistic	-0.04*	4.69	6.13	2.16

Note: the R2 of the estimation is at 0.95. The F-Statistic of 331.07 at 314 degrees of freedom is also in an acceptable range.

However, taking the outcome of an estimation without looking behind the scenes is only half the work. The above conclusion fits well with the intuitive feeling that investors do not consider the Aaa/AAA category as the holy cow, but they are also open to lower rating categories (see also the investors survey in the box). It must be noted that the overall investor base has a large German bias and German investors are always open to investments in Pfandbriefe – which is practically purely a Aaa/AAA Aa1/AA+ covered bond class. In a statistical analysis this could lead to a distorted result for the entire Aa1/AA+ segment. However, this can be remedied by omitting Pfandbriefe from the analysis.

> Table of regression analysis with respect to rating categories ex Germany

	Aa1/AA+	Aa2/AA	Aa3/AA-	below Aa3/AA-
β	11.91	45.17	50.11	50.67
δ	13.92	8.65	13.19	21.81
t-statistic	0.86*	5.22	3.8	2.32

The result, from a statistical point of view, does not change. As displayed above, in comparison to the Aaa/AAA category, the spread uplift of the Aa1/AA+ segment remains statistically not significant, while the other rating categories confirm the pickup in the mid-forties region at a sufficiently high confidence level.

The second element that needs further investigation is the sub-Aa3/AA- category. From an intuitive point of view, the insignificant difference between Aaa/AAA and Aa1/AA+ is acceptable. Furthermore, the almost equal pricing of the Aa2/AA and the Aa3/AA- category is intuitively acceptable, since the difference in covered bond ratings is often only a function of a lower D-Factor or a different TPI etc. and therefore issuers might have the same senior rating which supports the view of equal acceptance of the respective covered bonds. However, once a covered bond falls below the Aa3/AA threshold, indicates that the newsflow is no longer dealing with everyday problems but rather about existential issues. Either in the case of massive challenges for the issuer or the sovereign – in both cases investors hardly invest fresh money in the paper and turnover in the secondary market practically falls to zero. In such a scenario, intuition does not support an equally high spread pickup in comparison to the much better Aa2/AA and Aa3/AA- range.

Hence, a key in understanding this discrepancy is possible to be found in the quality of the quotes obtained: a quote backed by turnover is a more solid basis for the analysis than a purely taxed quote. On top of this, there is the problem of a very small basis for a statistical assessment of a sub Aa3/AA- category. A few hundred bonds in the double-A and above category are faced by single issues in the below Aa3/AA- category, which does not foster statistical significance. These two factors, the thin data basis in combination with the different pricing quality, actually lead to a rather unreliable result in the sub Aa3/AA- segment.

In a nutshell: in a cross sectional multivariate regression model, the impact of ratings on the pricing of covered bonds is significant. The effect relates more to the basis of rating clusters than single rating steps. The difference between the pricing of the Aaa/AAA category and the Aa1/AA+ category was not found to be significant. Furthermore, the pricing of the Aa2/AA and Aa3/AA- categories was not found to be significant. A rating change from the Aa1/AA+ category by one or two notches is associated with a spread increase of around 42 bp (see table of estimates above). From an absolute point of view, the 42 bp stemming from the rating just mentioned rating difference compares an additional pickup vs. Pfandbriefe (reference group) due to country specifics: for example the 215 bp for Ireland specific factors, 152 bp for Portugal or 146 bp for Spain. Even for Italy, the model quantifies country specific factors with 40bp. Hence, although statistically significant, rating differentials only explain a minority of the spread pickup stemming from peripheral covered bonds.

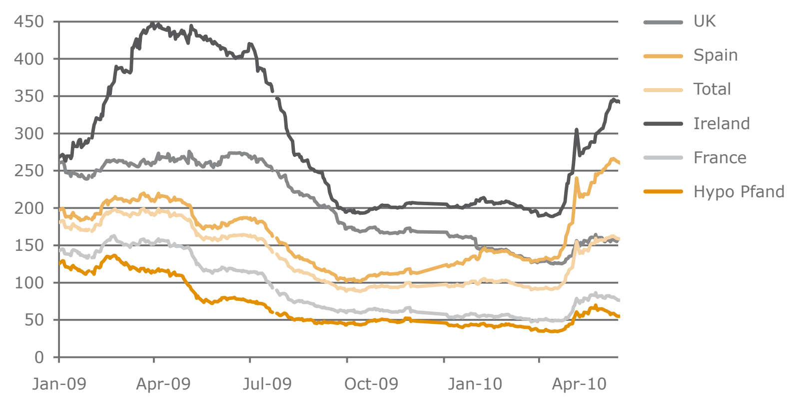
1.5 COVERED BOND PERFORMANCE AND SOVEREIGN SPREADS

By José Sarafana, Société Générale

Covered bonds are not immune to outside turmoil. Covered bonds have been severely affected in 2010, as they were in 2008. However, while in 2008 this was due to bank risk, this year it's all about sovereign risk. As EU- sovereign risk has increased, sovereign spreads have widened strongly, often trading more cheaply than covered bonds. Covered bond spread differences have also reached highs. Investors' behaviour has changed: they now begin by deciding which country to invest in, and only then which asset class - covered bonds or sovereign bonds.

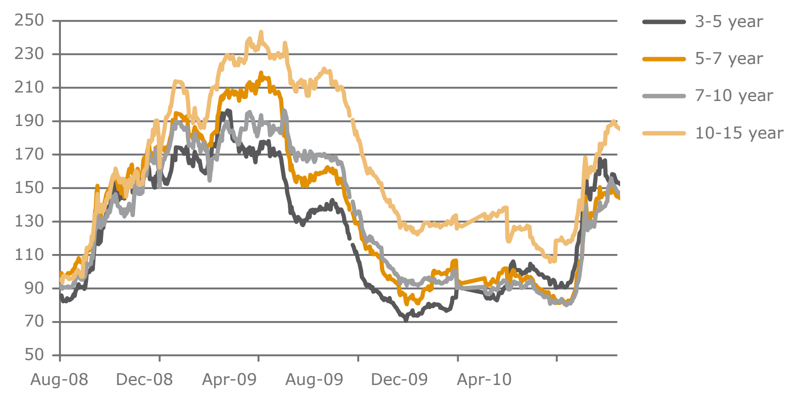
The current situation has created very strong spread differentiation between covered bonds issued in different countries – even between bonds issued by the same group in different jurisdictions.

> Graph 1: iBoxx € covered/Bund spread by country, bp



Source: IBoxx

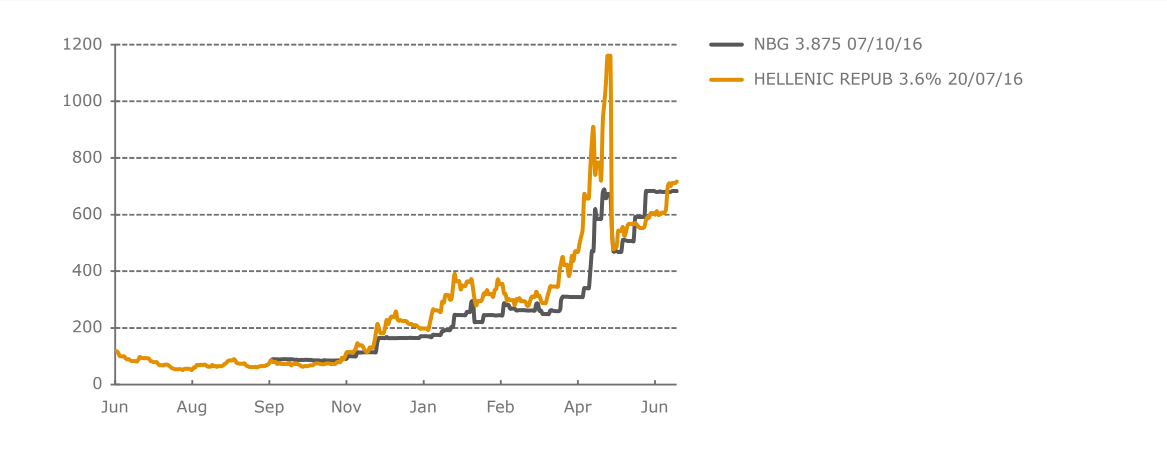
> Graph 2: iBoxx € covered/Bund spread by maturity, bp



Source: SG Cross Asset Research

It all started in September and October 2009, when the new Greek government announced that it had revised the 2009 budget deficit up to 12.4% of GDP. Past and future deficit numbers have also had to be corrected due to the "creative accounting" of the former Greek government. This led to a strong drop in investor confidence, as fund managers asked themselves whether Greece would be able to pay back its debt. Greek sovereign bond spreads began to widen in November, and the spread of the only Greek covered bond was also driven wider.

> Graph 3: Greek covered bond vs sovereign bond, z-spread, bp

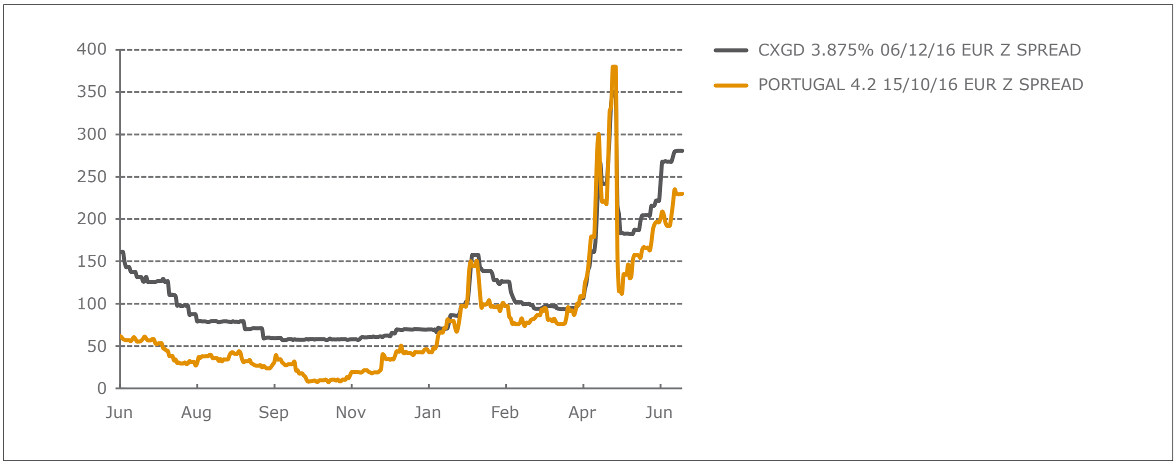


Source: SG Cross Asset Research

Investors could consider selling NBG covered bonds vs Greek sovereign debt with a similar maturity, if they are comfortable with the sovereign.

With a time lag of some months, we have seen similar moves in Portuguese Irish and Spanish covered bonds, as investors have also become concerned about these countries.

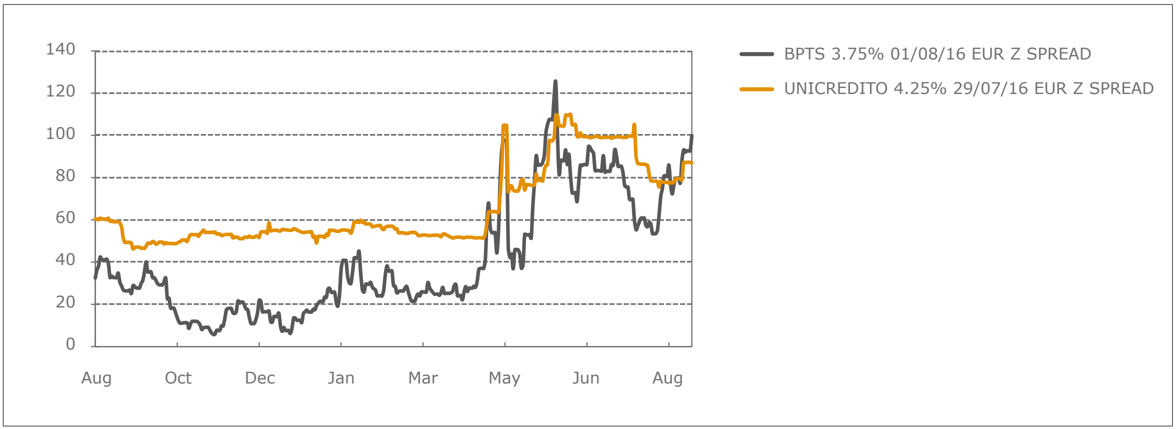
> Graph 4: Portuguese covered bond vs sovereign bond, z-spread, bp



Source: SG Cross Asset Research

From a pure credit point of view, sovereign and government-guaranteed bonds are safer instruments than covered bonds, which carry no explicit or implicit sovereign guarantee.

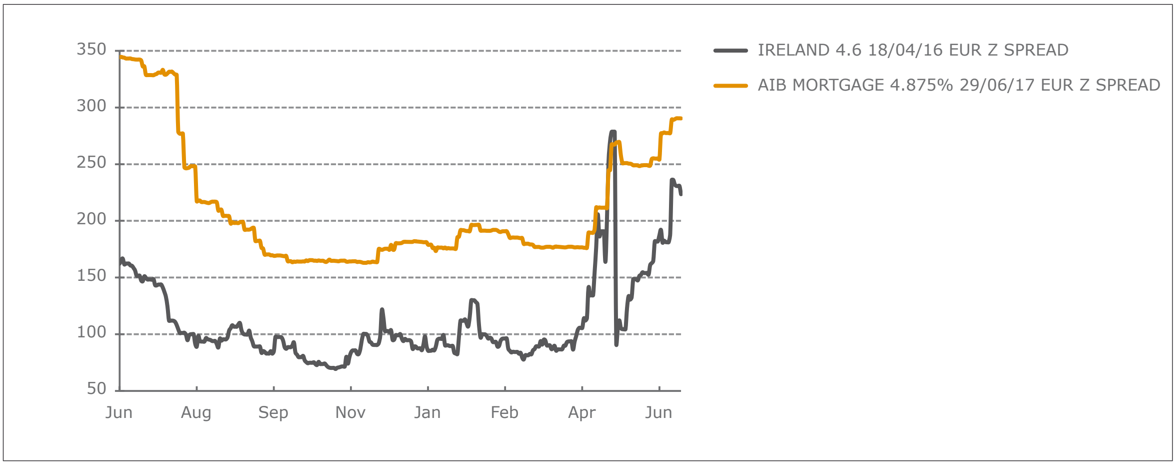
> GRAPH 5: ITALIAN COVERED BOND VS SOVEREIGN BOND



Source: SG Cross Asset Research

It could be argued that a covered bond trades richer than its respective sovereign because it is better rated. The rating limit for a covered bond is AAA, which is the rating of the eurozone as a whole, but not that of each of its individual members. For example, Caixa Geral covered bonds are rated higher than Portuguese sovereign bonds under the rating methodologies used by Moody's.

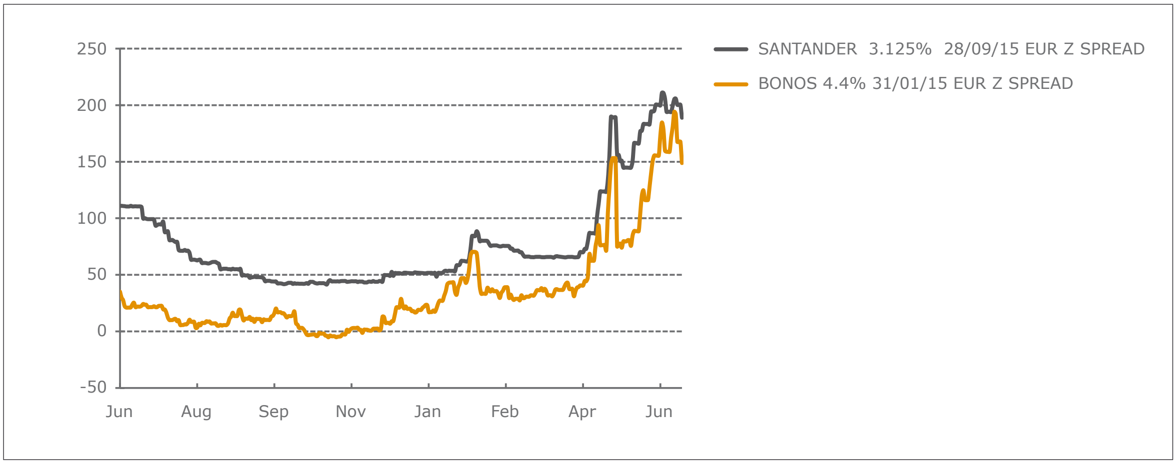
> GRAPH 6: IRISH COVERED BOND VS SOVEREIGN BOND



Source: SG Cross Asset Research

However, we do not think that ratings reflect realities to the full extent. If a state is in trouble, it could tax everybody - including covered bond issuers. So ultimately, the state always holds a stronger hand than a credit entity.

> Graph 7: Spanish covered bond vs sovereign bond

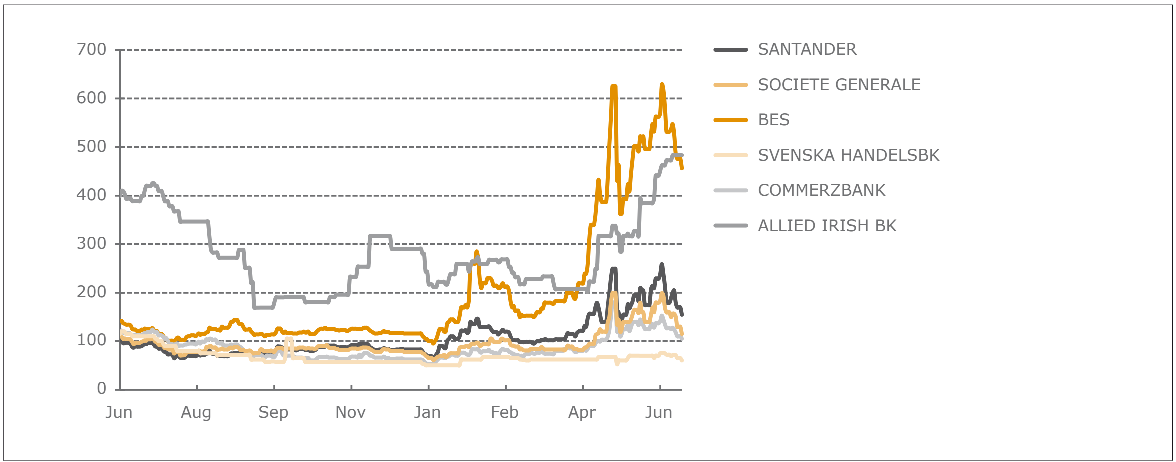


Source: SG Cross Asset Research

There is a second reason why sovereign and bank risks are linked. Banks usually hold large portfolios of their national debt. If sovereign creditworthiness were to be doubted, banks would also be directly affected. Bank CDS and their respective sovereign CDS trade in line to a surprising extent, as the charts below show.

The Portuguese bank is trading widest, followed by the Irish bank and then the Spanish one. The Swedish bank trades tightest, followed by the German and French banks.

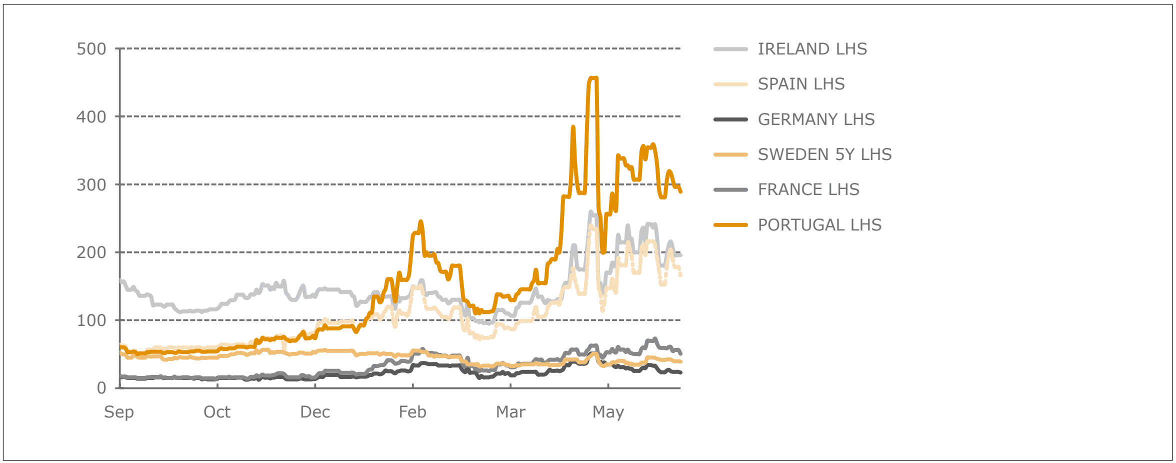
> Graph 8: 5-year bank CDS



Source: SG Cross Asset Research

Looking at sovereign CDS, the hierarchy is almost identical: Portugal, Ireland and Spain trade widest, followed by France, Sweden and Germany. We conclude from this that national risk is currently dominating investors' decisions, and that bank risk matters less.

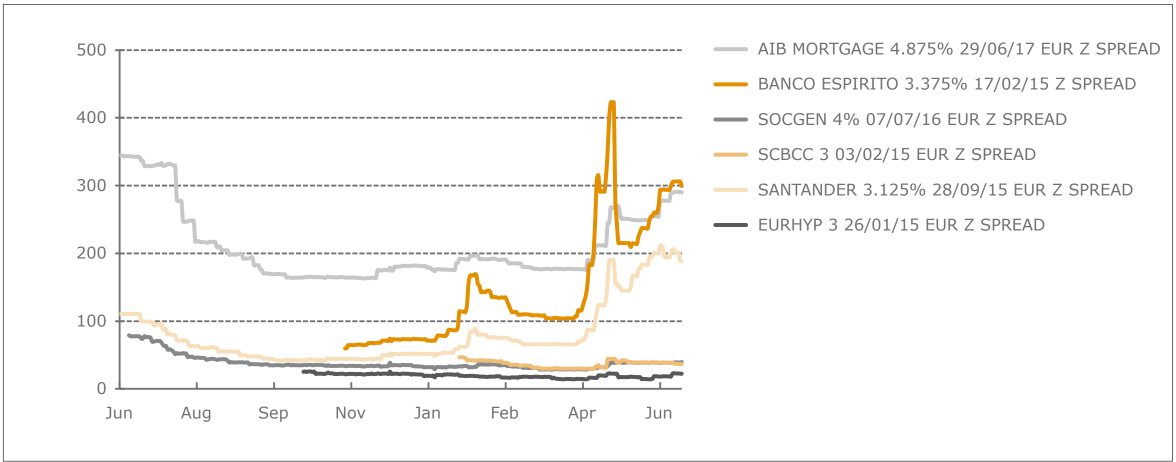
> Graph 9: 5-year sovereign CDS



Source: SG Cross Asset Research

Even current covered bond and sovereign spreads reflect this spread hierarchy.

> Graph 10: Covered bond credit curves, Z-spread bp



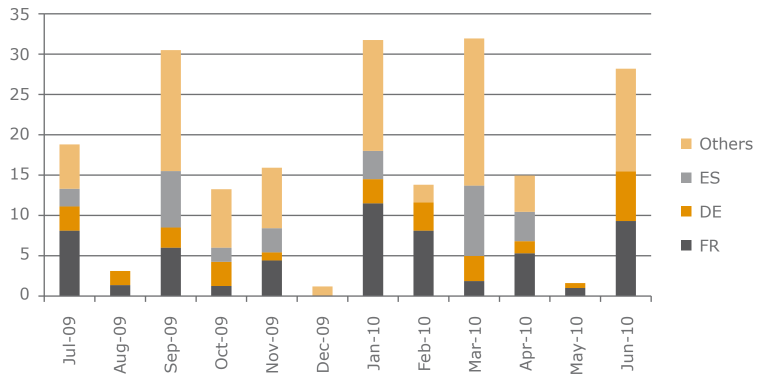
Source: SG Cross Asset Research

This has implications for the covered bond market as a whole:

1) **Pricing:** As national risk is the main pricing variable, investors are currently looking less than before at covered bond specifics (LTV limits, CRD compliance and covered bond ratings). Country economics are now the decisive input factor.

2) **Covered bond issuance:** High sovereign volatility renders covered bond issuance very difficult – as we saw in May, when there was almost no issuance. The composition of issuance has also changed. Covered bond issuers with stable sovereign markets have had a much easier time and have been able to increase their share of total issuance. Covered bond issuance has reached a record high of €110bn (YTD) at the time of writing. This demonstrates the extent of banks' need to use covered bonds for refinancing.

> Graph 11: Jumbo issuance per month



Source: SG Cross Asset Research

What if the current turmoil persists? Senior unsecured bank bonds are currently hard to sell, which puts banks under pressure to use covered bonds instead. But what about banks in countries which are caught up in sovereign turmoil? Government-guaranteed bonds are no solution, as investors often do not want to invest in any kind of assets linked to certain nations. There have been no attempts to issue government-guaranteed bonds out of Greece, for example, with sovereign bonds in trouble. The solution in Greece has instead been to set up covered bond programmes which are entirely sold or lent for repo transactions at the ECB. This refinancing is independent of investors' risk appetite. If the current sovereign turmoil should worsen, more banks in peripheral countries could follow Greece's example.

Outlook: The causes of the current spread distortion lie beyond the covered bond world, and we believe the solution will also come from elsewhere. Steps have been taken to curb the turmoil. A rescue plan for the peripheral countries has been set up, and fiscal consolidation is on the cards. All these efforts should improve risk sentiment.

Also, central bank support for covered bonds will not fall away entirely after the completion of the €60bn ECB purchase programme:

1) The ECB's bond purchasing plan is not limited to government bonds, and could easily be extended to covered bonds. It would make no sense politically for the European authorities to let the covered bond market go under after supporting it for a year;

2) European central banks have funds which are independent of the ECB purchasing programme. Even without an official statement on the issue, investment will continue.

1.6 SECONDARY MARKET LIQUIDTY

By Richard Kemmish, Credit Suisse and Sebastian Sachs, DZ Bank

(Lack of) secondary market liquidity

Liquidity is the most important argument in support of an investment in covered bonds! This statement, which was generally accepted at least until the outbreak of the financial crisis, is currently under scrutiny – as is in fact the whole issue of "liquidity". At that time, investors considered ample liquidity to be almost more important than the security and creditor protection offered to the buyers of covered bonds. The issuers marketed the covered bonds on the basis of the liquidity that is (apparently) always guaranteed through market making, leading to amongst other things, a scenario whereby most investors classified covered bonds as interest rate products – in other words, they were viewed as a Bund surrogate. Buying and selling at all times and in any amount proceeded without any problems (spread distortions). However, this raises the question as to whether the term liquidity at the time could really be compared with a sign of quality that should (must) generally apply to covered bonds, or did the efficient market bring about a wrong assessment that retaliated sorely in the course of the crisis?

At least the financial crisis demonstrated quickly that liquidity in its classic definition can and does disappear. Soaring swap spreads in the absence of underlying turnover led to a deficiency of market breadth and depth. The loss of liquidity hit the market so quickly that numerous investors were caught off guard. The market making in particular, which up to now guaranteed trading characterised by high liquidity, turned out to be a stumbling block. Holding fast for too long to binding buy and sell prices that were merely defensive prices in this phase contributed largely to the surge in spreads. The initial players already had reservations that they had been exposed to a myth for too long. Is it not the case that in times of crisis in particular, liquidity should do justice to its reputation as the greatest and most important asset for a functioning market and protect investors from problems? This was by no means the case.

Market making - a brief summary

Effectively, obligatory pricing no longer existed at the start of 2008, despite official confirmation to the contrary – a gentlemen's agreement, whereby no quote requests were sent to each other, was in place. However, the market making problems started quite quickly after the outbreak of the sub-prime and credit crisis in late summer 2007, even though the covered bond segment was spared, at least in the beginning.

Market making was partially responsible for the soaring swap spreads at the start of the crisis, when the first participating banks were forced to dispose of their positions. Given that virtually no bank had limits in place to purchase the bonds in questions, they were passed around like hot potatoes – and the swap spreads rocketed with every new query. Finally, the ECBC 8-to-8 Committee adjusted the bid/offer spreads and minimum volume on numerous occasions – albeit with only moderate success. In fact, market making was finally suspended temporarily in November 2007.

Since January 2008, the market was split officially as follows: the bid/offer spreads for covered bonds with a swap spread of less than 20 basis points were doubled and quoted for a volume of EUR 15m. Covered bonds with a higher spread featured a bid/ask spread that was three-times wider and for a minimum volume of EUR 5m. However, as we already described above, market making was de facto non-existent.

A final attempt to at least revive the pfandbrief segment was made on 1 September 2008. German jumbo covered bonds with a minimum remaining term to maturity of two years should feature three-times the bid/offer spreads for transactions up to EUR 15m. But then Lehman Brothers collapsed…

Initiatives to revive trading / enhance liquidity

The broad failure and consequently the suspension of market making after the outbreak of the crisis, and the corresponding drying up of liquidity on the secondary market, prompted numerous discussions and initiatives to counteract these circumstances. The so-called Packmohr plan commanded the most attention. This proposal involves transferring standard telephone trading to an electronic platform, to take into account above all the 'best execution' and greater transparency. The most significant difference to the standard market making to date should be where the participating traders would not be forced to continuously show binding bid and offer prices; rather, the system should function on the basis of a request-for-quote. Specific detailed information on executed trades should only be available to the investors. Other information should only be available to the other traders and other information in turn, only to the issuers. After an intensive discussion at the beginning it became clear quite quickly that implementation of the Packmohr plan was too difficult to be carried out in a short period of time. Then the discussions fizzled out.

Another initiative that was not launched until mid-2009 is a daily auction of covered bonds (as well as other securities such as agency bonds) on Eurex Bonds. This means that the market is shown a reliable price once a day - at least in the covered bonds, in which transactions are concluded in the course of the auction. However, one year down the road, there appears to be little support forthcoming for the auctions from the secondary market players – turnover is minimal.

The latest attempt to revive trading activity and therefore liquidity too was the announcement made by the European Central Bank to supply the market again with covered bonds that had been acquired within the scope of its purchase programme for covered bonds in the course of repo transactions. This would provide market participants with the opportunity to sell securities that they can borrow from the ECB. Short selling constituted an important part of the daily trading activities prior to the crisis. The high level of liquidity at that time could only be sustained since buying queries in covered bonds that were not held by the corresponding trader on his books could also be executed – a short sale in other words. However, the distortions on the financial market as the crisis continued to heighten meant that no trader dared to sell securities they did not hold – major uncertainty prevailed surrounding the price at which the bonds could be covered again at delivery. This eliminated an important component of the trading activities, which could not be restored to date.

Besides these initiatives that were launched to a more or less successful degree, distinctive investor trading was also being discussed increasingly by market players. They argued that the banks alone should not have to shoulder the blame, since they do not want or are unable to provide their balance sheets and therefore also liquidity to the secondary market because of stricter regulatory practice. Covered bond transactions among large investors could at least represent one step towards persuading more investors to dispose of their positions. This is namely where the root of all evil lies at the moment. Because of book losses or expectations of tighter spreads again in the medium term at least, investors are not or are only prepared to a very limited extent to dispose of a portion of their positions.

Looking back, it must be stated here in summary that after the suspension of market making, no solution has been found yet to restore the corresponding high level of liquidity (even if it is only a kind of pseudo-liquidity) to the market. Covered bond trading on the secondary market currently faces a dilemma whereby inadequate liquidity could lead to the threat of more and more market participants striving to trade on the primary market; it is a major cause for concern that positions might not be sold at satisfactory terms in the event of a sudden need for liquidity. The trading-related problems that are driving more and more players to question the covered bond market per se are impeding the opportunities for an active primary market to generate positive momentum for the secondary market.

The situation today

It is perhaps inevitable given the broader market conditions that secondary liquidity for covered bonds remains a long way behind what we as a market aspire to. At the time of going to press the volatility in markets in general, and southern European government bond markets in particular, remains near all time highs. As a consequence of this volatility the bid/ask spreads in many securities, even supposedly 'on-the-run' government bonds is exceptional, frequently exceeding 1 big figure. How can covered bonds be expected to trade at tight spreads while this situation remains?

Further, the days of live executable prices on several trading systems have yet to return, despite the work done by several of the trading systems to upgrade their offerings, the vast majority of covered bond trading takes place either via the brokers or via voice trading.

A further contributory factor is the inability of many market makers to take positions. As a reaction to the turmoil, risk managers have reduced trading lines, thus reducing the ability of the traders to take positions on their books and work them out over time. Traditionally trader balance sheets were the buffer of even large underlying flows of bonds, warehousing the positions until end buyers could be identified.

It would be misleading to say that trading is totally moribund. Whereas previously market making rules were 'one-size-fits-all', now a de facto tiering has emerged. There are some covered bonds with substantially better liquidity than others. Large, recently issued and well allocated bonds with lower spreads often see a two way market develop with bid/ask spreads emerge. Admittedly the spreads are wider than they used to be in the time of fixed market making commitments and the best two way markets are only to be found in the broker market, but at least there is a two way market.

Price transparency

Price transparency remains both a cause and an effect of the illiquidity. Because of the unwillingness of traders to risk firm on-screen prices (at least at bid/ask spreads that will not attract opprobrium from the issuers) it is difficult for any market participants, traders, issuers or investors, to know the actual fair value of any given bond.

One of the consequences of this is the often large gulf between new issue levels and secondary 'levels' (actually, indications). An issuer coming to market, particularly in a rare maturity, name or even jurisdiction, does not have the comfort of any meaningful secondary market comparables from which to start their pricing discussions. This combines with the increasing unwillingness of investors to participate in a soft-sounding process (the informal way in which syndicates and investors obtain an understanding of the actual demand for a bond ahead of an official launch) to create a cloud of unknowing around pricing. Price too tightly and risk a failed trade (with potentially disastrous publicity in the current environment), price too wide and you risk re-pricing the entire market wider. In recent months the market has seen worrying examples of both of these mistakes.

Post-trade price reporting

One of the major developments that will likely influence trading going forward is post-trade price reporting. The Committee of European Banking Supervisors (CEBS) and the ECB are both supportive of some form of reporting regime similar to that which exists in the US for credit markets.

Will it work for covered bonds? There are certainly many detractors and many technical hurdles to be overcome.

Those opposed to the concept cite the inability of market makers to exit large positions under conditions of high transparency. If traders can not trade a large holding without the entire market knowing about it and that price at which they own it, they will not be able to manage that holding over time. As a consequence they will be less willing to make aggressive bids for large positions and end investors will therefore get a worse service.

They also argue that an informational level playing field disincentivises precisely those trading houses who have made a large resource commitment to the market.

Some, but not all of the problems can be overcome with a combination of a greater time lag for price reporting (for example reporting trades at the close of the trading day after the transaction) and a separation of price and volume reporting, with the latter only being reported with a substantial time lag.

The practical problems - trade capture, avoiding price manipulation and agreeing asset spreads from cash prices - should be amenable to solution with a bit of work by market participants and systems providers. To this end the ECBC's market issues working group recently undertook a consultation on the topic of post-trade price reporting and has reported the results back to CEBS.

Looking forward

As covered bonds continue to be increasingly tied to the broader market's problems - the correlation of covered swap spreads and govvie spreads in most Southern European markets is now effectively 1 - it is inevitable that the true levels of liquidity to which we as a market aspire cannot return until some level of normality returns to the wider market. Our crystal ball is not up to the task of forecasting when this will be.

On a more positive note, now that the market making concept is, for all practical purposes dead in the water, liquidity and transparency are no longer artificial. It is also no longer binary ("market making: on" or "market making: off"). It is rather a function of the realities of that bond and the efficiency of the market. So any improvement in either of these will have a direct impact on the actual ability of investors to trade covered bonds. Liquidity friendly behaviour from issuers and market makers alike is therefore more important than ever.

Against that back drop, there are several important trends that we expect to influence the overall liquidity picture in coming months. We have already discussed the post-trade price reporting initiative. But also:

> **buy backs.** As banks see their bonds trade at increasingly wide levels, and as many of them sit on substantial levels of cash, the temptation to buy back your own bonds is inevitable. No problem with that if it is done in a responsible manner (in the Swedish domestic market for example, issuers regularly buy-back or tap issues as a way of enhancing liquidity). But we are hearing levels of complaints from some market participants about some buy back programmes, for example those which are not clearly communicated to the whole market, those that result in a specific bond being

squeezed to unrealistic levels and those that give a false impression of a bonds status as a jumbo (no problem with de-jumboing a bond per se, as long as that is properly communicated to the market).

- **the growth of the jumbolino.** As issuers become more flexible (or nervous) about their approach to the market we have seen a growth in deals that although launched and syndicated in the normal way may, or may not, turn out to actually be a jumbo. Hence the growth of the so-called jumbolino bonds, those that are announced without a specific size commitment but with an understanding that they will be sized appropriately based on the investor book that is built. Frequently issuers fully intend to subsequently tap such jumbolinos to make them jumbos in due course. How liquid can and should the bonds be?
- **further systems change.** Many of the trading systems have undertaken new initiatives in their covered bond trading platforms over the course of the crisis and we are aware of others which are planned.

These specific challenges, and the more general challenge of poorer liquidity in covered bonds, although an inevitable consequence of the new environment in which we operate must be addressed urgently. The treatment of covered bonds as an investment class under the new bank treasury rules (in particular the liquidity coverage ratio) is predicated on the ability of bank treasuries to liquidate their portfolios rapidly at low spreads to mid. The attractiveness of covered bonds to these and other investors depends on the market's continued work on this important topic.

1.7 THE INVESTOR'S PERSPECTIVE

By Fritz Engelhard, Barclays Capital and John Maskell, BlackRock

I. INTRODUCTION

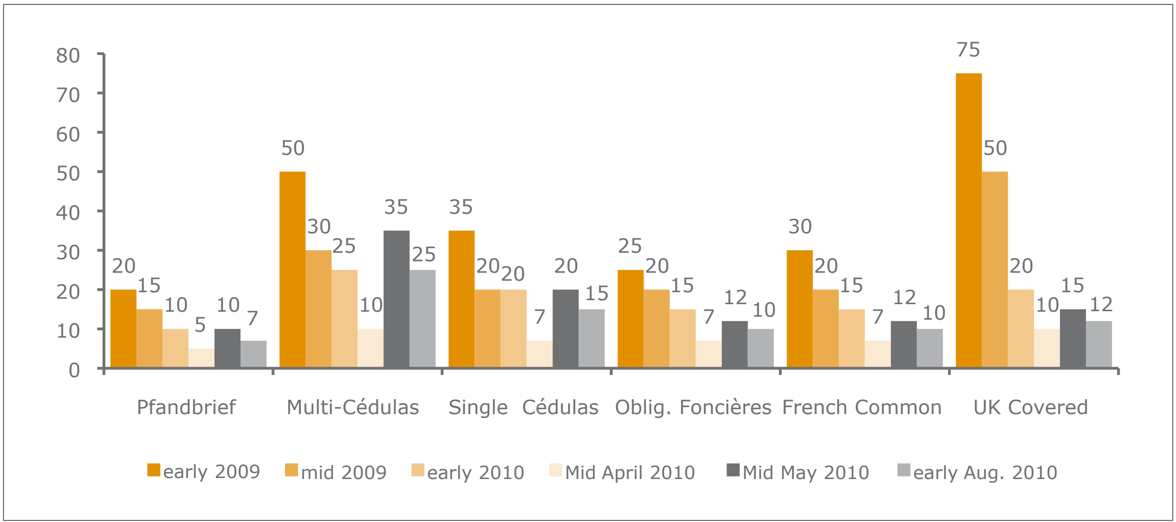
In this chapter we track the development of secondary market conditions over the past 12 months. We describe how liquidity conditions have evolved, how investors have been forced to adapt to spread volatility in sovereign debt markets and how they could benefit from relative value opportunities.

II. MANAGING SPILLOVER FROM SOVEREIGN SPREAD VOLATILITY

Between Q2 09 and Q4 09, secondary market liquidity in Jumbo covered bonds improved markedly. This was the result of a whole range of supporting factors. First, issuance activity in supra sovereign and agency (SSA) bonds and in government guaranteed bonds (GGBs) decreased substantially in the course of H2 09, which helped ease concerns regarding a permanent re-pricing of the sector through primary market transactions. Second, the European Central Bank's covered bond purchase programme (CBPP) led to a swing from one-sided selling to one-sided buying in covered bond markets. Third, the bond market rally, which saw the 5y swap rate decrease by 50bp between early June and early October, has created an incentive to some investors for taking profit. This in turn led to more two-way flow in Jumbo covered bond markets, thereby further improving secondary market liquidity.

Improved liquidity conditions reflected in the narrowing of bid/ask spreads. Average bid/offer spreads in Jumbo covered bonds persistently fell from rather wide levels of up to 75bp in Q1 09, to their lowest figure of down to 5bp in mid April 2010, thereby reducing significantly the liquidity gap between various market segments (Figure 1).

> FIGURE 1 – WHILST MONEY MARKET CONDITIONS IMPROVED, SPREADS FOR COVERED BONDS WIDENED



Source: Barclays Capital.

Already in February and more pronounced from mid April onwards, increasing tensions in sovereign debt markets had significant spill over effects in covered bond markets. The pattern was rather simple. Covered bonds issued out of European peripheral countries saw their swap spreads widen basically in line with swap spreads of the respective government bonds. The worsening of market conditions was also reflected in bid/ask spreads, which widened back to mid 2009 levels in Cédulas for example, but in jumbo Pfandbriefe widened back towards 10bp again.

The renewed worsening of secondary market liquidity was a kind of 'déjà-vu' experience for many investors, who still had fresh memories from their experiences in Q4 08 and Q1 09. However, in our view, the situation in April/May 2010 differed from the situation the market experienced in the pronounced liquidity squeeze of Q4 08/Q1 09. First, pressure was not coming out of traditional credit spread markets and stress in interbank lending markets but rather from the sell-off in sovereign debt markets. Second, the rally at the long-end of the yield curve has left many fixed income investors with outright gains on their investments. Third, there has been no distressed selling behaviour in covered bond markets characterised by price-insensitive inventory clearing operations. Fourth, screen prices have generally become more reliable, as market makers were less inclined to keep bid/ask spreads artificially tight, but they were more ready to express potential buying and selling levels through the quotes shown on the screens.

The above differences to the stressed situation in Q4 08/Q1 09, have some important implications for trading patterns and investor behaviour. As most covered bond investors mainly use their exposure to enhance return beyond their core mandates in sovereign markets, they were forced to shift their attention strongly towards managing their exposure to sovereign debt markets. Furthermore, even investors with pure non-sovereign mandates were obliged to focus on the development in sovereign debt markets, as the situation in the respective sovereign market generally overshadowed other traditional relative value factors, such as issuer-specific risk, demand/supply trends and, for covered bonds, the quality of collateral assets. If anything, most investors became stricter in limiting their exposure to those sovereigns that have been identified as more vulnerable and eventually entered short positions in underlying government bond markets to protect their covered bond portfolios against country risk.

From mid June 2010 onwards swap spreads of peripheral European sovereign debt tightened markedly on the back of the ECB's interventions in debt securities markets through the Securities Markets Programme (SMP)[1], positive net cash flows over the summer months and reduced fears regarding the funding needs of bank support entities particularly in Spain and Ireland. Consequently, trading conditions in the affected sovereign debt markets improved and covered bond investors needed to be quick in unwinding their country risk hedges. In addition, with a few days delay, covered bond markets also recovered and bid/ask spreads decreased again.

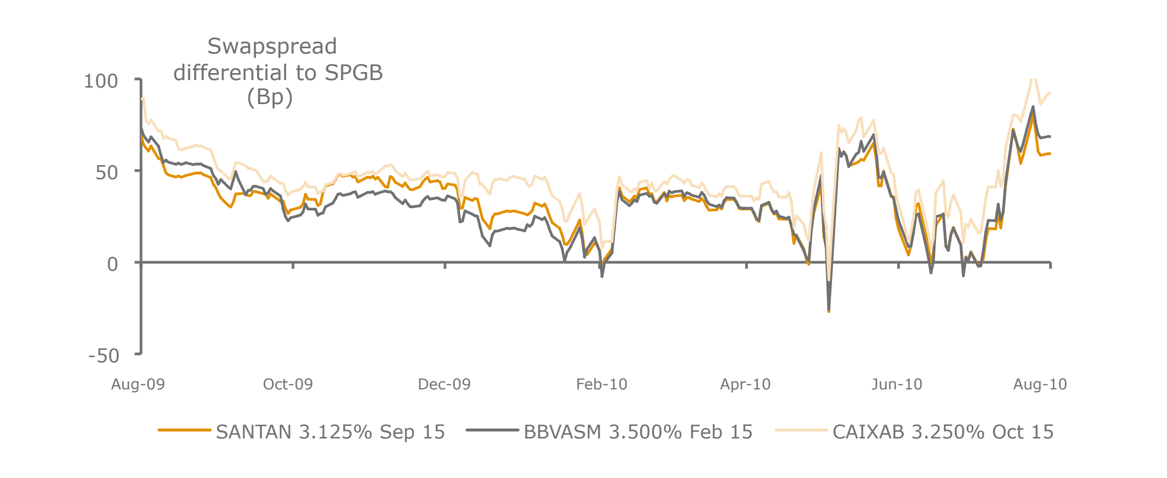
III. EXPLOITING RELATIVE VALUE OPPORTUNITIES

The spillover of volatility in sovereign debt markets to covered bond markets in H1 10 highlights that liquidity conditions are unsteady. In times of rising market tensions, investors could be quite restricted to fulfil their mandates in managing risk positions. This in turn leads quickly to a general reduction of risk limits and leverage. Consequently, only those investors who take into account potential changes in market conditions can also benefit from the opportunities arising from limited secondary market liquidity.

1 The ECB decided to introduce the Securities Markets Programme on Sunday 9 May 2010. (http://www.ecb.eu/ecb/legal/pdf/l_12420100520en00080009.pdf)

The most interesting relative value opportunities emerge from the gap between government bonds and covered bonds. In the rather short period between early May 2010 and early August 2010, the swap spread differential between Spanish Cédulas, the largest Jumbo covered bond sub-segment, and Spanish government bonds, moved from 0bp to +80bp, back down to 0bp and then wider again to +100bp (Figure 2).

> Figure 2 –Swap spread differential between 5yr Spanish covered and government bonds



Source: Barclays Capital.

The spread differential between covered and government bonds is largely a result of the time lag between spread moves in the two markets. This time lag partly results from country risk hedging operations. Generally, in an environment of rising market tensions in sovereign debt markets, the spread differential moves towards 0bp, whilst in a period of recovery, the swap spread differential widens again. The resulting swings offer excellent relative value opportunities, particularly for investors who wish to leave their country exposure neutral, but are able to switch between the two market segments.

ANNEX: THE COVERED BOND INVESTOR COUNCIL

By Nathalie Aubry-Stacey, International Capital Market Association

The ICMA Covered Bond Investor Council (CBIC) has been in existence for more than a year now. Covered bond issuers and traders have had their own organisations to represent their views for a long time. It was felt that investors too needed to ensure that their views were made known and interests protected at an early stage in every industry discussion.

The Council is an investor driven organisation, independent of issuers and the sell side. The CBIC aims at promoting the quality of the covered bond product and representing the interests of European covered bond investors. The CBIC promotes the simplicity and transparency of the product. There are a number of issues the CBIC is considering to develop the covered bond market:

- The current European covered bond market is highly fragmented both in respect of the legislation and the quality/accessibility of necessary information for investors to compare different covered bond programmes. Working on greater harmonisation where possible as well as setting minimum transparency standards and simplicity are key to the CBIC.
- The CBIC created a transparency working group from the outset, highlighting the importance of this issue for investors. CBIC is involved in ongoing discussions to improve the current market standards. The CBIC strongly believes it is of vital importance to improve transparency. Improving transparency will increase the investor base. The objective is to make it possible for investors and analyst to form an independent qualified assessment of all covered bond programmes.
- Another working group was set up from the start to discuss liquidity issues. The CBIC needs a long-term view on this issue and there is no easily found solution in sight. Attempts to reintroduce the old market maker commitment for Jumbo covered bonds albeit in a much weaker form have so far not succeeded. Banks for obvious reasons do not have the same balance sheet commitment as before the crisis and it is very unlikely that this will change. Fundamental questions about the current market structure have to be raised not only for the covered bond market but for other parts of the fixed income market as well. This is a difficult issue as well for investors. The CBIC would like to represent investor interest in future discussions about this matter including the implementation of a mandatory post trade transparency regime.

The European covered bond market as a financing tool for mortgage has survived the crisis without massive public intervention and the CBIC believes that only a continued focus on upholding the asset classes' high quality will safeguard the market against future crises. Any dilution of the quality of product or confusion with other fixed income products should be avoided.

The CBIC has been recognised by regulators as the voice of investors. However the CBIC would like to take the Council further and actively engage investors with an interest in covered bonds in its work, and be more active in the regulatory space. As investors the CBIC has of course very different views about investment decisions, but this market will continue to develop and it is essential that investors, as a group, participate in the discussions on the future development of this market which are essential for mortgage and public financing in Europe.

Currently, the Chairman of the CBIC is Claus Tofte Nielsen of Norges Bank, Oslo. The Vice Chairman is Andreas Denger of MEAG in Munch. Nathalie Aubry-Stacey at ICMA acts as Secretary for the Council and the CBIC can be contacted on cbic@icmagroup.org.

CHAPTER 2 - GENERIC SECTION

2.1 OVERVIEW OF COVERED BONDS

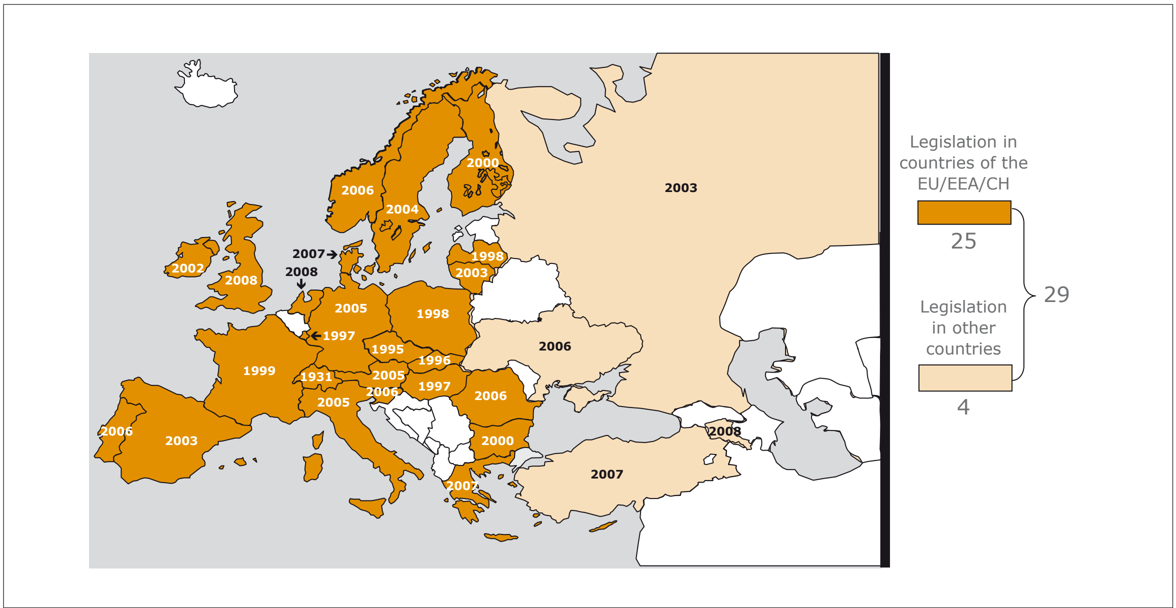
By Ralf Burmeister, LBBW, Ralf Grossmann, SG CIB
and Otmar Stöcker, Association of German Pfandbrief Banks

2.1.1 INTRODUCTION

Over the past decade, the covered bond market has developed into the most important segment of privately issued bonds on Europe's capital markets, with volume outstanding at the end of 2009 amounting to EUR 2.39 trillion[1]. Covered bonds were one of the first non state-guaranteed funding instruments of credit institutions to resume issuance activity after the Lehman default. It is generally accepted that the covered bond market should play a pivotal role in the exit strategies from government and central bank support as they provide lenders with a cost-efficient instrument to raise long-term funding for mortgage or public-sector loans and offer investors the (non state-guaranteed) top-quality credit exposure on credit institutions. The high importance of covered bonds for the financial system was also demonstrated by the decision of the European Central Bank to launch a EUR 60 bn covered bond purchase program.

Today there are active covered bond markets in about 25 different European jurisdictions and there is a strong expectation that the covered bond market will continue to grow, especially as national legislators across Europe have adopted modern covered bond regulations or modernised existing ones.

> Chart 1 – Covered Bond Legislation in Europe (as of July 2010)



Source: vdp

Regulatory developments in national markets and the enactment of new covered bond legislation have enhanced the quality of the covered bond instrument. Diversification in the group of covered bond issuers now means that this group not only includes specialised mortgage banks, but increasingly diverse players, such as Dutch and UK issuers, Spanish savings banks, German universal banks etc.

1 Source: EMF/ECBC. http://ecbc.hypo.org/content/default.asp?PageID=302

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

2.1.2 HISTORY

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

The creation and the expansion of covered bond systems in their different structures and features are a perfect example of a fruitful and effective exchange of ideas across all European borders. It is very impressive to see how the huge benefit of experience and exchange of international know how contributed to create the covered bonds in Europe during more than 230 years. In the 19th century, nearly every European country had a covered bond system. Their success influenced each other. Covered bonds also played an important role in stabilising financial systems at the end of the 19th century, a time of high bankruptcies of companies and banks.

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

The situation changed, when the first German Pfandbrief in benchmark format (Jumbo) was issued in 1995. The bond was issued in order to meet liquidity needs of investors and to provide increased funding for public sector loans. Since then, the Jumbo market has expanded strongly. The introduction of the Euro meant that investors could no longer diversify regarding currencies, but intensified their search for liquid products. Banks needed to look for new funding sources via high credit-quality liquid bonds to attract international capital investors. Therefore, banks in Western countries revitalised their covered bond systems to create a competitive capital market instrument. At the end of the 20th century Central and Eastern European countries reintroduced real estate finance techniques. Covered bonds were an important element of this process to fund the growing number of mortgage loans, due to the booming housing markets. The consequence of this is that today we again find covered bond systems in nearly all European countries.

2.1.3 THE PURPOSE OF COVERED BONDS

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

First of all, covered bonds offer cheap funding in absolute and relative terms and secondly -due to the high credit quality of covered bonds- also offer longer term funding for the issuer compared to other funding sources banks usually have at hand. One major experience motivating the introduction of such a high quality funding tool like covered bonds is the fact, that it has always been difficult to measure the creditworthiness of a bank, which is still true today. Therefore it is obvious to use a well defined funding channel for specific assets through a system, whose credit quality is delinked as much as possible from the issuing entity. The credit quality of covered bonds measured by ratings as well as the relative rating stability of the market is extensively discussed in the Chapter I. The very same idea of delinking assets and issuer also applies to the introduction of securitisation products, which is discussed in section of Chapter 2.2.

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

Especially the current financial crisis has highlighted the fourth major advantage from an issuer's perspective of using covered bonds: market accessibility. Although covered bonds clearly have suffered especially in Q4 2008 and in early 2009, there has been a tremendous comeback in terms of spreads, issuance volume as well as investors confidence.

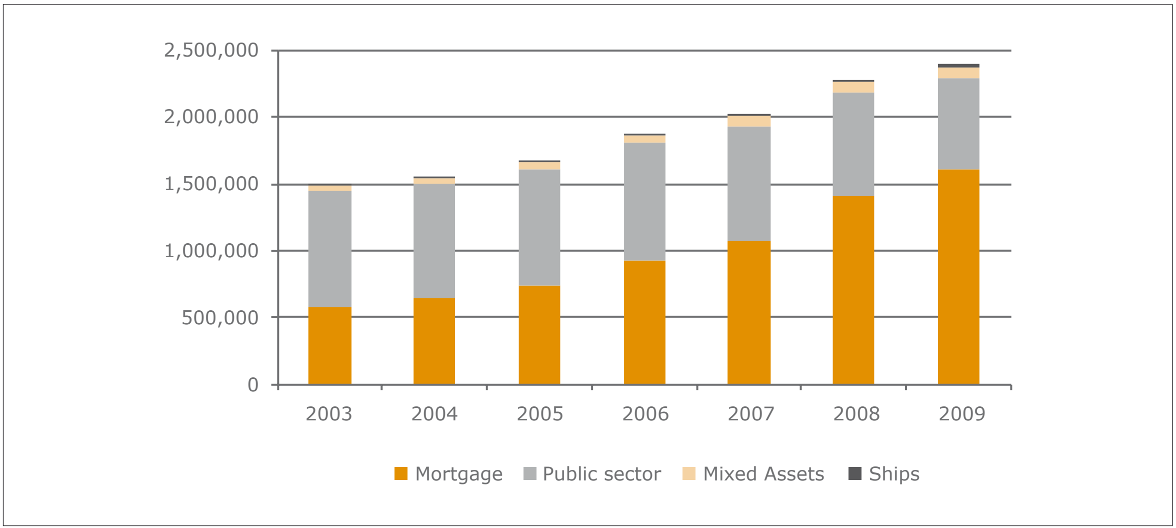
However, from an issuer's perspective, covered bonds are only one wholesale funding instrument among others. Looking at the past competition between Covered Bonds and securitisation products, at least for the moment the on-balance instrument of Covered Bond seems to have the edge. The ECB clearly states that the EU covered bond model is a valuable alternative to the US mortgage backed security model as it mitigates the moral hazard problems surrounding MBS products (see the ECB's Financial Integration Report, April 2010). On the other hand, pure reliance on senior unsecured funding and interbank markets as sole wholesale funding sources did prove to make a bank more susceptible to market turmoil. The financial crisis has brought Government Guaranteed Banks Bonds (GGBB) as an additional wholesale funding instrument, but which is by definition of temporary availability, although we have to note the extension of a number of European GGBB programmes. Therefore, it can be expected that covered bonds will increasingly be used worldwide by bank treasuries for their funding optimisation processes.

As the crisis has intensified the competition for deposits as a stable funding source for banks, the need for a low-cost wholesale funding instrument persists. Accordingly, large universal banks have set up covered bond programmes in recent years and have overcome the past predominance of specialized banks characterised by narrow business models and heavy reliance on wholesale funding. Summing up the experience made with covered bonds especially in times of stress, they have proven to be a reliable and efficient funding source which makes them an indispensable part of a bank's funding tool kit.

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 (residential and commercial) exist in all countries with covered bond systems. Covered bonds to fund public sector lending (to national, regional and local authorities) play an important role only in a limited number of European countries (Austria, France, Germany, Ireland, Italy, Luxembourg, Poland, Portugal Spain and UK). Covered bonds backed by ship loans are rarer but can be found in Denmark and Germany.

> Chart 2 – Total Outstanding Covered Bonds by underlying assets, 2003 to 2009, €m



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

2.1.5 LEGAL FRAMEWORK

UCITS AND CRD

1) UCITS

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

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

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

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

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

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

> which, in the event of **failure** of the issuer, would be used on a **priority** basis for the reimbursement of the principal and payment of the accrued interest.

Covered bonds that comply with Article 52 (4) UCITS directive are considered to have an attractive risk profile, which justify the easing of prudential investment limits. Therefore, investment funds (UCITS) can invest up to 25% (instead of max. 5%) of their assets in covered bonds of a single issuer that meet the criteria of Article 52(4). Similar, the EU Directives on Life and Non-Life Insurance (Directives 92/96/EEC and 92/49/EEC) allow insurance companies to invest up to 40% (instead of max. 5%) in UCITS compliant covered bonds of the same issuer.

By July 2009, all 27 EU Member States had sent UCITS-notifications to the EU Commission. 19 states notified the EU Commission on bonds and authorised issuers fulfilling the criteria of Article 52(4) UCITS mentioned above. Further 4 states notified their legislation, but specified that so far, no Covered Bond issues had been issued on their domestic markets yet. Finally, 4 other states only sent negative notifications, not disposing of a Covered Bond legislation in their country. All notifications are published on the website of the EU Commission:

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

2) CRD

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

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

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

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

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

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

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

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

3 Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast)

These requirements will have to be transposed by each EU Member State in order to obtain or to keep privileged treatment of their national covered bonds. While Article 52(4) of the UCITS Directive provided a fairly general and abstract framework for covered bonds, the CRD framework is much more specific in its definition of Covered Bonds. However, the covered bond definition of the CRD was established for supervisory purposes, and therefore does not necessarily coincide with the market's definition of covered bonds. The future will show whether the covered bond definition of the CRD will be a sufficient base to set long-term standards for the European covered bond market, or whether new instruments and markets will go beyond those limits in the future.

2.1.6 A COMPARATIVE FRAMEWORK OF VARIOUS COVERED BOND SYSTEMS IN EUROPE

To date, 31 countries have special covered bond legislation or arranged structured covered bonds on contractual basis in a general-law based framework. However, not all of these countries, where laws are in place, have significant issuance activity.

The ECBC Technical Issues Working Group conducted a comparative analysis, based on a questionnaire, which 24 countries have answered so far[4]. The questionnaire and the comparative overview are divided into 9 sections covering the essential features of covered bond systems. Here, we highlight some of the results of that comparative overview. The results are available from www.ecbc.eu.

Structure of the issuer

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

> Universal credit institutions

> Universal credit institutions with a special license

> Specialised credit institutions

> Special purpose entities

Framework

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

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

Cover assets

The eligible cover assets in existing European covered bond systems range from exposures to public sector entities, mortgage and housing loans, exposures to credit institutions, senior MBS issued by securitisation entities to ship loans. Some covered bond systems distinguish between regular cover assets

4 The Technical Issues Working Group has started to revise the questionnaire and to improve and clarify the comparative tables accordingly. Please note that some countries did not yet update their contributions to the country reports and the overview.

(usually mortgage, housing, public sector, ship loans and senior MBS) and substitution assets, where the latter is often subject to quantitative restrictions.

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

Valuation of mortgage cover pool & LTV criteria

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

Asset-liability guidelines

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

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

Cover pool monitor & banking supervision

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

Segregation of assets & bankruptcy remoteness

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

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

Risk weighting & compliance with European legislation

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

2.1.7 ECBC ESSENTIAL FEATURES OF COVERED BONDS

On the basis of extensive comparative analysis, the ECBC Technical Issues Working Group prepared the common essential features of covered bonds and corresponding explanatory notes[5]. The whole set of essential features and explanatory notes received approval by the ECBC Steering Committee and Plenary in March 2008.

2.1.8 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 2009 amounted to 2.39 trillion EUR (covered bonds covered by mortgage loans, public-sector loans and ship loans), which represents an increase of 5% year on year. The five largest issuing countries in 2009 were Denmark, Germany, France, Sweden and Spain respectively.

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

> Chart 3 – Volume outstanding CB in Europe end of 2009 in €m

	Public Sector	Mortgage	Ships	Mixed Assets	Total
Austria (e)	19,617	5,317	0	0	24,934
Canada	0	7,525	0	0	7,525
Czech Republic	0	8,186	0	0	8,186
Denmark	134	319,434	7,197	0	326,765
Finland	0	7,625	0	0	7,625
France	71,905	134,757	0	82,572	289,234
Germany	486,406	225,100	7,954	0	719,460
Greece	0	6,500	0	0	6,500
Hungary	0	7,116	0	0	7,116
Ireland	50,951	29,725	0	0	80,676
Italy	9,063	14,000	0	0	23,063
Latvia	0	85	0	0	85
Luxembourg	31,645	0	0	0	31,645
Netherlands	0	28,367	0	0	28,367

5 They are available at: http://ecbc.hypo.org/content/default.asp?PageID=503

	Public Sector	Mortgage	Ships	Mixed Assets	Total
Norway	951	51,340	0	0	52,291
Poland	139	578	0	0	717
Portugal	1,150	20,270	0	0	21,420
Slovakia	0	3,608	0	0	3,608
Spain	16,030	336,750	0	0	352,780
Sweden	0	133,903	0	0	133,93
Switzerland	0	46,283	0	0	46,283
Ukraine	0	4	0	0	4
United Kingdom	3,439	201,096	0	0	204,535
United States	0	12,896	0	0	12,896
Total	**691,430**	**1,600,465**	**15,151**	**82,572**	**2,389,617**
%	32%	64%	3%	1%	100%

Source: EMF/ECBC

Notes: **Austria**, the figures are estimates.

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

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

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

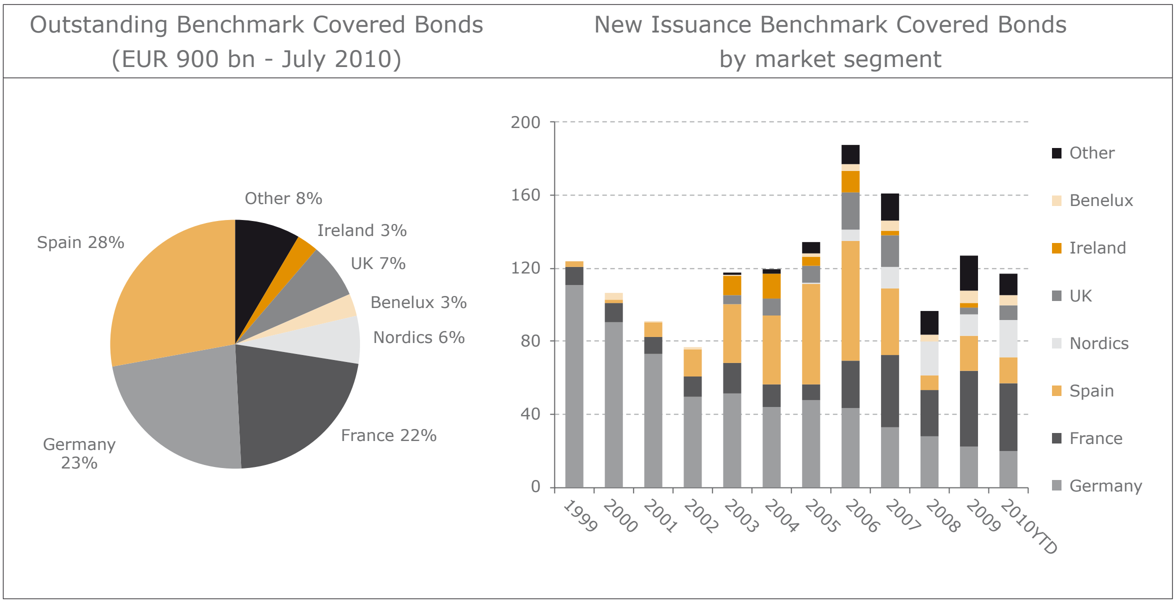
2.1.9 BENCHMARK COVERED BONDS

The Benchmark covered bond market constitutes the most liquid segment of the covered bond market. A Benchmark-format covered bond is a Euro-denominated, bullet maturity, fixed annual coupon bond with a defined minimum outstanding volume (in most cases EUR 1 bn). In order to enhance secondary market liquidity, the investment banks involved in bringing benchmark covered bonds to the market are committed to act as market-makers and quote two-way prices to investors and other market-makers. As a result of the financial crises, the price-quoting among market-makers came to an almost complete stop. However, price-quoting for investors was more robust, albeit at bid-offer spreads which were in line what investors experienced in other segments of the distressed fixed income market (e.g. non-core government bonds, agency bonds, etc…). As market volatility eased bid-offer spreads narrowed again, but overall price-transparency remained unsatisfactory for market participants. The ECBC is actively contributing to an industry-driven solution to improve post-trade transparency with the ultimate goal to enhance secondary market liquidity.

Benchmark covered bonds are primarily issued with maturities between 5 and 10 years, but shorter maturities of minimum 2 years and long maturities of 15, 20 years and longer play a role as well. The current total outstanding volume of the benchmark covered bond market is approximately EUR 900 bn (approx. 11% of liquid Euro-denominated bonds). Thus, the benchmark covered bond market is the second largest bond market in Europe after Government bond markets.

To increase the possibilities for trading, benchmark covered bonds were first introduced on the German market in 1995 under the name of Jumbo Pfandbriefe. Since then, the Jumbo market has grown very fast, and has strongly advanced international trade in Covered Bonds. So far, benchmark covered bonds have been also introduced in, Denmark, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland, Sweden, the UK, Norway, Switzerland, Greece, Canada and the US.

> Chart 4 – Benchmark Covered Bond Supply



Source: Market data, SG CIB

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

2.1.10 WHO INVESTS IN COVERED BONDS?

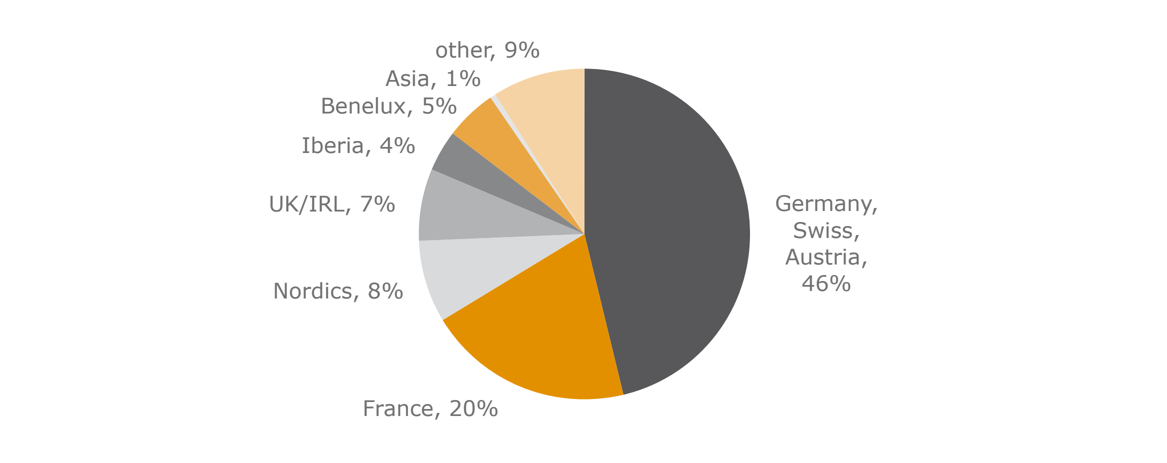
Covered bonds are attractive financial investments because they offer excellent credit quality, secondary market liquidity, international diversification and a large choice of maturities. Moreover, covered bonds enjoy privileged treatment in different areas of EU financial market regulation.

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

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

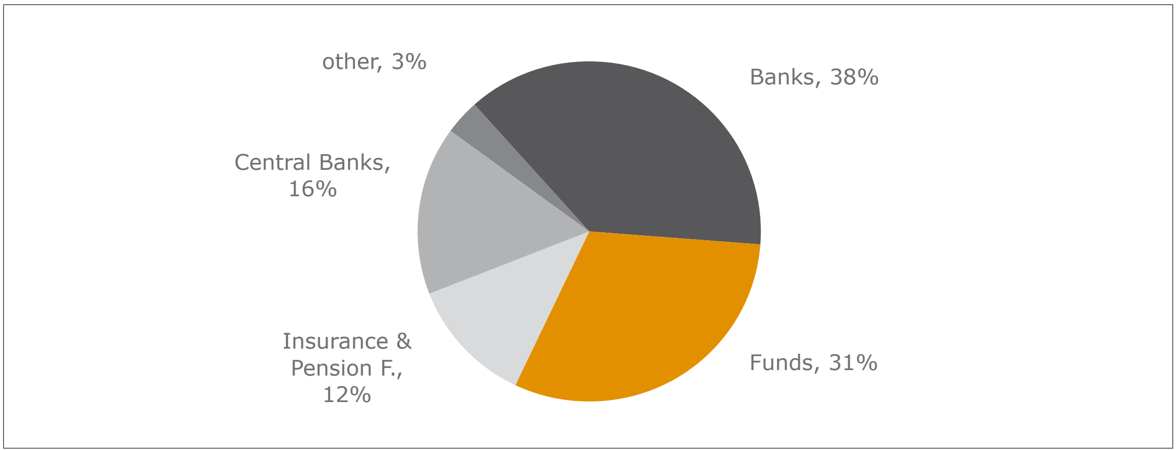
The trend towards longer maturities, which dominated the primary Benchmark covered bond market in the past years, has reversed during the financial crisis, but returned in 2009While in 2007 new issuance in maturities under 5Y accounted for 32% of total new Benchmark covered bond issuance, this share reached 65% in 2008, but fell to 16% in 2009 and reached 26% in 2010 year-to-date.

> Chart 5 – Benchmark Covered Bond Primary market placement by country / geographical area (averages 2010)



Source: SG CIB

> Chart 6 – Benchmark Covered Bond Primary market Placement by type of investor (averages 2010)



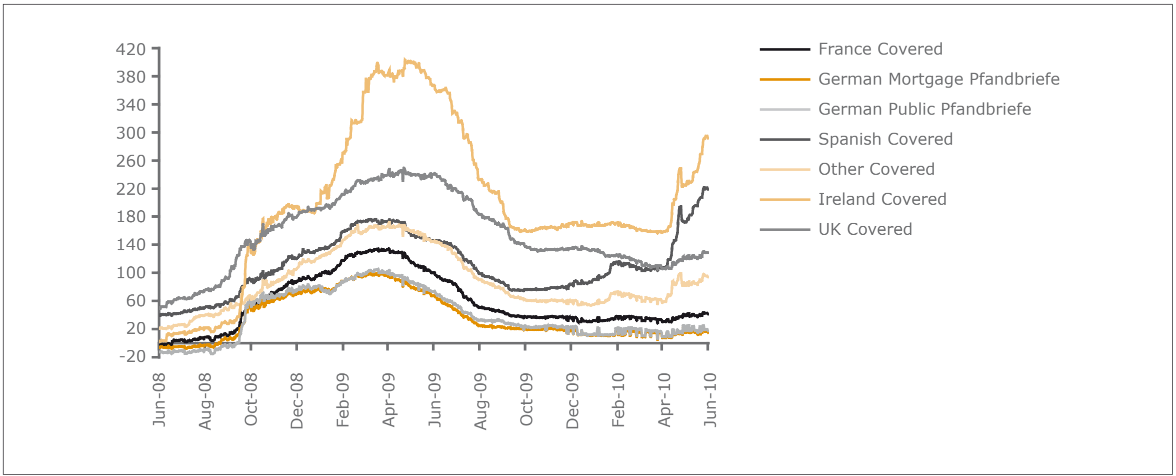
Source: SG CIB

2.2 RMBS VS. COVERED BONDS

By Bernd Volk, Deutsche Bank

Given that holders of covered bonds have a claim against an issuing bank and a pool of mortgage (or public sector) collateral, spreads of covered bonds are typically tight compared to senior bank bonds and mortgage backed securities (MBS). Whereas spreads of Covered Bonds widened significantly versus swaps in 2008 and H1 2009 they held up extremely well compared with MBS and tightened significantly in H2 2009 (although in jurisdictions like the UK & Netherlands spreads of MBS have tightened considerably too recently), in line with other liquid credits like agencies, supras, sub-sovereigns and state guaranteed bonds. In H1 2010, spreads of covered bonds diverged significantly, more or less in line with European sovereign spreads.

> Spreads of European Covered Bonds diverged significantly in H1 2010

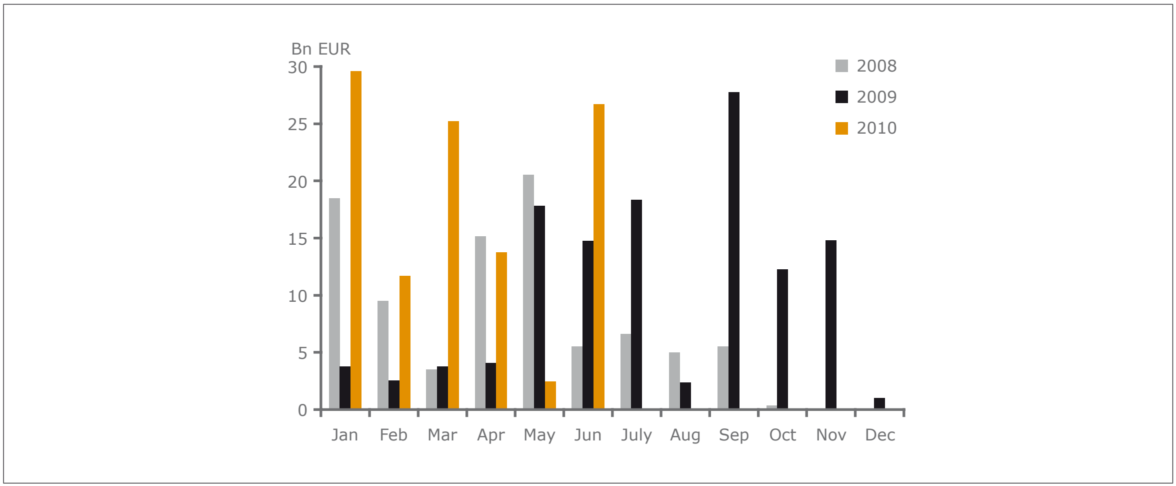


Source: iBoxx, Deutsche Bank

Recovery of New Issuance of EUR Benchmark Covered Bonds in Q2 2009 and New Issuance Record in H1 2010

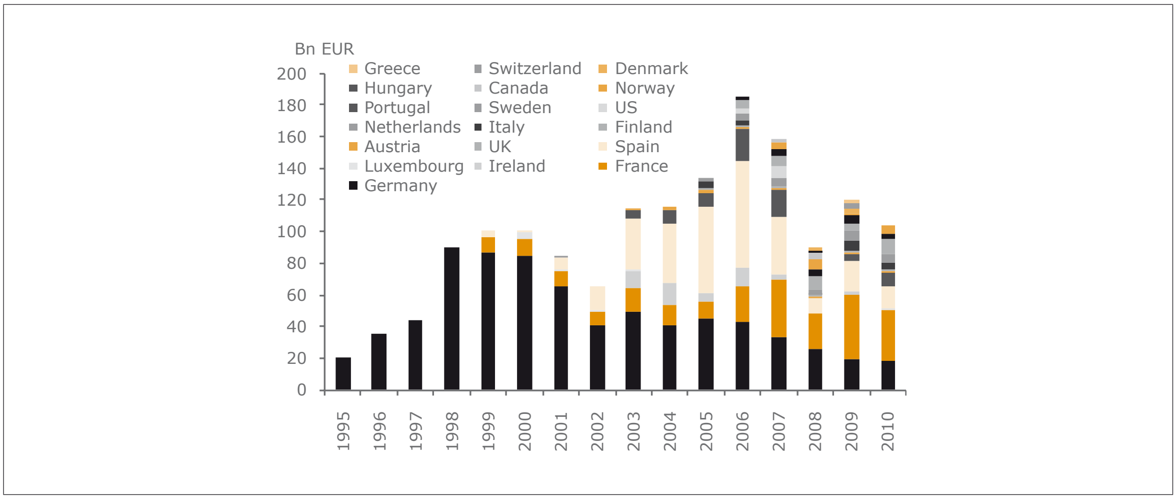
While new issuance of EUR benchmark covered bonds declined by 45% in Q1 2008 versus Q1 2007 (and most of the new issuance was done in short dated Covered Bonds), the market for MBS was almost completely closed. During the start of the financial market crisis, EUR benchmark covered bond issuance was substituted by state guaranteed benchmark bonds. However, Q2 2009 showed a significant recovery of new issuance of EUR benchmark covered bonds (also driven by the ECB announcement to buy covered bonds) while the primary market for publicly issued RMBS was still almost completely shut (given the loss of key investors such as SIVs, conduits, money market funds and some bank treasuries). In H1 2010, despite the primary market for peripheral sovereign bonds being challenging, a new issuance record of EUR benchmark covered bonds of almost EUR 100 bn was achieved. In June alone around EUR 19 bn of EUR benchmark covered bond were issued. Including issues with a volume of EUR 500 m and above, the total issuance volume in June was around 27 bn.

> June 2010 with a new issuance record of EUR benchmark Covered Bonds*



*including EUR 500 m issues, Source: Deutsche Bank as of 21 June 2010

> As of end of June 2010, new issuance of EUR benchmark Covered Bonds was already close to FY 09

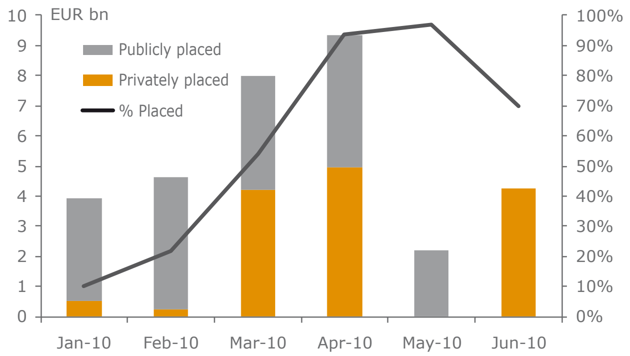


Source: Deutsche Bank

RMBS Issuance Volumes Remain Low

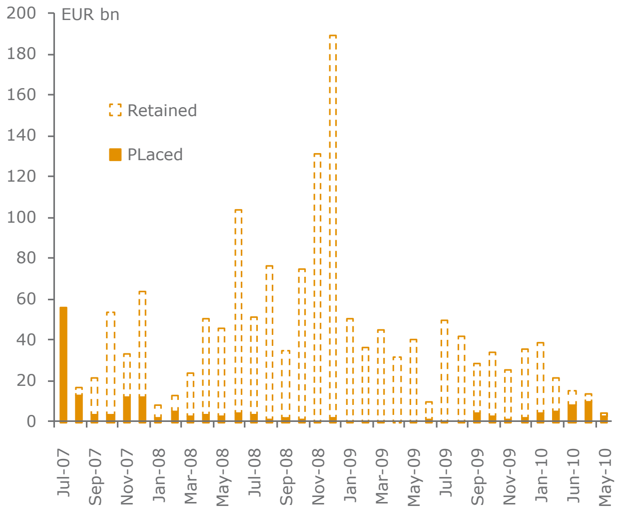
For most of 2009 RMBS issuance remained overwhelmingly dominated by banks' securitize-and-repo exercises. While the situation improved in H1 2010, investor placed issued RMBS volumes still remain low. Market revival has consisted of both public and private "club" syndications, with the latter taking greater hold as sovereign induced risk aversion returned.

> 2010 INVESTOR PLACED SECURITISATION ISSUANCE BY TYPE



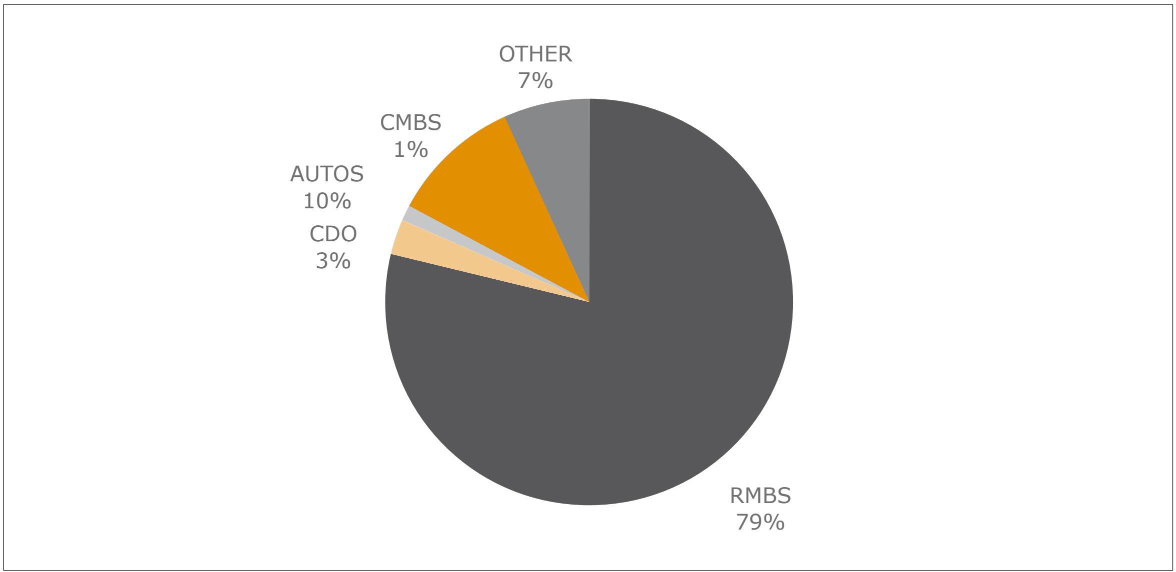
Source: Deutsche Bank

> MONTHLY PRIMARY VOLUMES OF EUROPEAN SECURITISATIONS



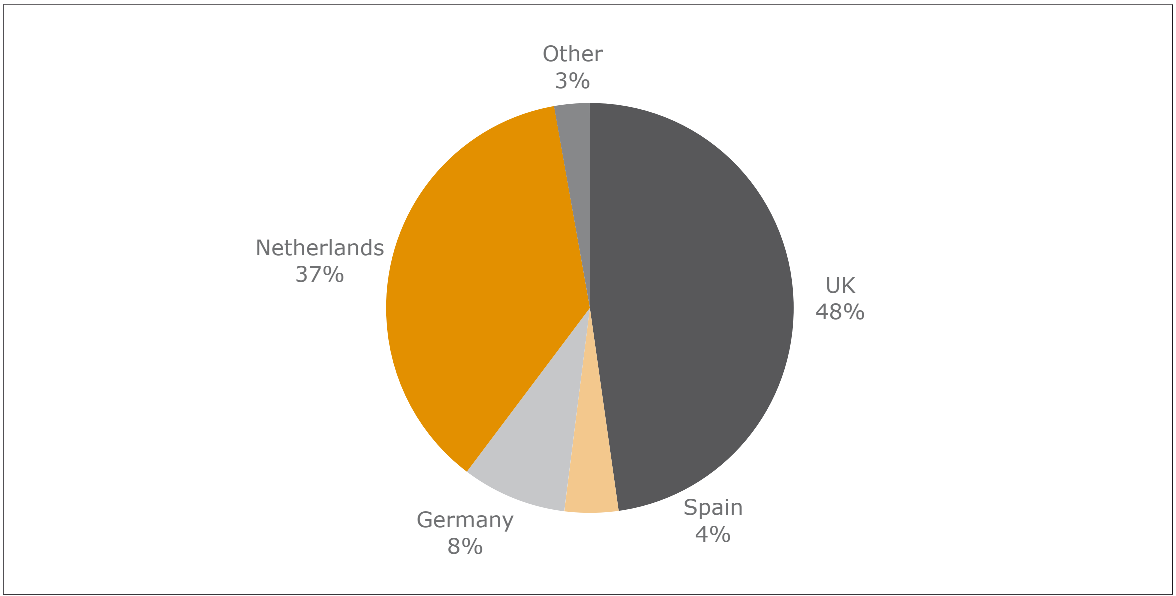
Source: Deutsche Bank

> Investor placed asset securitisations class breakdown (as of 21 June 2010)



Source: Deutsche Bank

> Investor placed country breakdown (as of 21 June 2010)



Source: Deutsche Bank

Pre-Crisis Convergence of Covered Bonds and MBS Stopped By Financial Market Crisis

Pre-crisis the boundaries between covered bonds and MBS were in certain instance beginning to become blurred. In some jurisdictions, MBS are eligible as collateral for covered bonds (e.g. France, Italy, Ireland and Luxembourg). Covered bonds were used as collateral within synthetic securitization transactions (e.g. several Geldilux SME CLOs). However, the covered bonds only collateralize such transactions Covered Bonds are often contracted beyond the structure stipulated by the legal framework. So called structured (or general law based) covered bonds are structured with the help of securitization techniques to replicate the dual claim characteristic for covered bonds (e.g. French and Canadian structured covered bonds). Given the change in the market environment and the market perception of convergence of covered bonds and MBS stopped with the start of the financial market crisis.

Regulatory Support for Covered Bonds, Regulatory Restrictions for RMBS

Generally, legislators and regulators increasingly support covered bonds, MBS face more restrictions. Despite repeated comments from authorities on the important role securitisation has to play in aiding the flow of credit to end borrowers, securitisations continue to receive less regulatory support than covered bonds. While certain initiatives are to be welcomed – transparency can only ultimately aid a fuller market recovery – many of the proposed regulations will delay or indeed have the potential in the extreme to reverse the new-issue revival observed to date. To this end, CRD II - 5% retention and greater disclosure, CRD III – more onerous capital requirements for securitisations held in trading books, CRD IV - more onerous liquidity requirements, Solvency II – capital requirements for insurance companies and credit rating agency legislation, all point to greater restrictions surrounding securitisation vis-a-vis covered bonds.

Covered Bonds are an On-Balance Sheet Funding Tool

In contrast to securitisations, in case of covered bonds, the assets are usually on the balance sheet of the issuer. Some covered bond structures, despite being issued by a credit institution, a specialised covered bond bank, could be seen as an SPV specifically dedicated to the issuance of covered bonds. The specialized issuer uses the issuing proceeds to grant loans to operating bank, the originator of the mortgage loans. The operating bank keeps the mortgage loans on its balance sheet and pledges them to guarantee the loans received from the covered bond bank.

Covered Bond Holders Have Recourse Against a Bank

A crucial difference between covered bonds and MBS is that covered bond holders have recourse against a bank, not only the underlying assets transferred to a SPV like in case of MBS. Hence, investors have a dual claim. Some MBS issuers highlight that there is a high correlation between the credit quality of the cover pool assets of covered bonds and the credit quality of the issuer. In case the cover pool credit quality worsens, the issuer credit quality will also worsen. However, in such a scenario, the issuing bank (or the parent company) might be 'too big to fail' and hence receive external support. Upcoming regulatory changes relating to liquidity buffers, leverage limits, reserve requirements and valuations would make the banks fundamentally stronger which in turn would support covered bond markets. In our view, this is one of the main reasons for covered bonds outperforming MBS at the beginning of the financial market crisis. At the end of the day, covered bonds are bank bonds. The preferential claim on the cover pool is an add-on, something which may be valued more or less by investors. This was also confirmed by the financial market crisis. Whereas there was no support for MBS (i.e. investors were fully exposed to the risk of the underlying assets and the structure they bought) there was strong support for covered bonds via support for the issuing banks in numerous cases (e.g. Washington Mutual, Northern Rock, Bradford and Bingley, Hypo Real Estate, Düsseldorfer Hypothelenbank, Kauphting). One could argue that while that has occurred to date, given sovereign pressures, a remaining risk potentially is the ability of governments to bail out banks. However, in our view, declining willingness of sovereigns to support banks would first hit Lower Tier 2 and senior bonds and not covered bonds. Hence, covered bond investors continue to rank highest regarding potential support.

Covered Bonds Have a Dynamic Cover Pool

Although all outstanding covered bonds by one issuer are typically backed by all loans in the cover pool, there is no connection between a specific cover pool and outstanding covered bonds (like typically in case of MBS). In case of issuer insolvency no further assets will typically be added to the cover pool i.e. the cover pool administrator loses the capability to bring in sufficient new assets in order to comply with the coverage regulations. As long as the issuer is solvent, the issuer manages the cover pool.

MBS Have Typically a Static Pool and Credit Enhancement by Tranching

As covered bonds typically have a fixed rate bullet structure, the cover pool has to be constantly 'refilled', i.e. mortgage loans becoming due have to be reinvested. This can lead to higher credit and market risk in the cover pool compared to triple A-rated tranches of MBS transactions. Generally, a dynamic cover pool creates the need of an accurate asset liability management including stress test scenarios. Apart from the credit risk of the cover pool assets, the main risks are the potential lower yield of newly added assets (negative carry risk as a result of differing amortisation profiles of covered bonds and cover assets) and the management of the interest rates risks between the fixed rate covered bonds and (often times) variable rates mortgage loans. As a result of the dynamic pool, covered bonds typically have a longer maturity than MBS. On the other hand, one of the main risks of AAA-MBS are strongly extended maturities. MBS repayment varies from jurisdiction to jurisdiction. The UK is predominantly characterised by Master Trusts, while rely upon high prepayment rates to meet scheduled maturities. Sponsors have however injected assets into trusts, issue further bonds or purchase notes in order to meet scheduled redemptions. MBS from Ireland, Portugal and the Netherlands will typically rely upon varying degrees of prepayment and sponsor call. Falling prepayment rates along with the lack of fully functioning debt capital markets has meant extension risk has become a core consideration in European RMBS.

In MBS, the highest credit risk is concentrated in the subordinated tranches following the 'tranching' of the mortgage portfolio where losses hit first. Investors have no recourse against the originator of the assets, and the risk is limited to the pool of assets which has been securitized. MBS cover pools are, in most cases, static in the sense that even if assets can be substituted after a deal's launch (for instance in UK MBS Master Trusts), these additional assets do not lead to an increase in overcollateralisation as they would in a covered bond. However, overcollateralisation does increase as the underlying pool of mortgage loans decreases over time due to borrowers paying back their obligations. MBS Master Trusts are separate in this regard, having revolving cover pools where principal repayments are re-invested in new assets, subject to a set of eligibility criteria/concentration limits that the underlying assets have to adhere to on a single asset and on a portfolio level. Nevertheless, in contrast to covered bonds, RMBS investors are exposed to the performance of the pool. Bad performance of the portfolio erodes investor protection. Investors in MBS only bear the risk arising from these mortgage loans and are independent from the credit risk of the respective (former) owner of such assets (the originator/seller e.g. a bank).

Conclusion

MBS investors are exposed to the risk of underperformance of the pool and maturity extension due to lower pre-payments. However de-leveraging via prepayments will often mean structural protection increases over time. Covered bonds are banks bonds and holders of covered bonds benefit from a preferential claim on a cover pool and the support of the issuing bank and every external support provided to the issuing bank.

Covered bond holders are not limited to cover pool assets and hence are not necessarily directly impacted by lower pre-payments or a worsening asset quality. While state guaranteed benchmark bonds issuance almost completely substituted EUR benchmark covered bond issuance at the beginning of the financial market crisis, new issuance of EUR benchmark covered bond recovered substantially in H2 2009 and H1 2010.

Overall, also driven by increasing regulatory and central bank support, covered bonds are likely to become an even more important funding tool for banks in the post-crisis financial market architecture.

2.3 COVERED BONDS AND THE EU CAPITAL REQUIREMENTS DIRECTIVE

By Fritz Engelhard, Barclays Capital

This chapter gives an overview on the treatment of covered bonds under the European Commission's capital requirements framework for banks, Directive 2006/48/EC, the Capital Requirements Directive (CRD). It also highlights the amendments concerning the use of a reduced LGD and the limitations for including mortgage backed securities in cover pools approved by the European Parliament on 7 July 2010.

CRD REFERS TO UCITS 22(4) AND ADDITIONALLY STIPULATES A SERIES OF ELIGIBILITY CRITERIA FOR COVER ASSETS

In June 2006, the European Commission published the CRD in its Official Journal. It basically became effective on 1 January 2008. The special treatment of covered bonds is an important feature of the CRD as it goes beyond the Basel II framework. With regards to covered bonds, the CRD text (Annex VI, PART 1, paragraph 68-70) refers to the criteria of Article 22 (4) of the EU Directive 85/611 (Directive on Undertakings of Collective Investment in Transferable Securities or UCITS)[1]. UCITS 22(4) 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 were stipulated. Initially, the eligibility criteria set a 20% limit for the use of RMBS and CMBS notes and allowed an unlimited use of RMBS and CMBS notes only until 31 December 2010 and only in case those securitisation notes were rated AAA. On 7 July 2010, the European Parliament adopted an amended text[2], which extends the derogation period to 31 December 2013[3], lowers the general limit for the inclusion of RMBS and CMBS notes from 20% to 10% and now restricts the use of securitisation notes beyond the 10% limit to cases where the underlying mortgages were originated within the same consolidated banking group and where a member of the same banking group holds the first loss tranche and where the notes are at least rated AA-. According to the adopted criteria, the asset pool of a covered bond may include:

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

1 Following the recast of EU Directive 85/611 under Directive 2009/65 on 13 July 2009, UCITS Article 22(4) will become UCITS Article 52(4) in July 2011 (http://ec.europa.eu/internal_market/investment/ucits_directive_en.htm).

2 http://register.consilium.europa.eu/pdf/en/10/st11/st11527.en10.pdf

3 Before the end of this period, and by 31 December 2012 at the latest, the Commission shall review the appropriateness of the amended rules. The review should be conducted through the European Banking Committee who can extend the period of the waiver or convert it to a general rule

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

c) Substitute assets from institutions with a minimum rating of AA-; the total exposure of this kind shall not exceed 15% of the nominal amount of outstanding covered bonds; exposures caused by transmission and management of payments of the obligors of, or liquidation proceeds in respect of, loans secured by real estate 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 real estate or shares in Finnish residential housing companies up to an LTV of 80% or by senior RMBS notes issued by securitisation entities governed by the laws of a Member State, provided that the relevant supervisory authorities ensure that at least 90% of the assets of such securitisation entities are composed of mortgages up to an LTV of 80% and the notes are rated at least AA- and do not exceed 10% of the nominal amount of the outstanding issue.

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

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

STANDARDISED AND INTERNAL RATINGS-BASED OPTIONS

As with other categories of risk exposures, the assessment of risk weightings is conducted within the context of either a revised standardised approach (RSA) or an internal ratings-based approach (IRBA). The latter comes in both foundation and advanced forms. Application to individual banks depends on the level of sophistication of their risk management systems.

THE RSA LINKS COVERED BOND RISK WEIGHTS TO THOSE OF THE ISSUERS' SENIOR DEBT

Under the revised standardised approach (RSA), covered bonds are assigned a risk weight on the basis of the one attributed to senior unsecured exposures to the credit institution which issues them. For banks with a senior weighting of 50%, the covered bond weighting has been reduced to 20%. In contrast, banks with a senior, unsecured risk weight of 150% will have a covered bond weight of 100%. The correspondence between senior and covered bond risk weights is as follows:

FIGURE 1: RISK WEIGHTINGS FOR SENIOR DEBT AND COVERED BONDS

	%	%	%	
Senior Unsecured risk weight	20	50	100	150
Covered bond risk weight	10	20	50	100

Source: European Commission.

The Basel Committee has set up two ways of linking bank credit ratings to bank risk weightings, which link the bank risk weighting to the credit rating of the home country sovereign or to that of the bank itself. This approach has also been followed in the EC Directive. On this basis, the correspondence of covered bond risk weightings to issuing bank credit ratings under the two calculation methods is shown in Figure 2 and Figure 3.

FIGURE 2: RISK WEIGHTS UNDER OPTION 1 (%)

Credit rating of sovereign	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Sovereign risk weight	0	20	50	100	150	100
Bank senior unsecured risk weight	20	50	100	100	150	100
Covered bond risk weight	10	20	50	50	100	50

Source: Basel Committee, European Commission, Barclays Capital.

FIGURE 3: RISK WEIGHTS UNDER OPTION 2 (%)

Credit rating of bank	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Senior unsecured risk weight	20	50	50	100	150	50
Covered bond risk weight	10	20	20	50	100	20

Source: Basel Committee, European Commission, Barclays Capital.

So, for example, under Option 1, if a bank is based in a country with a sovereign rating of AA- or better, its senior debt will be assigned a risk weighting of 20% and its covered bonds a weighting of 10%. For investing banks whose regulator applies Option 1, all banks within the EU, except for Greece and Malta, would attract a 20% risk weighting on senior unsecured debt because their sovereign ratings are all at least AA-/Aa3 (except for Greece and Malta, which are single-A). Hence, under this option, most EU covered bond issues would be assigned a risk weighting of 10%.

In contrast, Option 2 introduces more differentiation in risk weightings as the determining factor is the credit rating of the individual issuing bank. For banks that have a credit rating of less than AA-, this leads to a senior unsecured risk weighting of 50% and a covered bond weighting of 20%. The choice between Options 1 and 2 is at the discretion of national regulators. Figure 4 below gives an overview on how EU countries decided on the respective options.

THE IRBA SPECIFIES FUNCTIONS FOR DERIVING RISK WEIGHTS FROM INPUTS ON RISK COMPONENTS

Under the IRBA, banks that have been so authorised by their regulators 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 using functions specified by the Basel Committee and the EC (which in most cases are broadly comparable). Variations on the standard functions are provided to apply to different groups of assets, such as retail exposures and securitisations.

Two levels of IRBA have been established, namely the foundation and advanced levels. Those banks qualifying only for the foundation IRBA are allowed to provide their own estimates only of PD; the other risk components are provided by the regulator. Banks qualifying for the advanced approach are allowed to provide their own estimates of all the risk components, subject to any constraints that may be specified by the regulator.

EC SPECIFIES CONSTRAINTS ON KEY RISK COMPONENTS FOR COVERED BONDS

The Basel framework for IRBA calculations makes no separate reference to covered bonds. However, the CRD provides a specific framework for calculating internal ratings-based risk weights for covered bonds. (non-EC based banks applying the Basel framework to covered bonds would have to treat them as senior bank debt.) The EC legislation specifies constraints on risk components as follows:

- PD (which relates to issuer rather than issue default risk) must be at least 0.03%.
- LGD should be assigned a value of 12.5% and, exceptionally until 31 December 2010, 11.25% in case all exposure to public sector entities and all substitute assets have a minimum rating of double-A minus, securitisation notes make up only up to 10% of the total nominal amount of outstanding covered bonds, no ship mortgages are included in the cover pool OR the respective covered bonds are rated triple-A. On 30 June 2010, the European Parliament adopted an amendment, which will convert the exception for the application of an LGD of 11.25% into a general rule[4]. For banks applying the advanced version, 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. For the foundation approach, regulators may specify an effective maturity of 2.5 years for all bonds. All banks using the advanced approach would have to apply this maturity range.

Figure 4: National discretions regarding Options 1/2 in the RSA and the calculation of M in the IRBA across EU countries

Country	Within the RSA, exposures to institutions are assigned according to Option 1 (central government risk weight based method) ?*	Explicit maturity adjustment required under IRBA?**
Austria	Yes	No
Belgium	No	Yes

4 http://register.consilium.europa.eu/pdf/en/10/st11/st11527.en10.pdf

Country	Within the RSA, exposures to institutions are assigned according to Option 1 (central government risk weight based method) ?*	Explicit maturity adjustment required under IRBA?**
Bulgaria	No	No
Cyprus	Yes	Yes
Czech Republic	No	No
Germany	Yes	No
Denmark	Yes	No
Estonia	Yes	No
Greece	No	Yes
Spain	Yes	No
Finland	Yes	No
France	Yes	No
Hungary	Yes	No
Ireland	No	Yes
Italy	Yes	No
Lithuania	No	No
Luxembourg	Yes	Yes
Latvia	Yes	Yes
Malta	No	Yes
Netherlands	No	Yes
Poland	No	No
Portugal	Yes	No
Romania	No	No
Sweden	Yes	No
Slovenia	No	No
Slovakia	No	No
United Kingdom	No	Yes

Note: * within the scope of CRD Article 80 paragraph 3 and Annex VI Part 1 Paragraph 6.3; ** according to CRD Annex VII Part 2 Paragraph 12; Source: Committee of European Banking Supervisors (CEBS), Barclays Capital.

The below illustrations of risk weightings are based on an 11.25% LGD. The table illustrates figures for the range of possible effective maturities, as well as the central 2.5 yr case.

The room for discretion on the part of individual banks is limited, given the constraints on the specification of LGD and M. For PD, the default probability input, one-year default probabilities published by the rating agencies provide at least a starting point.

Figure 5: Rating agency cumulative one-year default rates (%)

	S&P (1981-2009)	Moody's (1983-2009)	Fitch (1991-2009)
AAA/Aaa	0.00	0.00	0.01
AA/Aa	0.02	0.02	0.08
A/A	0.08	0.06	0.13
BBB/Baa	0.26	0.20	0.58
BB/Ba	0.97	1.21	1.49

Source: S&P, Moody's, Fitch.

These figures reflect default history for corporates globally, so there may be reservations about their applicability to European banks. The different periods used in the agencies' surveys complicate comparisons, but the divergences in their figures highlight that this is not a precise science. Standard risk management caution would counsel using the highest figure in each of these comparisons.

Default probabilities produced by risk models used by individual banks may also show some variation from these figures. Our impression is that bank risk models generally operate on the basis of higher default probabilities than the rating agencies' historical studies suggest and that banks apply more differentiation than is provided by the rating agencies' broad alphabetic bands.

Figure 6 provides an illustrative matrix of risk weightings based on plugging a range of different default probabilities and the average life figures in the EC functions.

Figure 6: Risk weighted asset ratios (%) for different default probabilities and average lives (LGD = 11.25% in all cases)

	Probability of default (%)					
Bond Life (yrs)	0.03%	0.05%	0.10%	0.20%	0.25%	0.35%
1	2.01%	2.97%	4.95%	7.96%	9.19%	11.29%
2	3.22%	4.46%	6.89%	10.41%	11.80%	14.14%
2.5	3.83%	5.21%	7.86%	11.63%	13.11%	15.57%
3	4.43%	5.95%	8.83%	12.86%	14.42%	17.00%
4	5.65%	7.44%	10.77%	15.31%	17.03%	19.86%
5	6.86%	8.93%	12.71%	17.76%	19.65%	22.71%

Note: As five years is the maximum bond life that can be input, the bottom row of the table also provides the risk weighting to be applied to all longer maturities. Source: Barclays Capital.

The 0.03% floor for PD is likely to be applied by most risk models, at least down to banks rated at the bottom of the AA range. For covered bonds issued by banks in this top category, the risk weighting will range from 2.0% to 6.9% depending on maturity. This represents a significant capital saving relative to the risk weightings under the RSA. 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 RSA. Banks applying the IRBA will have a significant incentive in terms of capital utilisation to invest in shorter maturities.

The general point here is that different banks may use differing assumptions about default probabilities, and Figure 6 provides a matrix from which readers can derive or interpolate risk weightings based on their own assumptions. The matrix also highlights the importance of the assumption regarding the effective maturity requirement specified by individual regulators. In the event that all bonds are given a value of 2.5 for M, all covered bonds from issuers with senior ratings of A- or better would have a risk weighting of less than 10%. If regulators apply the range of one to five years for M, the 10% threshold moves up to A flat to A+ issuers for longer-dated covered bonds.

Implementation of CRD and consultation on national discretions

The final agreement on CRD was the starting signal for regulators and lawmakers in EU countries to implement the new capital adequacy regime in national regulations. The Committee of European Banking Supervisors (CEBS) provides an overview on the use of options and national discretions used by individual countries when introducing the CRD[5]. Following CRD implementation within the EU, the focus has been on consistency across EU countries. This is important in order to optimise regulatory efficiency and maximise clarity for the financial services industry, which frequently operates in several jurisdictions. On this background, the EU Commission asked CEBS for technical advice on options and national discretions in the CRD[6] on 27 April 2007. Following discussions with industry experts, on 22 May 2008, CEBS published a consultation paper[7] which was setting out its preliminary views. CEBS suggests keeping as a national discretion approximately one fifth of the 152 provisions covered in its analysis. On 17 October 2008, CEBS published its response and final advice[8] in which CEBS suggested to keep as a national discretion 28% of the 152 provisions covered in its analysis.

Refinements and Amendments to the CRD

In the course of 2008, the European Commission ran a number of public consultations for a refinement of the CRD. This has been mainly in three areas: (1) large exposures, hybrid capital instruments supervisory arrangements, the waivers for cooperative banks organized in networks and adjustments to certain technical provisions, (2) an adjusted proposal for securitizations and other risk transfer products and (3) trading book requirements for "incremental risk". Whilst within the consultation phase none of the initial proposals related to covered bonds or public sector entities, the final paper proposed a the reduction of the 100% exemption for covered bonds for large exposures to 75% and a restriction for the issuance of covered bonds to 50% of a credit institutions assets. In the meantime, however, these proposals were withdrawn.

Importantly, on 30 June 2010, the European Parliament adopted an amended CRD text which clarified the application of a reduced LGD of 11.25% and limitations for the inclusions of mortgage backed securities in cover pools.

5 http://www.c-ebs.org/sd/Options.htm

6 http://www.c-ebs.org/documents/CFA10onnationaldiscretions16052007.pdf

7 http://www.c-ebs.org/press/documents/CP18_ond.pdf

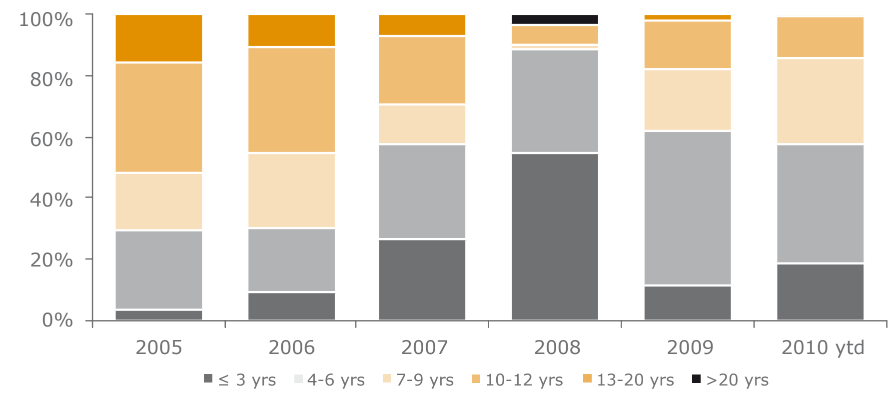
8 http://www.c-ebs.org/getdoc/5830b511-ce4b-4705-86ed-c1b835438f7f/CEBS-technical-advice-to-the-European-Commission.aspx

2.4 COVERED BONDS BEYOND BANK FUNDING: THE MACRO-ECONOMIC DIMENSION OF COVERED BONDS

By Ralf Burmeister, LBBW and Frank Will, RBS

Usually, the benefits of covered bonds are demonstrated at issuer level, highlighting that covered bonds offer comparatively cheap and reliable funding to issuers whilst helping to broaden the investor base. Providing issuer's access to long term funding, for example, has been well demonstrated throughout 2010 when looking at the average tenor of publicly placed covered bond issues. Also, the benefits of covered bond for investors, such as homogeneity within the same legal framework, special supervision or comparatively good rating stability even in an environment of strong rating pressure on sovereigns, are also quite frequently displayed. The intention of this article is to shed some light on a third aspect of covered bonds: the macro-economic benefits and financial stability through the use of covered bonds. In order to demonstrate this aspect, we would like to present the arguments at two different levels, firstly, the importance of covered bonds in mortgage financing, and secondly, their importance for financial stability.

> Annual € benchmark covered bond supply by maturity



IMPACT OF COVERED BONDS ON MORTGAGE AND PROPERTY MARKETS

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

Besides, the argument of macro-economic advantages in our view is also valid for public sector covered bonds, assuming that providing capital market access to public sector institutions is per se a positive feature. The general assumption behind this statement is of course that funding of any public sector body is a positive feature as these public entities spend their money sensitively in accordance with the needs and requirements of society. As the ECBC Fact Book surely is not the place to discuss whether public indebtedness and the society is always and in each case managed in the best way by public bodies, we will not follow that discussion furthermore, but rather restrict our arguments to mortgage backed covered bonds. Nonetheless, public sector covered bonds have undoubtedly reduced the funding costs of public sector borrowers.

The bundling of public sector assets resulted in an increase of diversification allowing borrowers to achieve higher ratings above their individual credit standing, funding benefits through benchmark transactions and a significant broadening of the investor base. All this contributed to a considerable reduction of the funding costs of public sector borrowers.

IMPACT OF COVERED BONDS ON FINANCIAL STABILITY

The second argument underpinning the significance of covered bonds for the overall banking sector and, ultimately, also their contribution to enhancing financial stability, is their favourable treatment by central banks and the role of covered bonds in the current crisis. An obvious example of the relationship between covered bonds and Central Banks is the recently concluded ECB Covered Bond Purchasing Programme (see also Article 1.2 "Was the ECB covered bond purchase programme a success?"). However, a more detailed investigation into this topic, quickly reveals more interesting facts about covered bonds and Central Banks:

> **The moral hazard problem of ABS is solved by using covered bonds.**

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

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

According to statements from the ECB, more than €300 bn of covered bonds were used as collateral in the first quarter of 2010. This should be compared to the overall outstanding volume of covered bonds of €2,390 bn. (For more information, see also Article 2.5 on covered bonds and repo). The Bank of England, as well as Norges Bank, have set up special covered bond programmes in order to support their domestic bank funding.

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

> Even before the ECB Covered Bond Purchasing Programme, central banks had already been well established and sophisticated investors in covered bonds prior to the crisis. Further, one would expect central banks to eventually return to the type of investment behaviour seen before 2007 once the current environment, characterised by unconventional monetary policy and the search for higher financial market stability, has passed. This again gives a good indication of how well this asset class is perceived by central banks.

> As ECB tends to have a preference for a unified European covered bond model (see, for example, the ECB report on financial integration cited above), it is fair to assume (without giving a timeta-

ble) that the central bank will facilitate some progress here. Therefore, **covered bonds are set to become another milestone in the integration of European capital markets**, which can be seen as an achievement on its own.

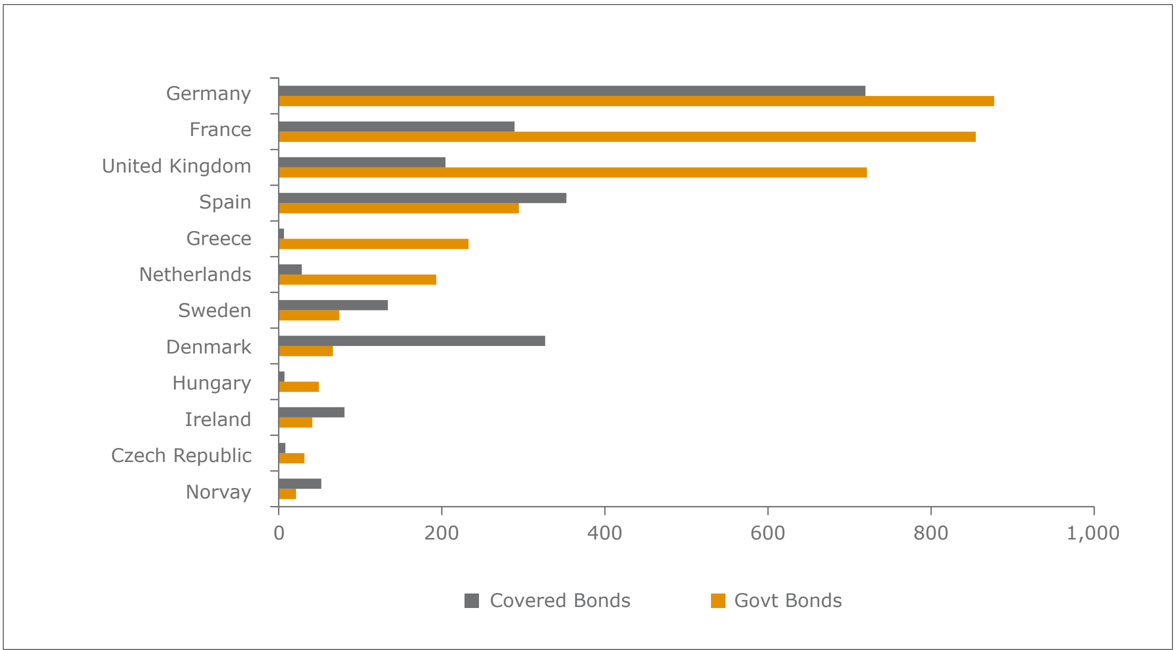
> The attractiveness of the product is also underlined by the significant increase in issuers over the last few years thereby diversifying the funding channels of banks, improving the availability of credit and helping to stabilise an even larger proportion of the banking sector.

Looking at the latest international trends, Canada and Australia are also considering the introduction of covered bond legislation, while the United States has been making steps towards a covered bond legislation (see Article 3.29 on developments in the United States). Furthermore, New Zealand has recently approved its new covered bond legislation, paving the way for the first issuance.

When looking at the pure size of today's covered bond market globally, it is also fair to state that the existence of covered bonds provide an investment alternative to government bonds or bank deposits. Providing an opportunity to diversify a portfolio beyond government bonds should also be seen as beneficial to investors and should be seen as a mitigating and therefore stabilising factor in capital markets when shocks hit other market segments.

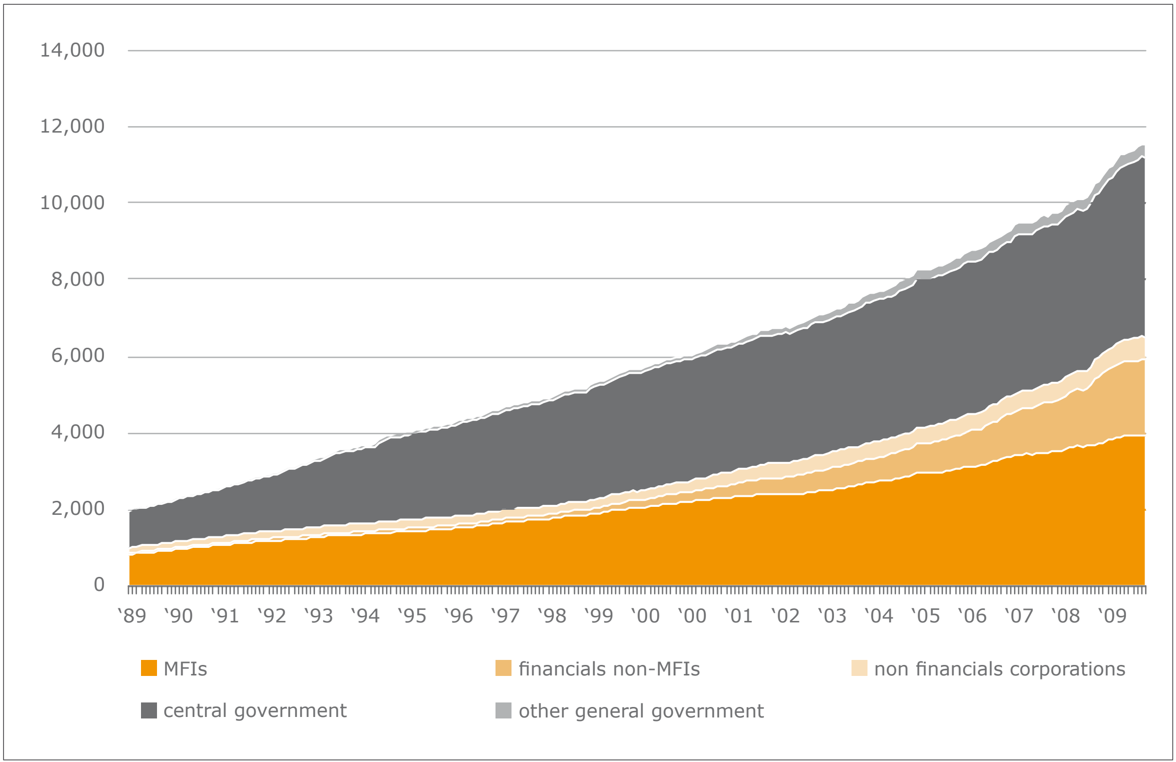
While it is of course stating the obvious, but the positive effects of covered bonds we would attribute to this asset class for the reasons mentioned above is clearly dependent on the extent to which covered bonds are used in a particular country with regard to the size of the domestic mortgage market, GDP and the alternative funding conditions for banks besides covered bonds. The below table provides data on the size of the covered bond market in most jurisdictions in absolute terms, as well as relative to GDP and the government bond market.

> Chart: Outstanding Volume of Selected Government Bond and Covered Bond Markets, end 2009, € bn



Source: OECD, ECBC, LBBW> Chart: Outstanding Volume of Selected Government Bond and Covered Bond Markets, end 2009, € bn

> CHART: OUTSTANDING VOLUME OF SELECTED GOVERNMENT BOND AND COVERED BOND MARKETS, END 2009, € BN



Source: ECB, LBBW

Looking at the role covered bonds have taken in the meantime for various especially European economies, we think it is fair, justified and to the benefit of the overall economy as well as financial stability to carefully examine ongoing banking regulation in order to determine, whether there are serious setbacks to be expected for covered bond funding. With the current regulatory initiatives with regard to e.g. regulating bank's asset liability matching, liquidity position or lending behaviour, these are all areas of crucial importance to the covered bond from the issuer's perspective – but they will be dealt with under banking regulation, not covered bond regulation. More details on this can be found in Article 1.3 on "Covered bonds and the era of regulation" in this year's edition of the ECBC Fact Book.

	Mortgage Backed Covered Bonds Outstanding, € bn							Mortgage Backed CBs as a % of Residential Loans Outstanding							Residential Mortgage Debt to GDP Ratio, %						
	2003	2004	2005	2006	2007	2008	2009	2003	2004	2005	2006	2007	2008	2009	2003	2004	2005	2006	2007	2008	2009
Austria	4.0	4.0	4.0	3.9	4.1	5.0	5.3	10.1	8.3	7.4	6.4	6.3	7.0	7.3	17.8	20.7	22.1	23.7	24.0	25.3	26.2
Czech R.	1.6	2.0	4.5	5.5	8.2	8.1	8.2	67.2	53.1	74.0	68.8	65.9	50.6	48.2	3.0	4.2	6.0	7.1	9.8	10.8	19.4
Denmark	204.7	216.1	246.4	260.4	244.7	255.1	319.4	100.0	100.0	100.0	100.0	100.0	100.0	100.0	78.4	79.7	84.9	89.1	93.1	95.4	103.8
Finland	0.0	0.3	1.5	3.0	4.5	5.8	7.6	0.0	0.4	2.3	4.1	5.5	6.5	7.7	35.1	38.2	41.9	44.5	45.7	48.0	58.0
France	38.3	47.5	57.2	74.0	103.6	159.4	176.0	9.9	11.0	11.3	12.8	15.9	22.5	23.9	24.2	26.0	29.2	32.0	34.4	36.4	38.0
Germany	256.0	246.6	237.5	223.3	206.5	217.4	225.1	22.1	21.3	20.4	18.9	17.9	19.0	19.6	53.4	52.3	51.9	50.9	47.6	45.9	47.6
Greece	0.0	0.0	0.0	0.0	0.0	5.0	6.5	0.0	0.0	0.0	0.0	0.0	6.4	8.1	15.5	18.3	23.2	27.2	30.6	32.5	33.9
Hungary	3.6	5.0	5.1	5.9	6.0	7.1	7.1	60.5	62.5	54.5	56.0	45.9	45.5	48.4	7.9	9.6	10.5	11.8	12.9	14.8	15.8
Ireland	0.0	2.0	4.1	11.9	13.6	23.1	29.7	0.0	2.6	4.2	9.7	9.7	15.6	20.1	42.5	51.7	61.0	69.7	73.7	81.5	90.3
Italy	0.0	0.0	0.0	0.0	0.0	6.5	14.0	0.0	0.0	0.0	0.0	0.0	2.1	4.2	13.0	14.8	17.0	18.6	19.7	19.6	21.7
Latvia	0.0	0.1	0.1	0.1	0.1	0.1	0.1	4.8	4.1	2.4	1.3	1.3	1.3	1.2	7.2	11.7	19.1	28.9	31.7	31.0	36.6
Luxembourg	0.0	0.0	0.0	0.2	0.2	0.2	0.0	0.0	0.0	0.0	1.3	1.1	1.0	0.0	30.3	32.0	33.0	33.2	37.0	37.9	42.0
Netherlands	0.0	0.0	2.0	7.5	15.7	21.0	28.4	0.0	0.0	0.4	1.4	2.8	3.6	4.7	83.9	88.2	93.5	96.7	98.3	98.9	105.6
Norway	0.0	0.0	0.0	0.0	6.4	21.9	51.3	0.0	0.0	0.0	0.0	3.6	12.8	26.3	52.0	53.3	56.5	56.2	62.4	55.5	70.8
Poland	0.2	0.2	0.6	0.5	0.7	0.6	0.6	1.8	2.3	3.8	2.0	1.9	1.0	1.0	4.5	4.7	6.0	8.4	11.6	15.6	18.2
Portugal	0.0	0.0	0.0	2.0	7.9	15.3	20.3	0.0	0.0	0.0	2.2	7.8	14.5	18.3	47.8	49.3	53.3	59.1	62.0	63.2	67.5
Slovakia	0.5	1.1	1.6	2.2	2.7	3.6	3.6	36.0	47.9	51.4	52.6	41.9	41.9	39.1	4.8	6.5	8.0	9.5	11.9	13.2	14.6
Spain	57.1	94.7	150.2	214.8	267.0	315.1	336.7	18.3	24.6	31.6	37.6	41.3	46.7	49.6	40.0	45.7	52.3	58.1	61.4	62.0	64.6
Sweden	0.0	0.0	0.0	55.3	92.3	117.6	133.9	0.0	0.0	0.0	27.2	41.7	53.7	56.7	48.5	57.0	59.4	64.8	66.9	66.7	82.0
UK	5.0	15.0	26.8	50.5	82.0	204.3	201.1	0.5	1.2	1.9	3.2	4.7	14.0	14.7	67.4	71.2	77.5	82.4	85.4	80.3	87.6
US	0.0	0.0	0.0	4.0	12.9	12.9	12.9	0.0	0.0	0.0	0.0	0.2	0.1	0.2	56.3	67.1	88.8	83.1	76.9	86.2	81.4
EU-27	571.1	634.4	741.5	920.9	1059.6	1370.0	1523.7	13.7	13.7	14.4	16.1	17.1	22.4	24.8	41.9	44.0	46.6	49.5	51.4	50.0	52.3

Source: EMF, ECBC, LBBW. Data as of August 2010.

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

	Covered Bonds Outstanding, € bn							Covered Bonds as a % of GDP							Covered Bonds as % of Govt Bonds						
	2003	2004	2005	2006	2007	2008	2009	2003	2004	2005	2006	2007	2008	2009	2003	2004	2005	2006	2007	2008	2009
Austria	10.8	10.8	17.0	19.5	19.3	22.3	24.9	4.8	4.6	7.0	7.6	7.1	7.9	9.0	7.1	6.2	10.9	10.7	9.2	11.0	17.5
Czech Republic	1.6	2.0	4.5	5.5	8.2	8.1	8.2	2.0	2.2	4.4	4.9	6.5	5.5	6.1	13.2	9.8	19.3	17.2	19.3	17.9	25.9
Denmark	211.6	222.5	253.3	267.0	252.6	262.3	326.8	112.3	112.9	122.2	122.1	111.3	112.6	146.6	200.9	196.2	292.8	307.8	284.3	276.0	491.6
Finland	0.0	0.3	1.5	3.0	4.5	5.8	7.6	0.0	0.2	1.0	1.8	2.5	3.1	4.5	0.0	0.4	2.4	4.5	6.4	9.0	17.1
France	86.9	105.8	124.8	154.6	200.1	264.5	289.2	5.5	6.4	7.2	8.6	10.6	13.6	14.9	10.1	10.6	13.5	14.5	16.1	21.6	33.8
Germany	1056.7	1010.1	975.9	948.8	888.6	805.6	719.5	48.8	45.7	43.5	40.8	36.6	32.3	29.9	115.1	94.9	99.6	82.2	67.6	64.2	82.0
Greece	0.0	0.0	0.0	0.0	0.0	5.0	6.5	0.0	0.0	0.0	0.0	0.0	2.1	2.7	0.0	0.0	0.0	0.0	0.0	1.5	2.8
Hungary	3.6	5.0	5.1	5.9	6.0	7.1	7.1	4.9	6.0	5.7	6.6	5.9	6.7	7.6	10.3	10.4	10.9	10.2	8.4	10.1	14.4
Ireland	12.4	29.2	45.1	61.8	64.8	75.7	80.7	8.8	19.6	27.8	35.0	34.1	41.6	49.3	33.7	67.3	119.7	147.5	139.9	128.5	195.9
Italy	0.0	0.0	4.0	8.1	8.1	14.6	23.1	0.0	0.0	0.3	0.5	0.5	0.9	1.5	0.0	0.0	0.3	0.5	0.5	0.9	2.0
Latvia	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.5	0.5	0.4	0.4	0.4	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Luxembourg	16.9	19.6	25.0	28.5	33.9	35.6	31.6	65.3	71.5	82.5	83.5	90.5	90.5	83.8	3406.6	3674.9	8513.6	22907.5	0.0	1279.6	1625.8
Netherlands	0.0	0.0	2.0	7.5	15.7	21.0	28.4	0.0	0.0	0.4	1.4	2.8	3.5	5.0	0.0	0.0	0.8	2.9	5.6	7.6	14.7
Norway	0.0	0.0	0.0	0.0	6.4	21.9	52.3	0.0	0.0	0.0	0.0	2.2	7.1	19.0	0.0	0.0	0.0	0.0	18.6	72.0	245.7
Poland	0.2	0.2	0.6	0.5	0.8	0.7	0.7	0.1	0.1	0.2	0.2	0.3	0.2	0.2	0.3	0.2	0.5	0.3	0.4	0.4	0.6
Portugal	0.0	0.0	0.0	2.0	7.9	15.4	21.4	0.0	0.0	0.0	1.3	4.8	9.3	13.1	0.0	0.0	0.0	2.0	6.7	13.4	26.7
Slovakia	0.5	1.1	1.6	2.2	2.7	3.6	3.6	1.7	3.1	4.1	5.0	5.0	5.5	5.7	4.9	7.5	12.4	13.3	12.9	16.0	23.1
Spain	62.0	101.9	159.9	226.4	283.3	332.1	352.8	7.9	12.1	17.6	23.0	26.9	30.5	33.6	18.5	27.4	48.2	61.8	70.8	78.8	119.8
Sweden	0.0	0.0	0.0	55.3	92.3	117.6	133.9	0.0	0.0	0.0	17.6	27.9	35.9	46.5	0.0	0.0	0.0	40.7	68.5	110.8	180.3
UK	5.0	15.0	26.8	50.5	82.0	204.3	204.5	0.3	0.8	1.5	2.6	4.0	11.2	13.1	0.8	2.1	3.4	5.4	8.0	19.8	28.4
US	0.0	0.0	0.0	4.0	12.9	12.9	12.9	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.1	0.4	0.3	0.5

Source: EMF, ECBC, LBBW. Data as of August 2010.

2.5 COVERED BOND REPOS - THE ECB LIFELINE FOR BANKS

By Frank Will and Sophia Kwon, RBS

INTRODUCTION

The financial crisis led to severe disruptions in the wholesale funding market across asset classes. The covered bond market was able to stay open longer than many others, but the collapse of Lehman Brothers in September 2008 marked the beginning of the longest period without benchmark covered bond issuance, as the market remained effectively shut until the beginning of 2009.

Although the markets re-opened in May 2009 spurred on by the ECB's covered bond purchase programme (see separate article), the sovereign crisis showed that the covered bond market was effectively only open to issuers out of jurisdictions that were untainted by the turmoil. However, the number of covered bond programmes continued to increase undeterred. Many of these programmes were set up not just to have an additional source of capital markets funding for when wholesale liquidity returns, but also to make use of the repo facilities at central banks as means to access liquidity in a closed wholesale market.

The ECB has been a key source of liquidity for banks in the Eurosystem during difficult periods. In 2009 the average amount of eligible collateral increased by 18% compared to 2008, whilst the average use of marketable assets as collateral rose by 29% in the same period.[1] The increase was mainly due to the fact that counterparties placed large additional amounts of collateral with the Eurosystem in response to the turbulences in the financial markets.

The role of covered bonds within the ECB's liquidity operations has become an increasingly important one. The use of covered bonds jumped by around 57% from 2008 to 2009, almost double the rate growth of total collateral (29%) during the same period. As they are considered to be a more liquid asset class, covered bonds receive preferential liquidity class classification and thus haircut valuations for repo transaction with the ECB compared with, for example, ABS. Moreover, unlike senior bank debt, the ECB will accept self-issued 'covered bank bonds' (see below) as collateral. 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.

In December 2008, the ECB published a report on the covered bond market, in which it noted that "in view of the main features of covered bonds, the smooth functioning of these markets is important from a financial stability perspective. In this context, it should be noted that covered bonds represent an important funding source for mortgage lending in several countries".[2] Various moves to support the liquidity of the product, the most notable of which is the €60bn covered bond buying programme, support the view that the ECB considers a properly functioning covered bond market to be in the interest of both market participants and regulators.

In terms of the covered bond buying programme, several factors have been noted by the ECB as contributing towards the decision to engage in purchases of covered bonds. Key drivers of the decision was the Governing Council's belief that outright purchases of covered bonds by the Eurosystem "could help to revive this market, in terms of liquidity, issuance and spreads"[3] and that, given that covered bonds

1 ECB Annual Report 2009

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

3 Keynote address by Jean-Claude Trichet, President of the ECB at the University of Munich, Munich, 13 July 2009 http://www.ecb.int/press/key/date/2009/html/sp090713.en.html.

had been a major source of funds for banks in the euro area before the intensification of the financial crisis last autumn, a revival of the covered bond market could help to support the lending to the non-financial sector.

The conservative nature of the product, in light of the "dire consequences of the imprudent evaluation of credit risk"[4] has also been highlighted as a key reason why the ECB chose covered bonds rather than any other asset class for its buying programme. Whilst independent from it, this is in line with a previous ECB statement which notes that "covered bonds possess a number of attractive features from the perspective of financial stability. Covered bonds as dual recourse instruments are less risky than most other bank securities and also increase banks' access to long-term funding, thereby mitigating liquidity risks. In the context of the ongoing financial market turmoil, it is important to stress that, on the whole, covered bonds have proven themselves relatively resilient, in particular in comparison with securitisation".[5]

On the following pages we outline the treatment of covered bonds within the ECB's liquidity operations, and the role these operations have played in maintaining liquidity throughout the financial crisis. We also look at the knock-on effects of the increased use of the ECB repo facility on covered bond issuers whilst we discuss the success of the ECB's €60bn covered bond purchase programme in supporting the proper functioning of the market in a separate article.

ELIGIBILITY CRITERIA FOR COLLATERAL IN EUROSYSTEM 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, with any lending being "based on adequate collateral".[6]

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).

Covered bonds, as dual recourse instruments, are on the Eurosystem's single list of collateral, as they limit the risk of losses to the central bank while contributing to the effective implementation of monetary policy.[7] "From a financial stability perspective, a crucial difference between covered bonds and securitisation is that covered bonds do not involve credit risk transfer. This gives the originating bank a

4 ibid

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

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

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

stronger incentive to conduct proper credit evaluation when granting loans and proper credit monitoring of borrowers during the life of the loan."[8]

The Eurosystem's Refinancing Facilities are in principal open to all financial institutions subject to minimum reserves in the euro area, provided they fulfil certain eligibility criteria. The Collateral Framework has experienced temporary expansion of rules and changes which remain permanent in response to the turmoil during the past two years, with the most recent amendments to the Facility having been announced in July 2010.

> Selected Eligibility Criteria for Eurosystem Credit Operations

	Standard Collateral Rules	Temporary Expansion of Eligible Assets (Effective on 14 November 2008 until end of 2010)	Further Specifications (Effective on 1 February 2009)
Type of Asset	• Debt instrument having a coupon that cannot result in a negative cash flow • Coupon should be zero coupon, fixed-rate coupon or floating-rate coupon linked to an interest rate reference or to rating of issuer or inflation-indexed • Debt instruments, including covered bonds, but not including ABS, must have a fixed, unconditional principal amount		Limits on the use of uncovered bank bonds as of March 2009: • The value assigned to uncovered bank bonds issued by an issuer or entity with close links must be less than a share of 10% in the value of the collateral pool of a counterparty, unless the market value of these assets is not higher than €50m • Uncovered bank bonds submitted as collateral to the Eurosystem until 20 January 2009 are subject to this limitation as from 1 March 2010
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 22 (4) of the UCITS Directive, (i.e. subject to covered bond specific legislation) • Covered bonds which do not meet these criteria (general law-based covered bonds) but meet all other requirements are eligible but classified as 'Credit Institution Debt Instruments'		
Cash Flow Backing ABS	• Must be legally acquired in accordance with the laws of a member state in a "true sale" • Must not consist of credit-linked notes (i.e. cannot be a synthetic structure)		For ABS issued as of 1 March 2009, the underlying pool should not contain tranches of other ABS. ABS issued before 1 March 2009 were exempted until 1 March 2010

8 ibid

Tranche and Rating	• Tranche (or sub-tranche) must not be subordinated to other tranches of the same issue • The original minimum rating was A- (S&P) / A3 (Moody's) / A- (Fitch) / AL (DBRS) • The minimum rating threshold was lowered to BBB- (S&P) / Baa3 (Moody's) / BBB- (Fitch) / BBBL (DBRS) for the first time in October 2008 as part of the temporary expansion of eligible assets. It has subsequently been prolonged and has taken the place of the original minimum rating for all assets except for ABS. • Assets in the triple-B bucket are subject to a graduated valuation		Additional rating criterion for ABS: AAA (S&P) / Aaa (Moody's) / AAA (Fitch) / AAA (DBRS) at issuance for all ABSs issued as of 1 March 2009. Must retain the single A minimum rating threshold over the lifetime of the ABS
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	Certificates of deposits (CDs) are eligible when traded on one of the accepted non-regulated markets subject to additional 5% haircut	
Type of Issuer/ Guarantor	Central banks, public sector or private sector entities or international institutions		
Place of Establishment of the Issuer/ Guarantor	Issuer must be established in the EEA or in non-EEA G10 countries and guarantor must be established in the EEA		
Currency of Denomination	Euro	GBP, USD and Yen denominated securities eligible subject to additional 8% haircut	

Source: ECB, RBS

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.

One can determine the applicable haircut for the ECB assets by referencing the tables as set out in the following. By way of example, a counterparty that enters into a repo transaction with the Eurosystem, pledging an asset which is a regional government bond, with a fixed coupon, maturing in 4 years. This asset will then be subject to a haircut of 3.5%.

> ECB Haircuts by Liquidity Category and Residual Maturity (since 1 February 2009 until year-end 2010)

<table>
<tr><th></th><th colspan="2">Liquidity Category I (Government Bonds)</th><th colspan="2">Liquidity Category II (Local & Regional Govt, Supras & Agencies, Jumbo Covered Bonds)</th><th colspan="2">Liquidity Category III (Trad. Covered Bonds, Multi-issuer Covered Bonds, Corporates Bonds)</th><th colspan="2">Liquidity Category IV (Unsecured Bank Bonds, Structured Covered Bonds)</th><th>Liquidity Category V (ABS)</th></tr>
<tr><td>Residual maturity (years)</td><td>Fixed coupon</td><td>Zero coupon</td><td>Fixed coupon</td><td>Zero coupon</td><td>Fixed coupon</td><td>Zero coupon</td><td>Fixed coupon</td><td>Zero coupon</td><td>Fixed or zero coupon</td></tr>
<tr><td>0-1</td><td>0.5</td><td>0.5</td><td>1</td><td>1</td><td>1.5</td><td>1.5</td><td>6.5</td><td>6.5</td><td rowspan="6">12*</td></tr>
<tr><td>1-3</td><td>1.5</td><td>1.5</td><td>2.5</td><td>2.5</td><td>3</td><td>3</td><td>8</td><td>8</td></tr>
<tr><td>3-5</td><td>2.5</td><td>3</td><td>3.5</td><td>4</td><td>4.5</td><td>5</td><td>9.5</td><td>10</td></tr>
<tr><td>5-7</td><td>3</td><td>3.5</td><td>4.5</td><td>5</td><td>5.5</td><td>6</td><td>10.5</td><td>11</td></tr>
<tr><td>7-10</td><td>4</td><td>4.5</td><td>5.5</td><td>6.5</td><td>6.5</td><td>8</td><td>11.5</td><td>13</td></tr>
<tr><td>>10</td><td>5.5</td><td>8.5</td><td>7.5</td><td>12</td><td>9</td><td>15</td><td>14</td><td>20</td></tr>
</table>

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

In July 2010 the ECB announced a new haircut scheme that graduates haircuts according to differences in maturities, liquidity categories and the credit quality of the assets concerned (next two tables). Category II haircuts remain unchanged. In category III the haircut for maturities up to 3 years will not be changed. However, the haircuts for 3-5 year maturities will be increased by 50bp, the 5-7 year bracket by 100bp, bonds with maturities of 7 years and more by 200bp. Haircuts are significantly higher for bonds in the triple-B bucket (see second table below), which is so far only relevant for a few retained Greek covered bonds rated triple-B by Moody's. As the ECB applies a 'best rating' approach most of the Greek covered bonds do not fall into the triple-B bucket at the moment because they are still rated single-A by Fitch. The additional valuation mark-down of 5% currently applied to theoretically valued asset-backed securities will be extended to theoretically valued bank bonds (including uncovered as well as covered bank bonds, namely Jumbos, traditional and structured covered bonds and multi-issuer covered bonds). The new haircut schedule will enter into force on 1 January 2011.

>Amended ECB Haircuts by Liquidity Category and Residual Maturity (effective 1 January 2011)

Credit Quality Steps 1 and 2 (AAA to A-)	**Liquidity Category I** (Government Bonds)		**Liquidity Category II** (Local & Regional Govt, Supras & Agencies, Jumbo Covered Bonds*)		**Liquidity Category III** (Traditional Covered Bonds*, Structured Covered Bonds*, Multi-Issuer Covered Bonds* Corporates Bonds*)		**Liquidity Category IV** (Unsecured Bank Bonds*)		**Liquidity Category V** (ABS*)
Residual maturity (years)	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed or zero coupon
0-1	0.5	0.5	1	1	1.5	1.5	6.5	6.5	16
1-3	1.5	1.5	2.5	2.5	3	3	8.5	9	
3-5	2.5	3	3.5	4	5	5.5	11	11.5	
5-7	3	3.5	4.5	5	6.5	7.5	12.5	13.5	
7-10	4	4.5	5.5	6.5	8.5	9.5	14	15.5	
>10	5.5	8.5	7.5	12	11	16.5	17	22.5	

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

>Amended ECB Haircuts by Liquidity Category and Residual Maturity (effective 1 January 2011)

Credit Quality Step 3 (BBB+ to BBB-)	**Liquidity Category I** (Government Bonds)		**Liquidity Category II** (Local & Regional Govt, Supras & Agencies, Jumbo Covered Bonds*)		**Liquidity Category III** (Traditional Covered Bonds*, Structured Covered Bonds*, Multi-Issuer Covered Bonds* Corporates Bonds*)		**Liquidity Category IV** (Unsecured Bank Bonds*)		**Liquidity Category V** (ABS)
Residual maturity (years)	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed or zero coupon
0-1	5.5	5.5	6	6	8	8	15	15	Not eligible
1-3	6.5	6.5	10.5	11.5	18	19.5	27.5	29.5	
3-5	7.5	8	15.5	17	25.5	28	36.5	39.5	
5-7	8	8.5	18	20.5	28	31.5	38.5	43	
7-10	9	9.5	19.5	22.5	29	33.5	39	44.5	
>10	10.5	13.5	20	29	29.5	38	39.5	46	

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

CLASSIFICATION OF COVERED BONDS WITHIN THE EUROSYSTEM OPERATIONS

The Eurosystem does currently not provide an official definition of what is classified as 'Covered Bonds'. 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 22(4) of the UCITS Directive.[9] Those bonds are grouped either into liquidity category II in case of Jumbo covered bonds, i.e. bonds with a minimum issue size of €1bn and at least three market makers, or into liquidity category III in case of traditional non-Jumbo covered bonds.

'Structured' covered bonds are issued under a general legal framework, rather than being subject to 'special public supervision', they do not fall within the UCITS definition and as such have not been recognised as covered bank debt by the ECB from a liquidity haircut perspective and were assigned to category IV. However, from 1 January 2011 all non-Jumbo covered bonds, including 'structured covered bonds' and multi-issuer covered bonds, together with traditional (UCITS-compliant) covered bonds, will be classified in liquidity category III.

COVERED BONDS AND 'CLOSE LINK' EXEMPTION

'Covered bank bonds' also benefit from certain preferential treatments compared with non-UCITS compliant covered bonds and other bank debt when it comes to self-issued bonds. The ECB states that "irrespective of the fact that a marketable or non-marketable asset fulfils all eligibility criteria, a counterparty may not submit as collateral any asset issued or guaranteed by itself or by any other entity with which it has close links".[10] This means that banks cannot, for example, use their own senior debt directly as collateral with the ECB.

In the past, issuers were able to securitize assets on their balance sheet and retain them as collateral for central bank repo operations. However, in addition to certain other changes outlined below, as a result of the increased use of securitisation technology to create ABS assets solely for use as collateral for central bank liquidity purposes, the ECB broadened the definition of 'close links', which now extends to situations where a counterparty submits an asset-backed security as collateral when it (or any third party that has close links to it) provides support to that asset-backed security by entering into a currency hedge with the issuer or guarantor of the asset-backed security or by providing liquidity support of more than 20% of the nominal value of the asset-backed security.

Apart from the fact that swap counterparties and liquidity providers to a transaction may now also be precluded from using the ABS as eligible collateral, originators of ABS (which have historically been able to use their retained ABS as eligible collateral) are no longer be able to do so if they provide a currency swap or liquidity above the 20% threshold.

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

9 Following the recast of EU Directive 85/611 under Directive 2009/65 on 13 July 2009, UCITS Article 22(4) will become UCITS Article 52(4) in July 2011.

10 European Central Bank, "The Implementation on Monetary Policy in the Euro Area", November 2008

HAIRCUT VALUATION CHANGES TO ECB REFINANCING FACILITY

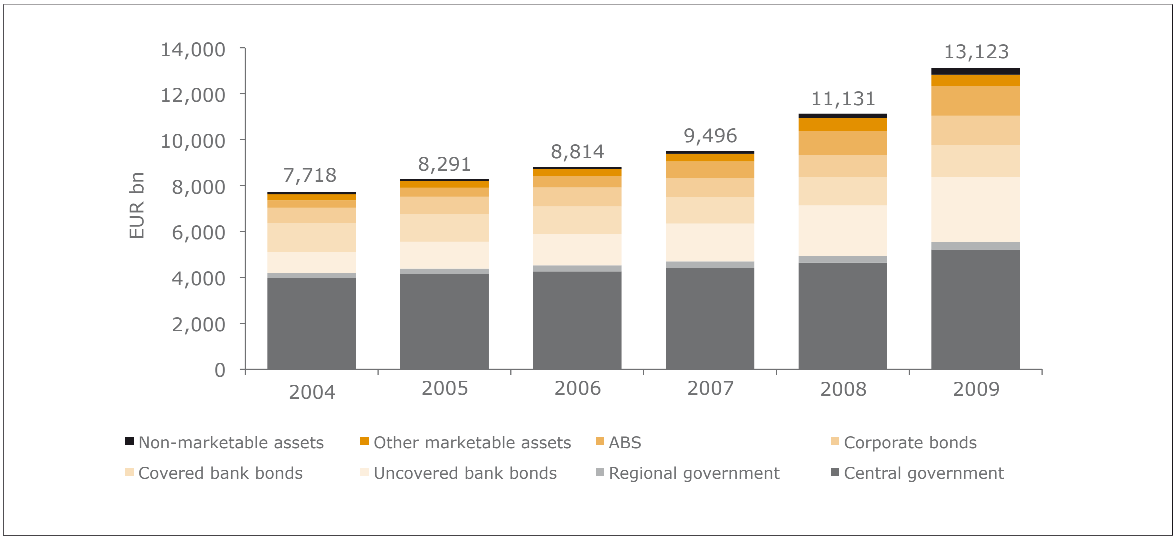
In response to the ongoing crisis, the ECB has taken a series of measures to help support the normalisation of the functioning of the euro money market in order to provide liquidity to solvent banks notwithstanding dysfunctional money markets. These include an increase in the level of funding being made available through the refinancing operations, and an alteration of the mix of funding by skewing supply away from 1-week to the 3-month term facility and also to the supplementary 6-month term facility, introduced in response to the dislocation in money markets.

The list of eligible collateral was enlarged (temporary expansion of eligible assets until end-2010), to include assets with lower credit ratings (from A- to BBB-, except for ABS) subject to an additional haircut of between 5 and 10%, debt instruments issued by banks on certain non-regulated markets (e.g. CDs), debt denominated in USD, GBP or JPY that fulfil all other eligibility criteria. Under the new graduated haircut schedule, the minimum rating threshold has been subsequently lowered to allow for triple-B rated assets (except for ABS) beyond the end of 2010.

USE OF COVERED BONDS AS COLLATERAL IN EUROSYSTEM OPERATIONS

Since 2004, the outstanding volumes of eligible repo collateral have grown considerably from €7.7 trillion to €13.1 trillion by the end of 2009. Central government debt accounts for the largest share (40%) followed by uncovered bank bonds (22%) and covered bank bonds (11%). Corporate bank bonds and ABS accounted for 10% each.

> Chart 1: Eligible collateral by asset type

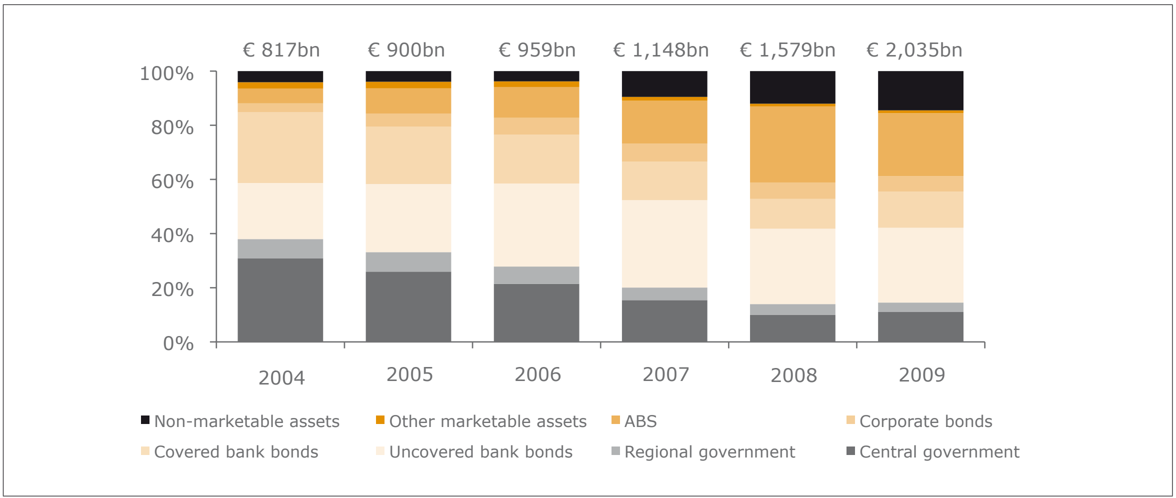


Source: ECB

The actual breakdown by type of the collateral used for repo transaction differs significantly from the market composition of the available eligible collateral as relative value considerations play an important role in the banks' decisions as to which collateral to post.

Over the last few years, there has been a general trend to lower the overall quality and/or liquidity of the collateral used by the banks for repo operations. The share of central government debt has fallen sharply, from a 31% share in 2004 to just 11% in 2009. Although the use of covered bank bonds (which includes only UCITS compliant covered bonds) jumped by around 57% 2008 to 2009, almost double the rate as total collateral use (29%), their share in the repo operations has dropped from 26% in 2004 to 13% in 2009. Since 2004, the share of uncovered bank bonds (which included general law based covered bonds) has significantly increased from 20% to 28% having peaked at 32% in 2007. The most notable increase over the period was in ABS, which grew from 6% to 28% in 2008 before falling to 23% in 2009. The share of non-marketable securities also rose significantly from 4% to 14% in 2009.

> Chart 2: Eligible collateral by asset type

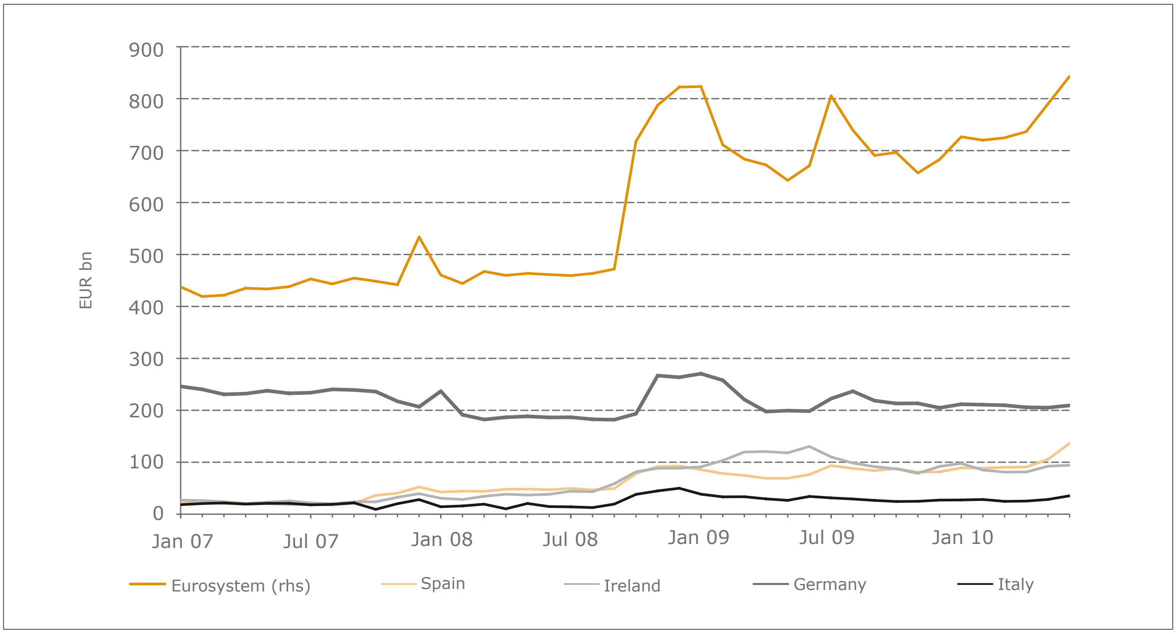


Source: ECB

The chart below shows the massive jump of main and long-term refinancing operations within the Eurosystem banks in autumn 2008. Only a few central banks publish figures of the national take-up of the repo facilities. The repo figures from the Deutsche Bundesbank, the Banco de España, the Central Bank of Ireland and the Bank of Italy show that banks in all four countries significantly increased the use of the ECB funding operations during that period. Only the volume for German banks has come down to lower levels again. The upwards trend in the overall usage can probably be attributed to the Greek banks. According to Fitch, Greek banks are relying on the ECB facilities extensively and substantially more than the other European banks and have recently increased usage further to boost short-term liquidity.[11]

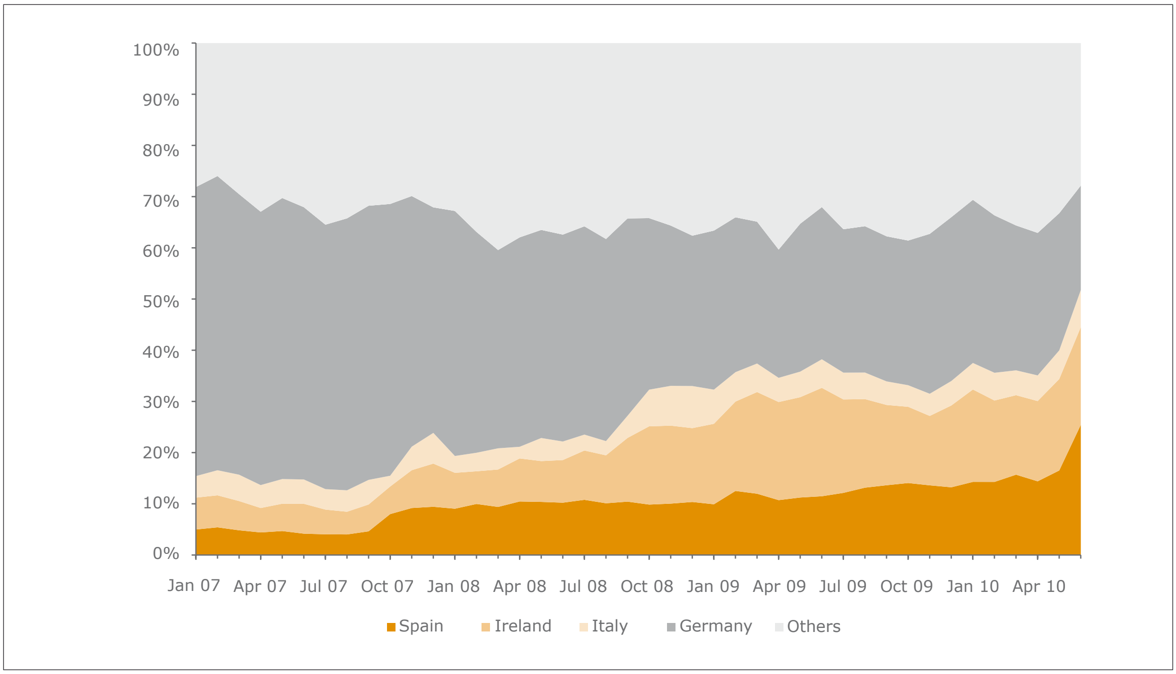
11 Fitch, "The Role of the ECB – Temporary Prop or Structural Underpinning?", May 2010

> CHART 3: MAIN & LONG-TERM REFINANCING OPERATIONS BY ECB AND SELECTED NCBS



Source: ECB, central banks

> CHART 4: COMPOSITION OF TOTAL EUROSYSTEM LENDING INCLUDING FINE TUNING BY NCBS



Source: ECB, central banks

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 to 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 April 2010 the ECB returned to variable tender procedures in the three-month longer term refinancing operations as part of the gradual phasing-out of its non-standard operational measures. Its main refinancing operations are to continue as fixed rate tender procedures with full allotment for as long as necessary, but at least until 12 October 2010. This tender procedure would also remain in use for the Governing Council's special-term refinancing operations with a maturity of one maintenance period, which will continue to be conducted for as long as needed and at least until 12 October 2010. The fixed rate in these special-term refinancing operations will be the same as the rate used in the respective main refinancing operations.[12]

POTENTIAL IMPACT AND OUTLOOK

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

The role of covered bonds as tool for long term funding was also noted by President Trichet in his comments following the announcement of the covered bond purchase programme, noting that they give banks "access to funding of a longer-term nature than the ECB's refinancing operations. Covered bonds thus allow banks to manage the maturity mismatch between their assets and liabilities". The motivation for choosing covered bonds rather than any other asset class for the programme was noted at this time as being two-fold: firstly, because the Governing Council felt that the programme would help revive the covered bond market, giving banks access to longer dated funding which in turn should support the flow of credit to the non-financial sector. Secondly, "covered bonds are different in nature from the various asset-backed securities that became so popular before turning sour with the financial crisis. 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."[13]

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

13 Keynote address by Jean-Claude Trichet, Munich, 13 July 2009 (see above)

CHAPTER 3 - THE ISSUER'S PERSPECTIVE

3.1 AUSTRIA

Martin Schweitzer, Erste Group Bank AG
Roland Berger, Unicredit Bank Austria

I. FRAMEWORK

Austria has three different frameworks under which Covered Bonds can be issued. These are:

1. Hypothekenbankgesetz: Mortgage Banking Act (Law of 7/13/1899, last amended 2005)
2. Gesetz betreffend fundierte Bankschuldverschreibungen: Law on Secured Bank Bonds (Law of 12/27/1905, last amended 2005)
3. Pfandbriefgesetz: Mortgage Bond Act (Law of 12/21/1927, last amended June 1, 2005)

Under these laws banks can issue two kinds of Covered Bonds, Pfandbriefe which are issued under the Mortgage Banking and Mortgage Bond Act, and Fundierte Bankschuldverschreibungen (FBS) issued under the Law on Secured Bank Bonds.

Amendments of all three laws have been brought forward by the industry in February 2010 with the aim of further harmonizing/unifying Austrian Pfandbrief legislation.

II. STRUCTURE OF THE ISSUER

The Mortgage Banking Act does stipulate a specialist banking provision and this would apply for any new mortgage banks. In practice, due to grandfathering of bonds issued before the law was implemented, exceptions are allowed and, in practice, all types of commercial banking activity are allowed. The Mortgage Bond Act applies to public-sector banks. And the Law on Secured Bank Debenture is applicable for all other issuers.

Under all frameworks, the issuer holds the assets on the balance sheet and the assets are not transferred to a separate legal entity. This means that the Covered Bonds are an unconditional obligation of the issuer, rather than a direct claim on the cover assets. In the case of insolvency of the issuer, the cover assets will be separated from the rest of the assets and a special cover pool administrator will be appointed. The Covered Bond holders have a preferential claim on the cover assets.

III. COVER ASSETS

The cover pools have either mortgage-backed or public-sector assets. ABS/MBS are not eligible.

A Pfandbrief or Fundierte Bankschuldverschreibung (FBS) issue always corresponds to one asset class.

The geographical scope of eligible mortgage assets is restricted to EU / EEA countries, to Switzerland;

USA, Canada and Japan are not eligible. For EEA countries that do not recognise a preferential claim, a 10% limit is in place. For öffentliche Pfandbriefe, the geographic scope of assets is the same.

The limits for FBS are similar. In addition also bonds that have the status of "Mündelgelder" are eligible (such as other local public bonds, or Austrian Pfandbriefe).

Derivative contracts are allowed in the cover pool and the Austrian legislation allows for interest rate currency and credit derivatives. Derivatives are only allowed for hedging and there is no limit in place on the volume of derivatives in the cover pool.

Substitute cover assets are limited to 15% and can consist of cash, bank deposits and bonds from public issuers from EEA countries and Switzerland.

IV. VALUATION AND LTV CRITERIA

The Mortgage Bank Act stipulates conditions for property valuation and the value of mortgage lending and the valuation method must be approved by the regulator. One condition is a 60% LTV (loan to value) for residential and commercial mortgages based on the mortgage lending value.

There is no provision for property valuation for FBS. In practice, issuers have incorporated an LTV provision into their articles of association which is 60% LTV.

In practice, monitoring of the property value is done by the issuer and a regular audit of the cover register is undertaken. The valuation of the property used in the calculations cannot exceed the resale value of the property, and valuation guidelines are approved by the regulator in line with general Mortgage Business valuation approvals (i.e. in IRB approval).

V. ASSET - LIABILITY MANAGEMENT

All Austrian Covered Bond laws enshrine the matching principle whereby the total volume of assets in the cover pool must at least cover the total nominal amount of Covered Bonds in issuance. The cover pool assets must also cover the outstanding bonds in terms of interest income. In addition, a mandatory overcollateralisation level of 2% is in place, which must be held in highly liquid substitute cover assets.

As well as these rules, banks can make additional voluntary provision in their articles of association which can strengthen the overcollateralization or asset- and liability management. An example of this would be to extend the matching principle to a net present value instead of nominal value and apply interest rate shocks, which is used by many of the international benchmark issuers.

The legislation also contains some maturity matching requirements to the extent that bonds cannot be issued if their maturity is considerably greater than the maturity of assets in the cover pool.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The cover pool is monitored by a trustee ("Treuhänder"), who is appointed by the Minister of Finance. The trustee is liable according to the Austrian civil code and has formal functions only. The monitor has to ensure that the prescribed cover for the Pfandbriefe exists at all times and that the cover assets are recorded correctly in the cover register. Without his approval, no assets may be removed from the cover pool.

For FBS the pool is monitored monthly by the government commissioner ("Regierungskommissar"), who works for the ministry of finance on behalf of the Finance Market Authority (FMA*).

Any disputes between the issuer and the trustee would be settled by the regulator. For FBS if the government commissioner is concerned that the rights of the Covered Bond holders are being infringed then he can apply to the courts to appoint a joint special representative of the creditors.

* The FMA is responsible for banking supervision in Austria.

VII. SEGREGATION OF COVER ASSES AND BANKRUPTCY REMOTENESS OF COVERED BONDS?

A cover register (Deckungsregister) permits the identification of the cover assets. All mortgages, public-sector loans, substitute cover assets and derivative contracts need to be registered in the cover register.

Austrian Banks need to inform customers that loans will be introduced into the cover pool and state that loans in the cover pool are not subject to compensation. Set-off statements for derivative counterparties are admissible when they refer to claims and liabilities from the same Master Agreement.

The legal effect of registration is that in the case of insolvency of the issuer, the assets which form part of the separate legal estate (the so called "Sondervermögen") can be identified: All values contained in the register would be qualified as part of the separate legal estate.

While the bank carries out the daily administration of the cover register, it is the cover pool monitor who supervises the required cover und registration in the cover register.

Asset segregation

If the issuer becomes insolvent then the cover assets will be segregated from the remainder of the assets as a direct consequence of the insolvency proceedings. These assets shall form what is known as a 'Sondervermörgen' and are earmarked for the claims of the Covered Bond holders. Any voluntary overcollateralisation is also bankruptcy-remote but cover assets that are not needed to satisfy the claims of the Covered Bond holders are passed back to the insolvent issuer.

The cover assets will be managed by a special administrator, who is appointed by the bankruptcy court, after consultation with the FMA. The special administrator has the right to manage and dispose of the recorded assets.

Impact of insolvency proceedings on Covered Bonds and derivatives

Covered Bonds do not automatically accelerate in case of insolvency of the issuer, but will be repaid at the time of their contractual maturity. The cover assets are administered in favour of the bond holders and any claims of the Covered Bond holders in respect of interest or principal repayments are to be paid from the assets. Consequently, in respect of derivatives, there is no legal consequence of insolvency and the counterparty claims as derivative transactions rank pari passu with the claims of the Covered Bond holders.

Preferential treatment of Covered Bond holders

Covered Bond holders enjoy preferential treatment as the law stipulates the separation of the cover assets on the one hand and the insolvency estate. The satisfaction of the Pfandbrief creditors is not limited to the cover assets. On the contrary, these creditors also participate in the insolvency proceedings with respect to the Pfandbrief bank's remaining assets. As long as the separate legal estate has sufficient liquidity, a moratorium on the insolvency estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of Covered Bond holders.

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

Access to liquidity in case of insolvency

Once appointed, the cover pool administrator has the right to manage the cover pool in order to satisfy the claims of the Covered Bond holders. The cover pool administrator can, for example, sell assets in the cover pool or enter into a bridging loan in order to create liquidity to service the bonds in issue.

The cover pool administrator also has access to any voluntary over collateralisation, which is also considered bankruptcy-remote. Any voluntary overcollateralisation that is not necessary to cover the claims of the Covered Bond holders can be transferred back to the insolvency estate.

Sale and transfer of mortgage assets to other issuers

The Covered Bond administrator can also sell the assets collectively to a separate credit institution. This institution must then take over all liabilities with regard to the Covered Bonds. In fact, one of the tasks of the special administrator is to find a suitable credit institution that will buy the assets collectively.

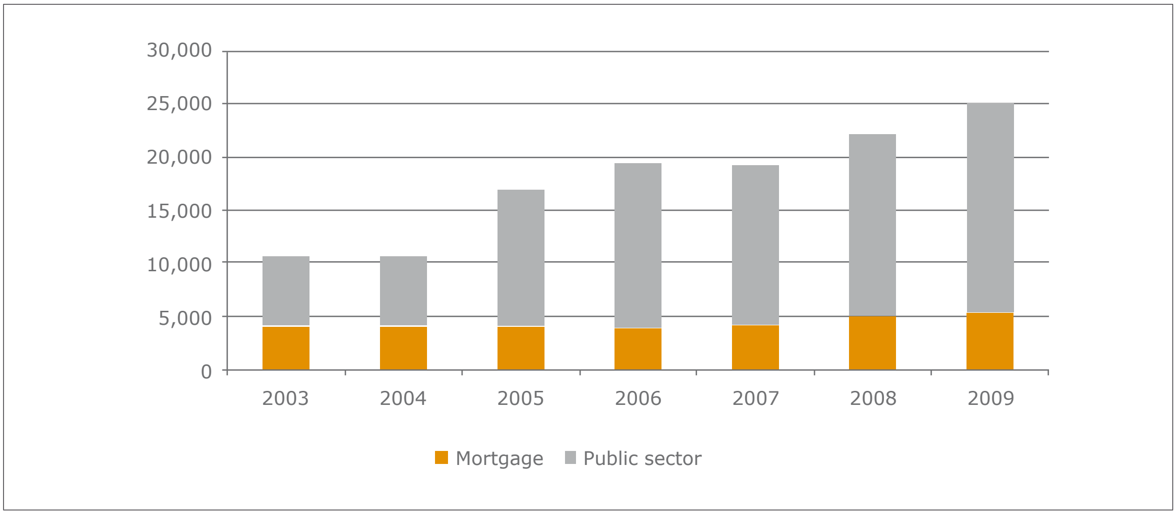
VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Austrian Pfandbriefe as well as Austrian Covered Bonds (FSB) fulfil the criteria of the UCITS 22(4) directive, as well as those of the CRD Directive, Annex VI, Part I, Paragraph 68 a) to f). This results in a 10% risk weighting in Austria and other European jurisdictions where a 10% risk weighting is allowed.

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

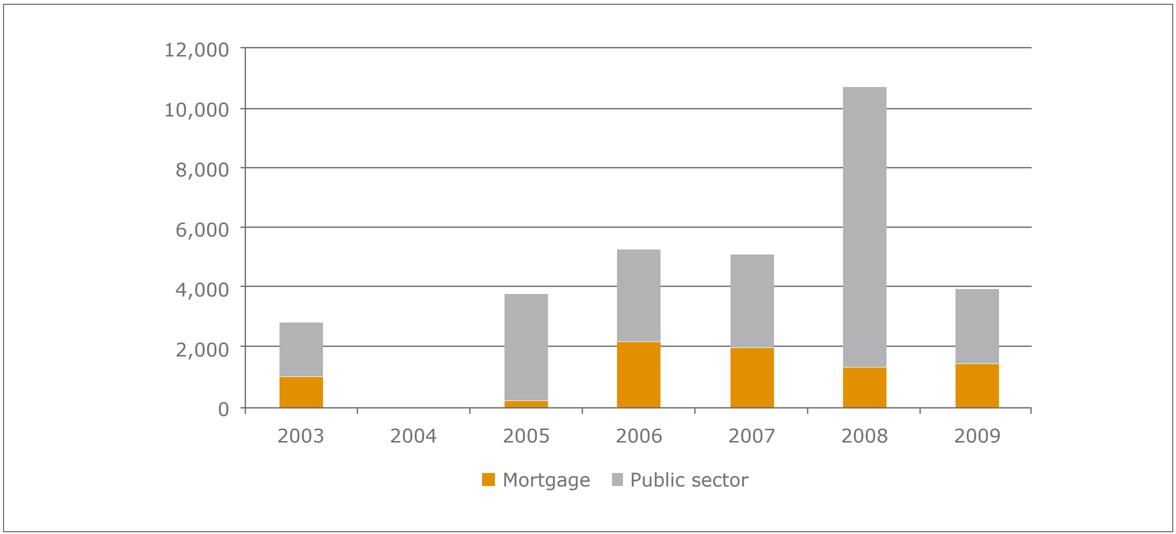
Finally, Covered Bonds in Austrian have special treatment from asset management companies. They are allowed a higher exposure to UCITS 22(4) eligible Covered Bonds compared to senior Covered Bonds.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2009, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2009, €M



Source: EMF/ECBC

Issuers: Austrian issuers at the end of 2009 were Bank für Arbeit und Wirtschaft, EB Hypo Burgenland, Erste Group Bank, Hypo Alpe Adria, Hypo Investment AG (NÖ LB), Hypo Tirol, Kommunalkredit AG, Landeshypothekenbank Steiermark, Oberbank AG, Oberösterreichische Landesbank, Österreichische Volksbanken AG, Raiffeisenlandesbankbank NÖ, Raiffeisenlandesbankbank OÖ, Raiffeisenzentralbank, Salzburger LandesHypo, Sparkasse Kitzbühel, Sparkasse Kufstein, Sparkasse Niederösterreich, Sparkasse Schwaz, Waldviertler Sparkasse, Unicredit Bank Austria and Vorarlberger Landeshypo.

3.2 BULGARIA

Yolanda Hristova, UniCredit Bulbank and
Franz Rudolf, UniCredit

I. FRAMEWORK

In Bulgaria, the legal basis for covered bond issuance is the Mortgage-backed Bonds Law issued by 38th National Assembly on 27th September 2000, published in the State Gazette (Darzhaven vestnik) issue 83 of 10 October 2000, amended; issue 59 of 2006; in force on the date of entry into force of the Treaty of Accession of the Republic of Bulgaria to the European Union; amended; issues 52 and 59 of 2007; amended; issue 24 of 2009; effective as of 31 March 2009.

II. STRUCTURE OF THE ISSUER

Pursuant to the Mortgage-backed Bonds Law, the Mortgage-backed bonds shall be securities issued by banks on the basis of their loan portfolio and secured by one or more first mortgages on real estate in favour of banks (mortgage loans). Only banks may issue bonds called mortgage-backed bonds.

The real estate under the previous paragraph shall be insured against destruction and shall be of the following type:

1. housing units, including leased out;
2. villas, seasonal and holiday housing;
3. commercial and administrative office spaces, hotels, restaurants and other similar real estate; and
4. industrial and warehousing premises.

The issuing bank shall adopt internal rules on conducting and documenting mortgage appraisals of real estate which shall comply with the requirements of Article 73, paragraph 4 of the Bulgarian Law on Credit Institutions.

Securities issued under procedures other than the one laid down by the Mortgage-backed Bonds Law may not referred to with, or include in their appellation, the extension "mortgage-backed bond", or any combination of these words.

III. COVER ASSETS

The outstanding mortgage–backed bonds shall be covered by mortgage loans of the issuing bank (principal cover). To substitute loans from the principal cover that have been repaid in full or in part, the issuing bank may include the following of its assets in the cover of mortgage-backed bonds (substitution cover):

> cash or funds on account with the Bulgarian National Bank (BNB) and/or commercial banks;

> claims on the Government of the Republic of Bulgaria or the Bulgarian National Bank, and claims fully secured by them;

> claims on governments or central banks of states as determined by the Bulgarian National Bank;

> claims on international institutions as determined by the Bulgarian National Bank;

> claims fully backed by government securities issued by the Government of the Republic of Bulgaria, the Bulgarian National Bank, the Governments, Central Banks or international institutions;

> claims secured by gold; and

> claims fully backed by bank deposits denominated in Bulgarian levs or in a foreign currency for which the BNB quotes daily a central exchange rate.

The substitution cover of mortgage-backed securities shall not exceed 30% of the total amount of liabilities of the issuing bank under that issue. Mortgage-backed Bonds cover from any issue (the sum total of the principal cover and the substitution cover) may not be less than the total amount of liabilities towards the principals of Mortgage-backed Bonds from that issue which are outstanding and in circulation outside the issuing bank.

The claims of the bondholders under mortgage-backed bonds from each issue shall be secured by a first pledge on the assets of the issuing bank included in the cover of that issue. The pledge is a subject of entrance in the Central Registers of Special Pledges, with the respective issue of mortgage-backed bonds being indicated as a pledge creditor.

The issuing bank shall request an entry and submit to the Central Register of Special Pledges all data required for the entry of the pledge within one month after executing a Mortgage-backed Bonds Issue and shall update that data at least once every six months thereafter. The pledge shall remain in force until the full redemption of the liabilities of the issuing bank under the respective issue of Mortgage-backed Bonds without the need for any renewal. Deletion of the pledge entry shall be made upon the full redemption of the issuing bank's liabilities under the respective issue of Mortgage-backed Bonds on the basis of a document issued by the bank's auditors.

IV. VALUATION – MORTGAGE APPRAISER OF A PROPERTY

Mortgage appraisals of property shall be performed by officers of the issuing bank or by physical persons designated by it having the relevant qualifications and experience.

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

The mortgage appraisal shall explicitly specify the method or combination of the above methods used with the relative weight of each method in the appraisal, as well as the sources of data used in the analysis and calculations.

Subsequent mortgage appraisals of property used as collateral on the loans recorded in the register of mortgage-backed bonds cover shall be made at least once every twelve months for loans which:

> have outstanding liabilities exceeding 1% of the issuing bank's own funds; or

> have not been consistently classified as standard risk exposures throughout that period.

V. ASSET-LIABILITY MANAGEMENT

Art.6 of the Law on Mortgage-backed Bonds stipulates that mortgage loans shall be included into the calculation of the principal cover at the value of their outstanding principal but at no more than 80% of the mortgage appraisal value of the real estate as housing units, including leased ones, and at no more than 60% of the mortgage appraisal value of the real estate as villas, seasonal and holiday housing units used as collateral on mortgage loans.

Substitution cover of mortgage-backed bonds from any issue may not exceed 30% of the total amount of liabilities of the issuing bank under that issue.

Mortgage-backed bonds cover from any issue (the sum total of the principal cover and the substitution cover) may not be less than the total amount of liabilities towards the principals of mortgage-backed bonds from that issue which are outstanding and in circulation outside the issuing bank.

In making calculations under the previous paragraph for Mortgage-backed Bonds and assets constituting their cover denominated in different currencies, the official foreign exchange rate for the Bulgarian lev to the respective currency quoted by the Bulgarian National Bank of the day of the calculation shall apply.

A loan recorded in the register of the cover of Mortgage-backed Bonds from a particular issue may be repaid at any time by bonds of the same issue at their face value.

VI. SEGREGATION OF COVER ASSETS

After the record of the assets in the register as a cover of mortgage-backed bonds of a particular issue may be used as collateral solely for the liabilities of the issuing bank on that issue. The issuing bank may not allow any encumbrances on its assets constituting the cover of outstanding mortgage-backed bonds. The issuing bank accounts assets recorded in the register of mortgage-backed bonds cover separately from the rest of its assets.

The issuing bank shall keep a public register of the cover of mortgage-backed bonds issued by it as the register is kept separately by mortgage-backed bonds issue.

VII. MINIMUM INFORMATION REQUIREMENTS FOR ISSUANCE PROSPECTUSES

The offering or the draft prospectus for an issue of mortgage-backed bonds consists of data valid at the time of their preparation, such as:

1. the Rules of the issuing bank concerning the contents, the entry and deletion procedures as well as the terms and procedures authorizing access to the register and its internal rules of conducting and documenting mortgage appraisals;
2. data on mortgage loans held in the issuing bank's portfolio on the basis of which an issue is being made, including for each loan:
   - the size of the outstanding principal at the time of extending the loan and by the end of the most recent full quarter;
   - loan life at the time of extending the loan and the remaining term to maturity;
   - interest rates, fees and commissions on the loan;
   - risk classification of the loan by the end of each calendar year from the time it was extended and by the end of the most recent full quarter;
   - type of real estate mortgaged as collateral, their mortgage appraisal value and the ratio between the outstanding principal and the mortgage appraisal value at the time of extending the loan and by the end of the most recent full quarter;
3. characteristics of the mortgage loan portfolio on the basis of which the issue is made, including a distribution of loans by:
   - the size of the outstanding principal;
   - the residual term to the final repayment of the loan;
   - interest rate level;

- their risk classification by the end of the most recent full quarter;
- the ratio between the outstanding principal and the most recent mortgage appraisal value of the real estate pledged as collateral.

In public offerings of Mortgage-backed Bonds the provisions of the Public Offering of Securities Act (POSA) and the Ordinances on its enactment shall apply. In non-public offerings of Mortgage-backed bonds the provisions of Commerce Law shall apply.

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

In case of declaring the issuing bank bankrupt, the assets recorded as of the date of declaring the bank bankrupt in the register of the mortgage-backed bonds cover shall not be included in the bankruptcy estate. Proceeds from the liquidation of assets recorded in the register as a cover on a particular issue of mortgage-backed bonds are distributed among the bondholders from that issue in proportion to the rights under their bond holdings. Any funds remaining after settling the claims under mortgage-backed bonds from a particular issue is included in the bankruptcy estate.

The asset pool under the above mentioned paragraphs are managed by a holders' trustee of mortgage-backed bonds which is appointed by the bankruptcy court when it has been established that the bank has outstanding liabilities under mortgage-backed bonds. The trustee is managing the assets by individual mortgage-backed bonds issue.

The Trustee shall be a person who meets the requirements of Article 217, para.1 and para2, items 1-3 of the Public Offering of Securities Act and is not engaged in any relationship with the issuing bank or any of the holders of mortgage-backed bonds which give reasonable doubt as to the former's impartiality. The Trustee shall have the powers of an assignee in bankruptcy in respect of the asset pool described above, as well as in respect of any outstanding liabilities of the issuing bank under mortgage backed bonds.

The Trustee shall manage the above mentioned assets separately for any mortgage-backed bond issue. The Trustee shall sell the above described assets under the procedure set forth in Articles 486-501 of the Civil Procedure Code and shall account any proceeds to an escrow account opened for each issue with commercial banks as determined by the Bulgarian National Bank. The Trustee shall publish in the State Gazette (Darzhaven vestnik) and in at least two national daily newspapers the place and time for the tender for the sale of assets under the procedures of previous sentence not later than one month prior to the date of the tender.

The bondholders of any issue of mortgage-backed bonds of a bank which has been declared bankrupt shall have the right to obligate the Trustee to sell loans included in the issue cover to a buyer specified by them and the Trustee shall follow precisely the decision of the Bondholders' General Meeting under the previous sentence.

The liabilities of the issuing bank under a Mortgage-backed Bonds issue shall be deemed repaid when the amount of outstanding principals of the sold loans becomes equal to the total amount of liabilities on principals and interest accrued on the bonds prior to the sales.

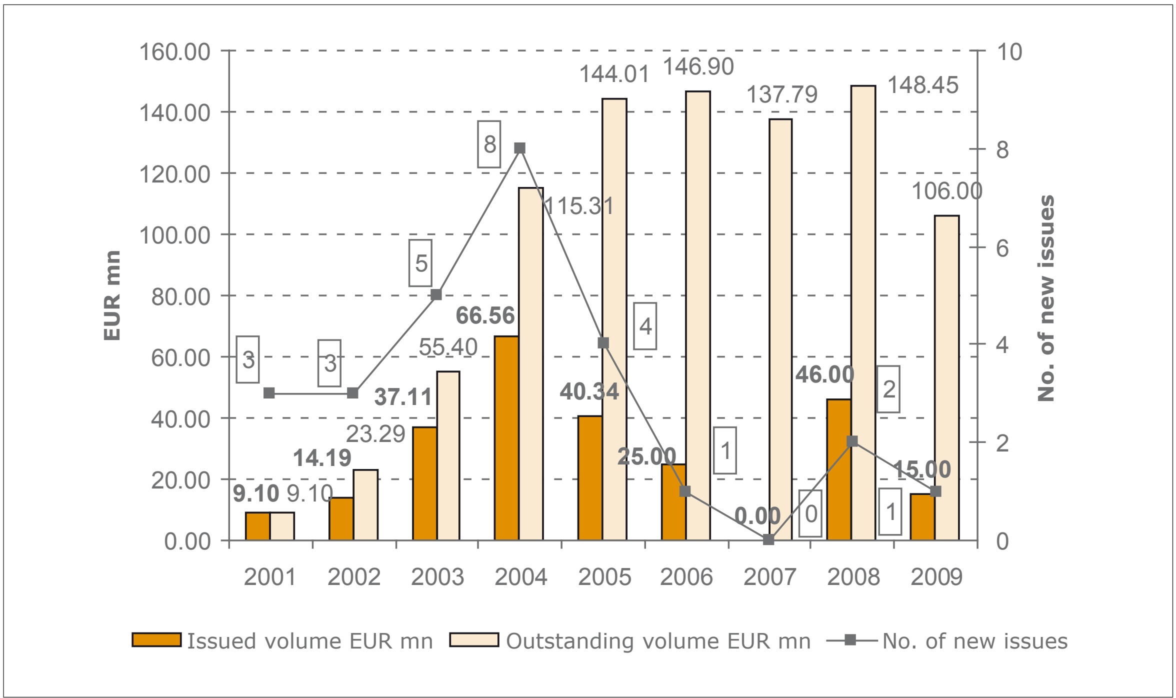
IX. COMPLIANCE WITH EUROPEAN LEGISLATION

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

X. BULGARIAN MORTGAGE BOND MARKET INFORMATION

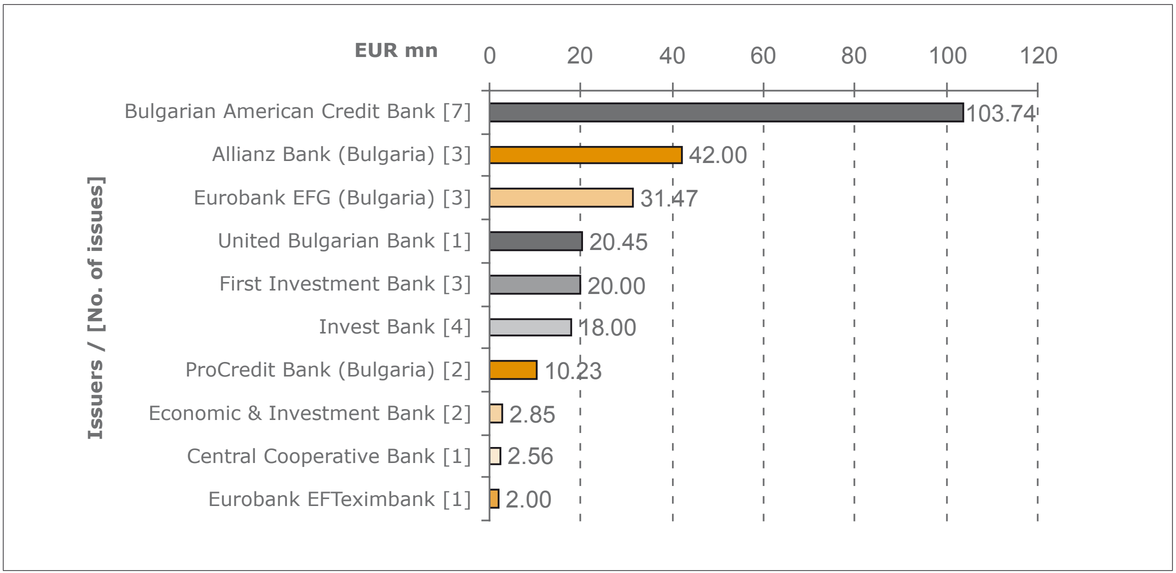
Since the adoption of the Bulgarian Law on Mortgage-backed Bonds in 2000 27 Mortgage Bond Issues have been issued until the end of 2009. The total amount of the issues stands for EUR 253.3 mn originated by 10 issuing banks. As of the end of 2009 the outstanding Mortgage Bonds amount to EUR 106 mn.

> FIGURE 1: MORTGAGE BOND ISSUES IN BULGARIA



The leading issuer in terms of both volume and number of issues is Bulgarian American Credit Bank with 7 Mortgage Bond issues at a total amount of EUR 103.74 mn.

> FIGURE 2: MORTGAGE BOND ISSUERS IN BULGARIA



3.3 CANADA

By Hiren Lalloo, RBC Capital Markets

I. FRAMEWORK

There is no dedicated legal framework for the issuance of Covered Bonds in Canada. As such, Canadian Covered Bonds are based on contractual agreements structured within the general legislation. On March 4, 2010, the federal government announced in its budget that it intends to introduce Canadian covered bond legislation in order to help federally regulated financial institutions diversify their funding sources.

II. STRUCTURE OF THE ISSUER

Canadian financial institutions are regulated by the Office of the Superintendent of Financial Institutions ("OSFI"). In June 2007, OSFI issued a statement permitting Canadian financial institutions to issue Covered Bonds up to a maximum of 4% of their total assets. To date, five Covered Bond programs have been established by large Canadian financial institutions, namely Royal Bank of Canada (RBC), Bank of Montreal (BMO), Bank of Nova Scotia (BNS), Canadian Imperial Bank of Commerce (CIBC) and Toronto-Dominion Bank (TD). Covered Bonds have been issued under all five programs to date.

The Canadian Covered Bond programs are all based on a similar structure that was derived from the UK structures, given the similarity of the legal systems (Canadian common law is derived from English common law). Canadian Covered Bonds are direct, unconditional obligations of the Issuer. In the event of the insolvency or default by the Issuer, investors have a claim over the pool of cover assets. The cover assets are held in a bankruptcy remote special purpose entity, the Guarantor, which provides an unconditional and irrevocable guarantee on the Issuer's obligations under the Covered Bonds. In Canadian Covered Bond programs, the Guarantor is either structured as a limited liability partnership or a trust, subject to accounting and tax considerations of the Issuer. A bond / security trustee holds security over the cover assets on behalf of the investors. Following an Issuer event of default, the Guarantor is required to meet the Covered Bond obligations using the cash flows generated from the cover assets. The Guarantor is permitted to sell the cover assets to meet these obligations, as required. The entire pool of cover assets is available as security for all the outstanding Covered Bonds issued under the program so there is no direct link between particular assets and a specific series of Covered Bonds.

The cover assets are segregated from the Issuer through a legal true sale between the Issuer and the Guarantor. Whether structured as a limited liability partnership or a trust, the Guarantor is bankruptcy remote from the Issuer. The Issuer grants the Guarantor a loan (the inter-company loan), the proceeds of which are used by the Guarantor to purchase the cover assets. Legal title to the mortgages remains with the Issuer and is only transferred to the Guarantor following breach of a ratings trigger and subsequent replacement of the Issuer as servicer. Borrowers are notified of the sale of the mortgages to the Guarantor upon breach of the trigger and the security interest in the mortgages is perfected.

Typically, additional cover assets are sold to the guarantor to either meet the asset coverage requirements on an ongoing basis or to issue additional Covered Bonds under the program. The structure of the Canadian Covered Bond programs incorporates a unique feature related to the inter-company loan, which accommodates the sale of surplus assets to the Guarantor at launch. The loan is split into a Demand Loan and a Guarantee (or Term) Loan. The Guarantee (or Term) Loan represents the portion of the cover assets required as collateral for the outstanding Covered Bonds, as determined by the Asset Coverage Test ("ACT"). The balance of the inter-company loan constitutes the Demand Loan, which represents the excess cover assets held by the Guarantor. The Issuer can call the Demand Loan at any time, which would result in the excess cover assets being sold back to the Issuer or a third party to repay the outstanding Demand Loan. To meet regulatory requirements, the Demand Loan ensures that Covered Bonds investors only have access to the assets that are required as collateral for the Covered Bonds. Transferring surplus assets to the Guarantor at closing provides Canadian Issuers the flexibility to access the market quickly as the cover assets are continuously analyzed and monitored by the rating agencies.

III. COVER ASSETS

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

Under the Canadian Bank Act, mortgage insurance is required for any mortgage with an LTV in excess of 80% originated by a regulated financial institution. Alternatively, originators can bulk insure pools of conventional mortgages or HELOCs for funding or capital purposes. This insurance is provided by the Canada Mortgage and Housing Corporation ("CMHC") and other approved third party insurers, including Genworth Financial. The insurance for the collateral within the Canadian Covered Bond programs is provided by CMHC, which is a Canadian crown corporation wholly owned by the Government of Canada, whose obligations carry the full faith and credit of the Government of Canada.

The structure of Canadian mortgages differs from those in the US and the UK. The term of Canadian mortgages is typically one to five years (based on an amortization term of up to thirty-five years), after which the borrower is required to renew or refinance the mortgage. In most cases, the mortgage is renewed with the same lender if the borrower is current and has met the required payments under the mortgage. The lender does have the option not to refinance the mortgage.

HELOCs are secured loans that do not have a fixed maturity term. Borrowers are only required to pay outstanding principal on demand. Payments are required at least monthly and can be as low as the interest due on the outstanding amount.

Certain Canadian mortgage products are often structured to provide the borrower with flexibility. This enables the borrower to split their mortgage into various separate amortizing tranches with different terms as well as a non-amortizing HELOC or a secured credit card, backed by the same property. These various facilities are subject to a maximum LTV for each borrower determined during the underwriting process. For the RBC program, only the amortizing mortgage tranches have been included as collateral within the cover pool whereas with the TD program, the collateral is made up of both the amortizing and non-amortizing tranches. The cover assets in all the Canadian Programs are geographically diversified across Canada, with larger concentrations in the urban centres.

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

IV. HEDGING AND ASSET - LIABILITY MANAGEMENT

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

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

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

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

Within the Canadian Covered Bond programs, there is an inherent liquidity mismatch due to the bullet payment nature of the Covered Bonds and the cash flows generated from the cover assets. Following a default by the Issuer, the cash flows generated from the cover assets cannot ensure timely repayment of the outstanding Covered Bonds. To mitigate this liquidity risk, each program incorporates overcollateralization based on the type of assets in the cover pool. In addition, a reserve fund is required to be built up for the benefit of the Guarantor if the issuer's ratings fall below a stipulated level. This required reserve amount is typically equal to one month of permitted third-party expenses, servicing fees, interest due on the covered bonds and, if applicable, non-termination swap payments. This amount is retained in a GIC account and following an Issuer Event of Default, the balance of the Reserve Fund will form part of available revenue receipts to be used by the Guarantor to meet its obligations under the Covered Bond guarantee.

Most of the Canadian programs permit the issuance of both soft-bullet and hard bullet covered bonds. With the soft-bullet bonds, if the Issuer is unable to repay all the amounts due under the Covered Bonds at maturity (after any applicable grace periods), a Notice to Pay will be served on the Guarantor. If the Guarantor has insufficient funds to pay the outstanding Covered Bonds in full, the legal final maturity date will be extended to the extended maturity date. For the existing covered bonds the extension period is twelve months. During the extension period, interest will continue to be payable on the Covered Bonds on a monthly basis. In addition, principal amounts outstanding can be repaid on the monthly payment dates to the extent funds are available. This minimises the risk of the Covered Bonds defaulting following an Issuer Event of Default and gives the Guarantor reasonable time to dispose of any collateral in an orderly manner (through whole loan sales / securitization) to the extent required. Given the typically short remaining term of the amortizing mortgages within the cover pool, large amounts of principal will be received by the Guarantor through scheduled amortization.

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

Similar to the other structured covered bond programs, the dynamic ACT is performed on a monthly basis. This test ensures that there are always sufficient assets available within the cover pool as collateral for the outstanding Covered Bonds. Under the test, the balance of the asset pool is determined, factoring in the required level of over collateralisation (based on the asset percentage), LTV caps and non-performing mortgages and adjusting for potential negative carry. The asset percentage is confirmed by the rating agencies and depends on numerous factors including the credit quality and historic performance of the pool and the ability of the Guarantor to dispose of the assets in a stressed environment. The asset percentage for the Canadian Covered Bond programs currently ranges between 93% and 96%, depending on the type of collateral. All the Issuers have voluntarily incorporated a minimum level of over collateralisation within their programs, by capping the asset percentage at 97.0%.

If the ACT is not met on a calculation date, an ACT Breach Notice is served to the Issuer. If the Issuer fails to cure the ACT breach by transferring additional cover assets or cash to the Guarantor by the following calculation date, an Issuer Event of Default occurs. Other events that result in an Issuer Event of Default include:

> Default by the Issuer on Covered Bond interest or principal or any other obligations under the Covered Bonds

> Liquidation, insolvency, winding up, etc. of the Issuer

> Failure to rectify any breach of the Pre-maturity Test (only applicable to hard bullet covered bond issuance)

Following an Issuer Event of Default the Covered Bonds are not automatically accelerated. The trustee will serve a notice to pay to the Guarantor, following which the unconditional and irrevocable guarantee becomes effective and the Guarantor is responsible for the amounts due under the Covered Bonds.

Similar to the UK programs, after the activation of the Guarantee an Amortisation Test ("AT") is run on a monthly basis to ensure that the Guarantor has sufficient assets to meet these obligations. Under the test, the aggregate asset amount is calculated, factoring in the mortgage balance and LTV and adjusting for potential negative carry. If the aggregate asset amount is less than the outstanding balance of the Covered Bonds, the AT is failed resulting in a Guarantor Event of Default. Other events that result in a Guarantor Event of Default include:

> Default by the Guarantor on any guaranteed amounts

> Default by the Guarantor on any other Covered Bond Obligations

> An order is made or an effective resolution passed for the liquidation or winding up of the Guarantor

> The Guarantor ceases or threatens to cease to carry on its business or substantially the whole of its business

> The Guarantor stops payment or is unable, or admits inability, to pay its debts generally as they fall due or is adjudicated or found bankrupt or insolvent

> Proceedings are initiated against the Guarantor related to liquidation, insolvency, winding up, etc. of the Guarantor

> The Covered Bond guarantee is not or is claimed not to be in full force and effect by the Guarantor

Following a Guarantor Event of Default, the Security Trustee serves a Guarantor Acceleration Notice on the Guarantor. At this point, the Covered Bonds are accelerated and the Guarantor disposes of the cover assets as quickly as practical to meet the Covered Bond payments.

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

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

V. VALUATION AND LTV CRITERIA

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

When calculating the asset balance for the ACT, an LTV cap of 80% for uninsured mortgages and 90% for insured mortgages / HELOCs (subject to a stipulated CMHC ratings level) is applied to the latest valuation. In addition, the latest valuation of each mortgage / HELOC is multiplied by a factor which depends on whether the mortgage / HELOC is performing or non performing (greater than ninety days delinquent). For performing mortgages / HELOCs, the factor is 1, while for non performing mortgages the factor is 0.9 if insured and CMHC is rated above a stipulated level or zero if CMHC is rated below the stipulated level or the mortgage is uninsured. The result of this amount is then multiplied by the asset percentage and the lower of the two calculations is used to determine the available collateral amount under the ACT.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The Issuer prepares investor reports on a monthly basis. In addition, quarterly reports are prepared for the rating agencies, including an updated cover pool, which is used to confirm / recalculate the asset percentage used in the ACT. In addition, the ratings of the program are reaffirmed by the rating agencies prior to each issuance under the program.

An independent audit firm (the Asset Monitor) will test the calculation of the ACT performed by the Issuer (as Cash Manager) on an annual basis. However, if the rating of the Cash Manager has been downgraded below the trigger level stipulated by the rating agencies or if an ACT Breach Notice has been served on the Issuer and not yet revoked, the Asset Monitor will test the calculation on a monthly basis, until the situation is resolved. In addition, if the test reveals an error in the ACT calculation, the Asset Monitor will test the calculation monthly for a period of six months.

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

Under the Canadian Covered Bond programs, the Issuer sells the cover assets to the Guarantor pursuant to a mortgage sale agreement. The sale of the assets constitutes a legal true sale. As there is no dedicated legal framework for the issuance of Covered Bonds in Canada, all contractual agreements are structured within the general legislation.

Although there is no specific asset register, the assets are flagged on the Issuer's computer/IT systems and the cash flows are segregated in favour of the Guarantor. The Guarantor also owns other assets, including substitute assets, the GIC and benefits under the swap agreements. The Guarantor is structured as a bankruptcy remote, special purpose entity and as such, following insolvency of the Issuer, all the assets of the Guarantor are segregated from those of the bankruptcy estate of the Issuer. True sale and bankruptcy remoteness opinions provided by counsel form part of the transaction documents. The Issuer is responsible for ensuring the collateral restrictions are met.

Title to the cover assets is retained by the Issuer until breach of certain trigger events, following which the Issuer is required to notify the borrowers of the mortgage sale thereby perfecting the legal assignment of the mortgage loans and their related security to the Guarantor.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Canadian Covered Bonds are currently 20% risk weighted under the CRD Standard Approach, as if they were unsecured securities issued by a regulated financial institution.

ANNEX

The Canadian economy continues to remain strong relative to its peers, with the lowest net debt to GDP ratio amongst the G7. Over the last decade, Canada has been highly ranked for economic strength and employment growth and has achieved the highest real GDP growth within the G7 (see figure 2). Prior to the crisis, Canada enjoyed consecutive fiscal surpluses for eleven consecutive years. The Canadian regulators proactively responded to crisis through strong fiscal stimulus and monetary policy. Canada's banking infrastructure, which was ranked #1 for soundness by the World Economic Forum in October 2008, continues to be stable as Canada's banks are vigilantly regulated and conservative by nature.

Canada has a diversified, export oriented economy and is rich in natural resources. This provides a sound foundation for future economic recovery. Unemployment in Canada remains below the long term average, with job reductions focused on the automotive and manufacturing sectors (see figure 3). The unemployment rate is now below that of the US. The economic environment has been stable through 2010, with modest recovery in certain sectors. In response, the Bank of Canada has resumed cautionary interest rate increases.

The mortgage and consumer fundamentals in Canada continue to remain solid. The mortgage products available in Canada are conservative (typically a one to five year term with up to thirty five year amortization period, with very limited teaser rate or hybrid products). In addition, prepayment penalties discourage refinancing booms. Sub-prime mortgages make up a very small and declining component of the Canadian mortgage market. The market is dominated by the big five Canadian Chartered banks (over 60% of the market), which retain the majority of mortgages on their balance sheets. This encourages strong underwriting discipline based on high credit and documentation standards. A key difference between the Canadian and US mortgage market is that mortgage interest in Canada is not deductible for tax purposes. As such, Canadian borrowers have little incentive to carry mortgage balances and in general are less leveraged than their American counterparts (see figure 4). Despite the conservative mortgage market, home ownership in Canada is comparable to that of the US at approximately 68%.

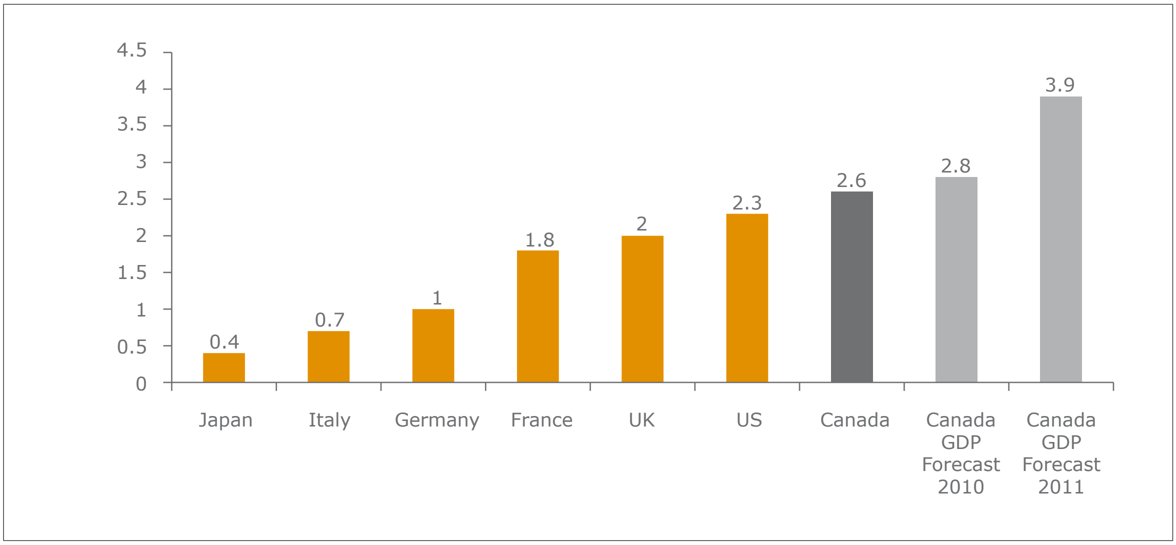
House prices in Canada have remained steady and according to the IMF in March 2009 the Canadian housing market was the least over-valued leading up to the crisis (see figure 5). The conservative lending practices in Canada and the strong economic and consumer fundamentals have resulted in stable mortgage delinquency rates (90+ days) compared to the US (see figure 6). In addition, equity investment in Canadian homes is significant and has remained stable (see figure 7).

Figure 1: Overview – Canadian Covered Bond programmes

	RBC	BMO	CIBC	BNS	TD
Programme Size	€15bn	€7bn	€8bn	US$15bn	€10 billion
Outstanding Covered Bonds	€2.00bn due Nov12 €1.25bn due Jan18 C$750mm due Nov14 C$850mm due Mar15 US$1.5bn due Apr15	US$2bn due Jun15 €1bn due Jan13	€2.32bn due Sep10 CHF375m due Jan15 CHF300m due Dec11 CHF500m due Jun17 US$2bn due Jan13 US$1.25bn due Jul15	US$2.5bn due Jul15	US$2bn due Jul15
LTV cap	80%	90%, subject to a CMHC rating of at least AA (low), otherwise 80%	90%, subject to a CMHC rating of at least AA (low), otherwise 80%	90%, subject to a CMHC rating of at least AA (low), otherwise 80%	90%, subject to a CMHC rating of at least AA (low), otherwise 80%
Asset percentage applied in ACT	93%	95%	96%	95%	95%
Overcollateralisation	107.5%	105.3%	104.2%	105.3%	105.3%
Non performing mortgages	No recognition for the ACT	Multiplied by a factor of 0.9, subject to a CMHC rating of at least AA (low), otherwise no recognition	Multiplied by a factor of 0.9, subject to a CMHC rating of at least AA (low), otherwise no recognition	Multiplied by a factor of 0.9, subject to a CMHC rating of at least AA (low), otherwise no recognition	Multiplied by a factor of 0.9, subject to a CMHC rating of at least AA (low), otherwise no recognition
Soft / Hard Bullet	Soft Bullet	Soft / Hard Bullet	Soft / Hard Bullet	Soft / Hard Bullet	Soft / Hard Bullet
Asset monitor	Deloitte	KPMG	Ernst & Young LLP	KPMG	Ernst & Young LLP
Asset Type	Conventional Mortgages	CMHC Insured Mortgages	CMHC Insured Mortgages	CMHC Insured Mortgages	CMHC Insured Home Equity Lines of Credit

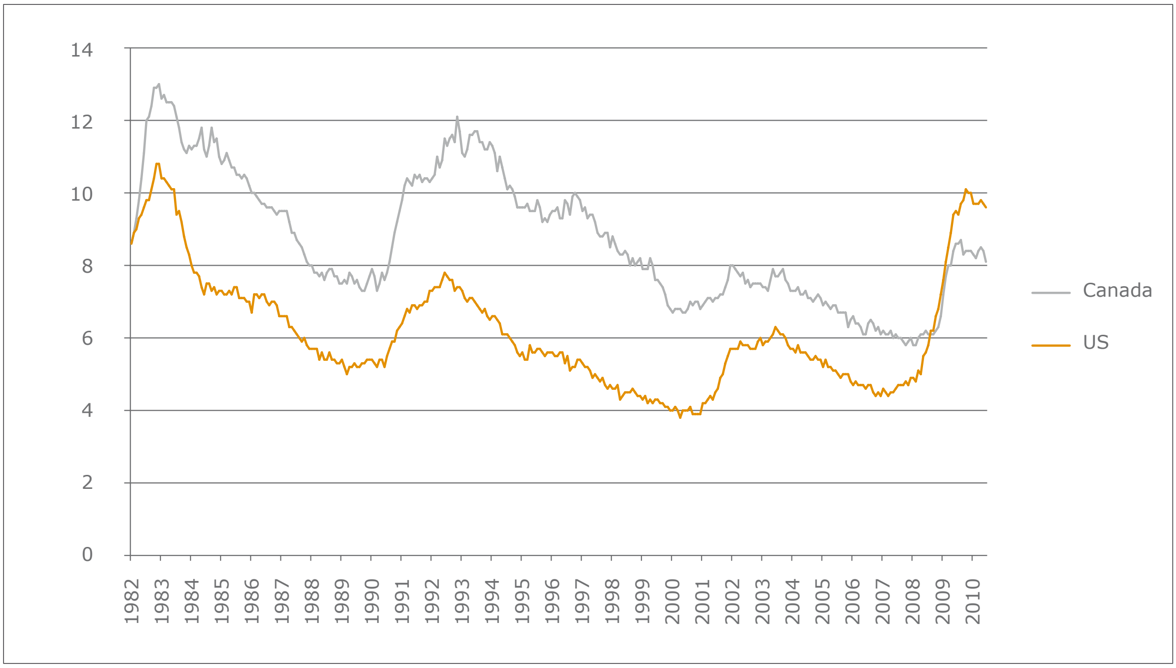
Source: Transaction documents

> Figure 2: G7 Real GDP Growth (%) – 1998-2009



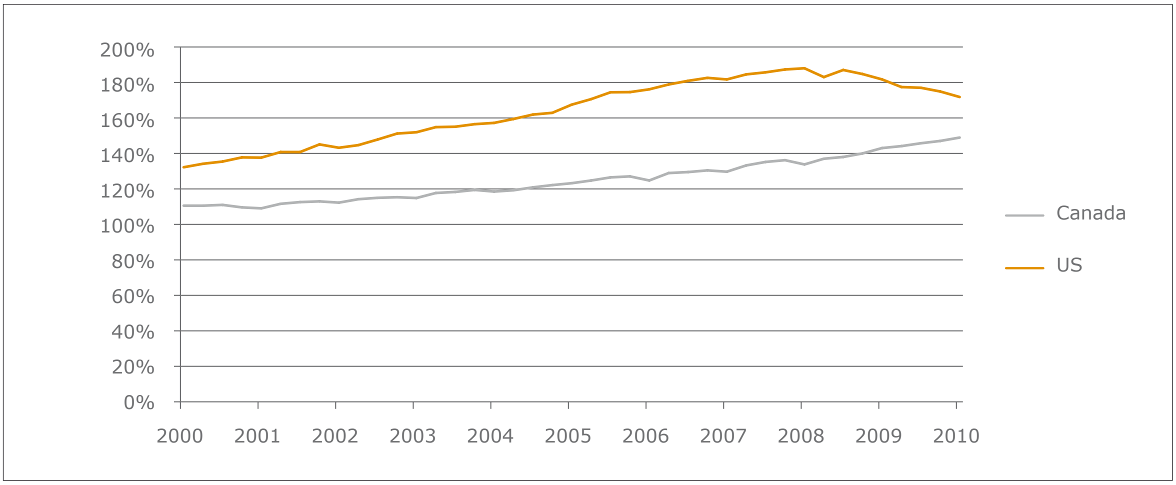
Source: Bank of Canada, RBC Economics Research

> Figure 3: Unemployment Rate (%) 1982 - 2010



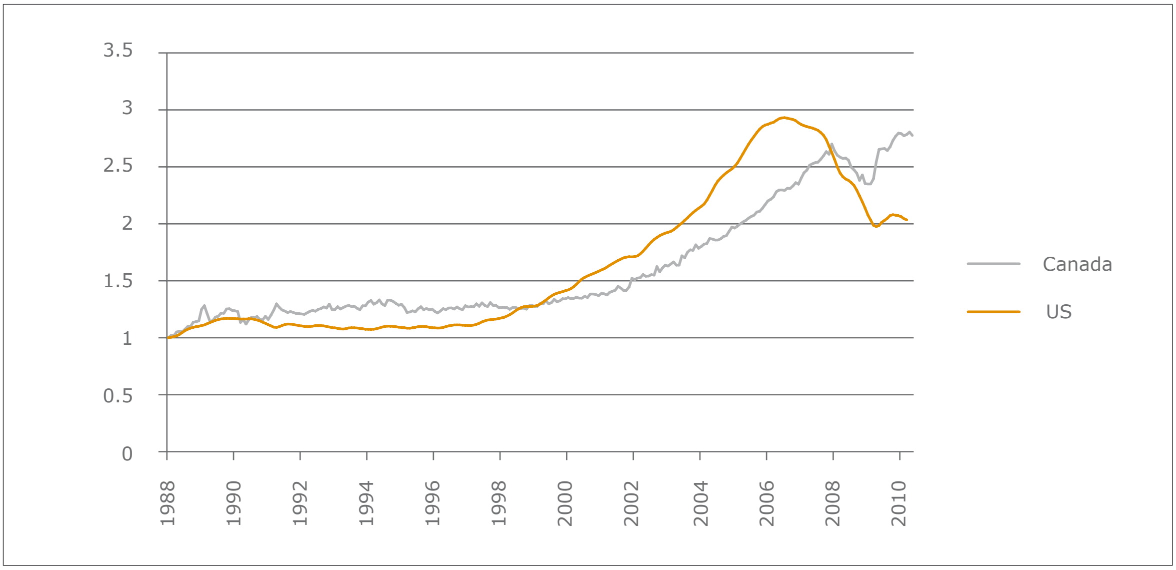
Source: Bank of Canada, Bureau of Labour Statistics, RBC Economics

> Figure 4: Household Debt as % of Disposable Income



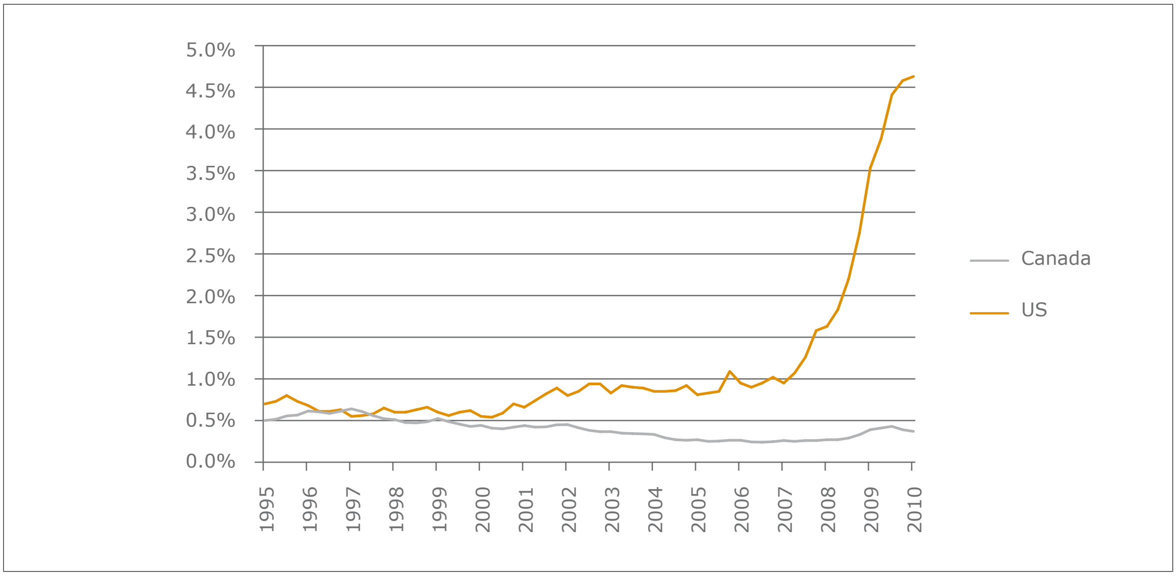
Source: Statistics Canada and U.S. Federal Research Division (March 2010)

> Figure 5: Average House Price (Indexed, 1998)



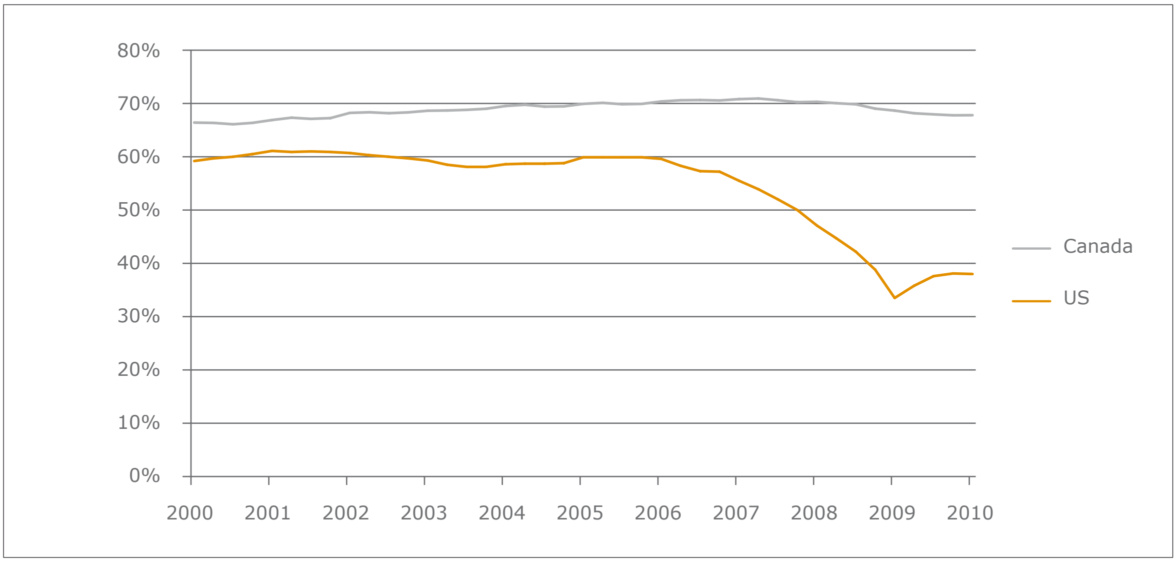
Source: Canadian Real Estate Association, Standard and Poor's (May 2010)

> Figure 6: Mortgage Delinquencies (90+ days)



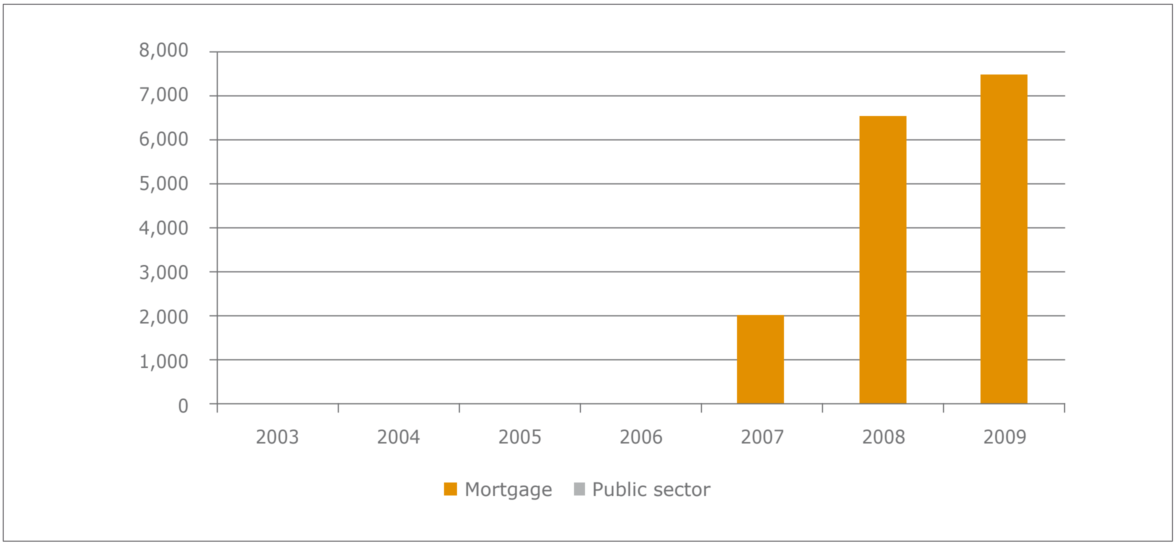
Source: Canadian Bankers Association (CBA) and Mortgage Bankers' Association as at March 2010

> Figure 7: Homeowners' Equity as % of Total Value of Real Estate Assets



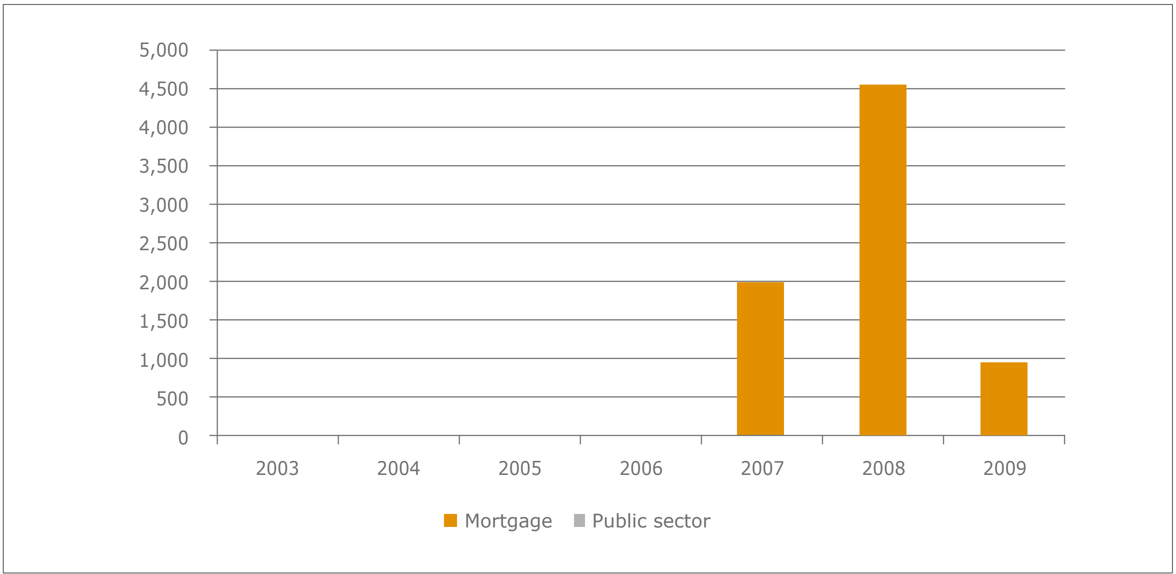
Source: Statistics Canada and U.S. Federal Research Division (March 2010).

> FIGURE 8: COVERED BONDS OUTSTANDING 2003-2009, €M



Source: EMF/ECBC

> FIGURE 9: COVERED BONDS ISSUANCE, 2003-2009, €M



Source: EMF/ECBC

Issuers: Canadian issuers as at July 31, 2010 were Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, Royal Bank of Canada and Toronto Dominion Bank

3.4 CZECH REPUBLIC

By Pavel Kuhn, Ceska Sporitelna a.s.

LEGAL REGULATIONS

It has been possible to issue the mortgage Covered Bonds ("Hypotecni zastavni list" - hereinafter referred to as "MCB") in the Czech Republic from January 1, 1992 on the basis of the general regulation contained in the Commercial Code.

At present, the MCBs, the mortgage credits (hereinafter referred to as "MC") and the other terms and conditions of mortgage financing are regulated in detail in the Covered Bond Act (hereinafter referred to as "DBA") which entered into force on 1 July 1995. Since, the DBA was amended on 1 April 2004.

Mortgage Covered Bonds may be issued by any bank complying with the terms and conditions of the Act on Banks. However, the right to issue MCBs is subject to a specific license granted by the Czech National Bank.

COVERAGE OF MCBs

Pursuant to the DBA, the MCBs are such covered notes the nominal value of and revenue from which are fully covered with (i) receivables from mortgage credits or parts of these receivables (the so-called "regular coverage") and (ii) possibly also in an alternative manner specified in the Act (the so-called "substitutive coverage"). The text "mortgage Covered Bond" has to make a part of the name of this Covered Bond. No other securities and/or Covered Bonds are allowed to use this name. The Czech legal framework does not provide the possibility to create public sector cover assets.

MORTGAGE RIGHT

The repayment of the MC including accessories has to be secured with the mortgage to a real estate, even to a real estate under construction. The real estate under the mortgage right has to be located on the territory of the Czech Republic, a member state of the European Union or another country making a part of the European Economic Area. The credit is considered to be the mortgage credit on the day of origin of legal effects of the mortgage right registration.

The mortgage right ensuring the MC used to cover the MCBs has to be in the first position in the Real Estate Register. There are two exceptions to this rule: the real estate under mortgage may have a priority mortgage right securing a credit which

1) is extended by a construction savings bank or a credit extended for a cooperative housing construction supported by the State. The precondition for this is that the construction savings bank or the creditor of the cooperative housing construction credit that have the priority sequence of the mortgage right have given a written consent to the issuer of MCBs to establish the mortgage right in the following sequence. The receivable from the MC secured with a mortgage right not in the first position may not be used to cover the MCBs without such consent.
2) will be repaid so that the mortgage right related to the MC will move from the second position to the first position of registration in the Real Estate Register.

The sum of all the liabilities from all the MCBs in circulation issued by one issuer has to be fully covered with the receivables or their parts from the MC (regular coverage) or possibly in a substitutive manner (substitutive coverage).

REGULAR COVERAGE OF MCB

Only such receivables from the MC or their parts may be used for regular coverage of the liabilities from all the MCBs in circulation that do not exceed 70% of the mortgage value of the real estates under mortgage.

If any mortgage rights in priority sequence are attached at the same time to any real estate that serve to secure the construction savings credit and the housing construction credit, only the receivable from the mortgage credit or its part in the maximum amount of the difference between 70% of the mortgage value of the real estate under mortgage and the sum of the receivables from the credit extended by the construction savings company and the cooperative housing construction credit may be used for the purposes of coverage of the MCBs.

SUBSTITUTIVE COVERAGE

Substitution cover assets are restricted to 10% of the nominal amount of MCBs outstanding. The following substitution assets are eligible:

> cash;

> deposits of the issuer at the Czech National Bank (hereinafter referred to as "CNB");

> deposits at the Central Bank (National Bank) of a member state of the European Union or another country making a part of the European Economic Area or at the European Central Bank;

> government bonds and/or securities issued by the Czech National Bank;

> government bonds and/or securities issued by the member states of the European Union or by other countries making a part of the European Economic Area, their Central (National) Banks and the European Central Bank; and

> government bonds issued by the financial institutions established with an international agreement the contracting party of which is the Czech Republic, or the financial institutions with which the Czech Republic entered into an international agreement.

MORTGAGE VALUE

The issuer of the MCBs determines the mortgage value of the real estate under mortgage, and namely as the customary price, taking into consideration

> the permanent and long-term sustainable characteristics of the real estate under mortgage,

> the revenues attainable by a third party at regular management of the real estate,

> the rights and defects associated with the real estate, and

> the local real estate market conditions and impacts and presumed development of this market.

The customary price is considered to be such price that could be achieved in the event of the sale of the same or similar real estate as at the valuation date and in dependence on its condition and quality. The customary price should not reflect the extraordinary market circumstances, the personal relations between the participants and the subjective assessment of the interest of one of the parties. The mortgage value shall not exceed the customary price of the real estates.

The conditions allowing the use of the receivable from the MC to cover the MCBs have to be complied with throughout the period for which the receivable from the MC is included in the MCB coverage.

RECORDS

The issuer of the MCBs is obligated to keep separate and conclusive records on the summary of all of its liabilities from the MCBs in circulation issued by it and on its coverage. The content of the records is defined in an obligatory regulation by the CNB. Pursuant to this regulation, the issuer of the MCBs shall keep the Coverage Register and the Coverage Ledger.

The Coverage Register contains a summary of how the liabilities of the issuer of MCBs are covered – with both the regular coverage (i.e. the list of the receivables from the MCs used to cover the MCBs) and with the substitutive coverage, if applicable. The records in the Coverage Register shall be updated by the issuer continuously as the changes occur.

The Coverage Ledger contains the full summary of the liabilities of the issuer from its MCBs in circulation and the valuation of the assets of the Coverage Register.

The records shall be kept in CZK in paper form or in electronic form. The recordkeeping including the insertion of the MCs for coverage and elimination of the MCs from the coverage shall be made by the departments independent of the departments responsible both for the extension of MCs and for issuance of the MCBs and namely up to the managing Board member.

POSITION OF THE HOLDER OF THE MORTGAGE COVERED BOND IN THE BANKRUPTCY PROCEEDING OF THE ISSUER

In the event of bankruptcy or bankruptcy proceedings of the issuer of the MCBs, the receivables from the MCBs in circulation issued by it have a priority rank for satisfaction. The assets (the receivables from the MC) serving to cover the MCBs of the bankrupt issuer constitute the mortgage substance. A special administrator may be appointed to administer the mortgage substance and to satisfy the claims resulting from the MCBs in circulation. The yield from the encashment of the mortgage substance shall be first used to satisfy the costs of administration and encashment of the mortgage substance and then immediately to satisfy the receivables of the MCBs without limitation of their amount. Only the rest shall be used to satisfy the other receivables from the bankrupt.

ISSUER AS MORTGAGE CREDITOR

In the event of default of the MC, the issuer may enforce its mortgage right by selling the real estate in a judicial sale pursuant to the rules of civic court proceedings, in a voluntary or non-voluntary public auction pursuant to a special law or by selling the real estate in an execution proceeding via an executor and pursuant to the rules of execution.

The receivables from the mortgage credits or their parts that serve to cover the nominal value of the mortgage Covered Bonds enjoy an elevated protection in the enforcement of the mortgage right by the issuer. After the sale of the real estate under mortgage, the receivables from the mortgage credits that serve to cover the nominal value of the mortgage Covered Bonds are satisfied from the auction yield immediately after the costs of the auction and before the other receivables secured with the mortgage right.

Upon the bankruptcy order against the debtor from the MC, the issuer gets the position of a separate creditor that has the right that its receivable is satisfied from the encashment of the subject of mortgage (real estate) after deduction of the costs related to the maintenance, administration and sale of the real estate (encashment yield) at any time during the bankruptcy proceeding. The separate creditors are satisfied up to 70 per cent of the encashment yield falling on them. The non-satisfied portion may be satisfied within a distribution and in the class the receivable belongs to as per its nature.

STATE SUBSIDIES

The debtor from the MC may reduce his income tax base with the interests he has paid to the issuer from the MC used to finance his housing needs.

The interest revenues from such MCBs are so far exempt from the income tax that are covered by the issuer with the receivables from the MC for housing investments.

SUPERVISION OF THE ISSUER (BANK)

The activities of the issuer of MCBs are regulated by the law and are subject to the supervision by CNB.

The issuer of MCBs is obligated to require prior approval from the CNB for a number of important decisions, for example the sale of the enterprise or its part, cancellation or merger of the issuer, decrease in the issuer´s registered capital, etc.

The issuer has a number of information obligations towards the CNB. For example, it is obligated to inform the CNB on presumed modifications of any of the provisions of its Articles of Association, on the proposals for personal changes in its statutory body and in the managing staff, on the intention to open a branch office or an agency abroad, or on the intention to establish a legal entity abroad or to participate in such entity with its assets. Besides, the issuer in the capacity of the bank is obligated to prepare and to submit information on its business activities in the extent and within the dates determined by the CNB.

The CNB has integrated and continuously integrates to the domestic regulations binding on the issuers any and all regulations, directives, rules, normative, principles and recommendations by the EU and the European Commission that regulate the activities of the issuers – banks, in particular in relation to their cautious business (including, for example, the BASEL II rules). Such regulation applies for example to (a) the standards of liquidity management and creation of minimum obligatory reserves, (b) capital adequacy and credit involvement, or (c) classification of receivables from credits and creation of reserves and adjustments to such receivables.

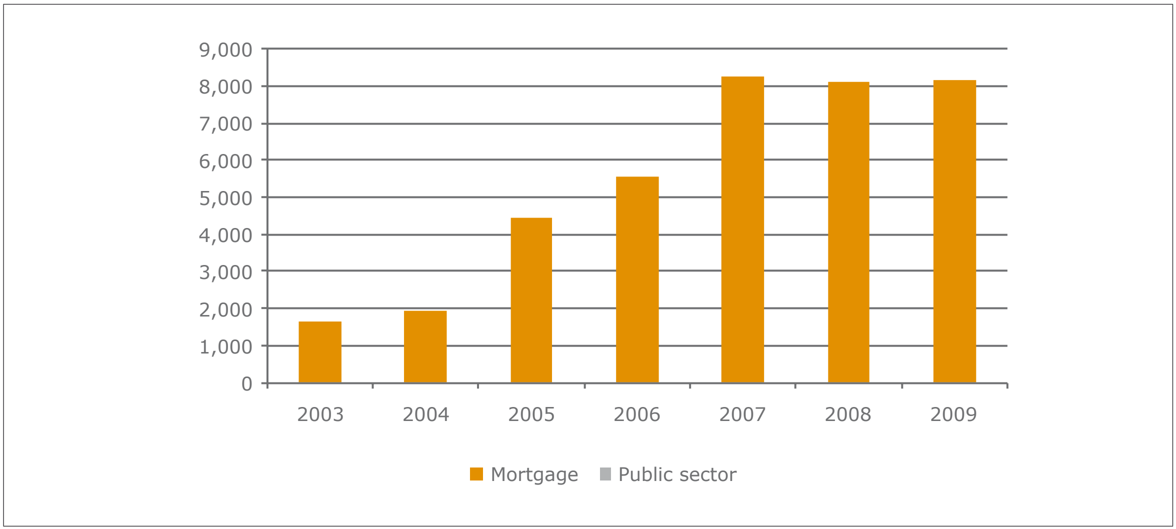
The CNB also supervises the issuer activities from the position of a Government supervisory body over the capital market. Each issuer having its MCBs in circulation is obligated to send to the CNB the reports showing its economic results and its financial situations in the determined intervals and to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

A breach by the issuer of the obligations supervised by the CNB is considered to be the so-called deficiency in bank activities. If a deficiency in bank activities is identified, the CNB may assume any of the measures pursuant to the Act on Banks. For example, it may require the issuer to make good, it may change the license of the issuer, impose a fine upon the issuer, suspend (for a maximum of one year) the right of the issuer to issue Covered Bonds, prohibit the issuer to issue the Covered Bonds or order the issuer to repay prematurely the nominal value of the MCBs issued by it, including the aliquot revenue.

COMPLIANCE WITH EUROPEAN LEGISLATION

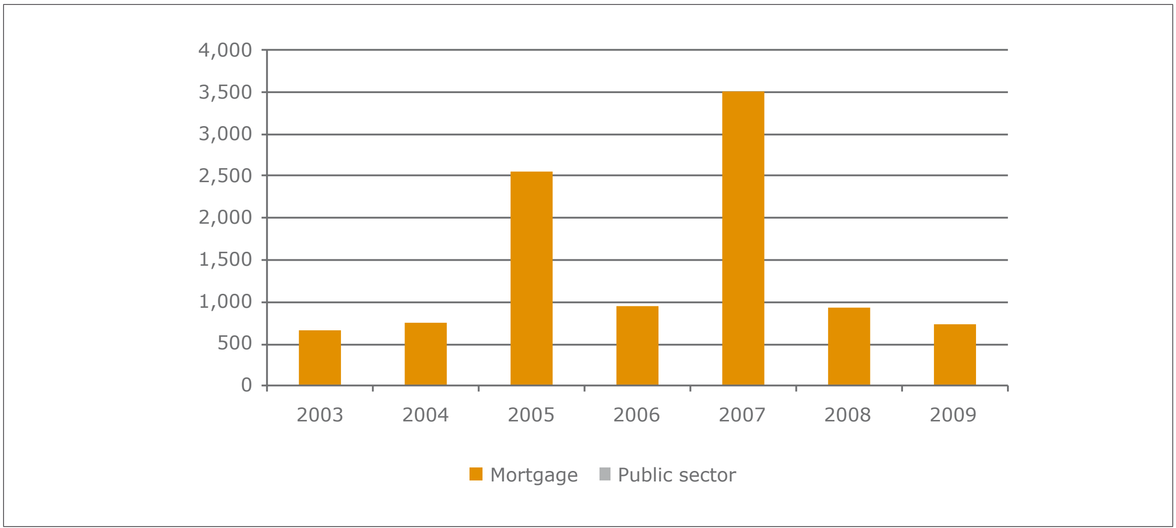
The Czech MCB legislation complies with the requirements of Art. 22 par. IV UCITS Directive.

> Figure 1: Covered Bonds Outstanding 2003-2009, €m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2009, €m



Source: EMF/ECBC

Issuers: Czech issuers at the end of 2009 were Česká Sporitelna, Ceskoslovenská Obchodní Banka, Hypotecni Banka, Komercni Banka AS, Raiffeisen Bank AS, UniCredit Bank Czech Republic, Volksbank CZ AS and Wüstenrot Hypotecni Banka.

3.5 DENMARK

By Mette Saaby Pedersen, Association of Danish Mortgage Banks
and Svend Bondorf, Nykredit

I. FRAMEWORK

The Danish rules regarding the financing of real property were amended in 2007. The Danish Act on covered bonds (SDOs) came into force on 1 July 2007. It was passed to implement the SDO rules of the new EU capital adequacy rules (CRD). At the same time, it met the political objective of giving both mortgage banks and commercial banks the opportunity to issue SDOs.

Danish mortgage banks and commercial banks are regulated in detail by the Danish Financial Business Act (Lov om finansiel virksomhed). Danish mortgage banks are also governed by the Danish Mortgage-Credit Loans and Mortgage-Credit Bonds etc. Act (the "Mortgage Act") (Lov om realkreditlån og realkreditobligationer mv.). The mortgage banks are specialised banks.

Specific bankruptcy regulations laid down in the Financial Business Act and the Mortgage Act prevail over general bankruptcy regulations (sections 247a-247i of the Financial Business Act and sections 22-33 of the Mortgage Act).

II. STRUCTURE OF THE ISSUER

The Danish Financial Supervisory Authority (FSA) may license mortgage banks, commercial banks and ship financing institutions[1] to issue covered bonds.

In the past, only mortgage banks were allowed to issue mortgage bonds/covered bonds. Now commercial banks are also able to issue covered bonds to fund mortgage loans. However, mortgage banks still have the exclusive right to issue covered mortgage bonds.

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

> the (traditional) mortgage bonds (*Realkreditobligationer*, ROs) issued by mortgage banks. ROs are UCITS compliant (article 22(4)).

> the (new) covered mortgage bonds (*Særligt Dækkede Realkreditobligationer*, SDROs) issued by mortgage banks, fulfilling the former as well as the new legal requirements. SDROs are both UCITS (article 22(4) and CRD compliant (Annex VI, 68).

> the (new) covered bonds issued by commercial or mortgage banks (*Særligt Dækkede Obligationer*, SDOs). SDOs are both UCITS (article 22(4) and CRD compliant (Annex VI, 68).

In addition, all ROs issued before 1 January 2008 maintain their covered bond status in accordance with the grandfathering option under the CRD.

The new legislation in Denmark allows for joint funding, i.e. two or more institutions joining forces to issue covered bonds in order to achieve larger issues.

Danish mortgage banks operate subject to a specialist banking principle in accordance with Danish legislation, which confines the activities of issuers to the granting of mortgage loans funded by the issuance of mortgage bonds. The cover pool may include unsecured loans to public authorities and guarantees issued by public authorities. Mortgage banks may also carry on other business related to mortgage banking.

1 Ship financing institutions are regulated by the Act on a Ship Financial Institute (Act no 1376 - 10 December 2007).

The specialist banking principle implies that mortgage banks are confined to granting loans that meet the requirements for cover assets imposed by legislation. Similarly, the funding sources are limited to ROs, SDOs and SDROs. This is due to the fact that Danish mortgage banks are not allowed to accept deposits etc as a source of funding, cf section 8 of the Financial Business Act.

The issuer (mortgage bank or commercial bank) holds the cover assets on its balance sheet as well as all rights under the cover assets. Bonds and cover assets are assigned to individual capital centres in mortgage banks and to registers in commercial banks. The individual bonds, however, are not linked to individual mortgage loans. In case of suspension of payments or bankruptcy proceedings, the assets of the capital centres and registers will be frozen, and no excess funds may be transferred from them. In a bankruptcy scenario, the assets of a/each capital centre/register constitute a separate cover pool, cf section 27 of the Mortgage Act and section 247d of the Financial Business Act.

Issuers have their own employees. Outsourcing of activities is allowed if control measures are deemed satisfactory by the FSA, and consumer protection regulations are observed. The valuation of property may be outsourced provided that the issuer conducts sample valuations on a regular basis. The loan origination process may be outsourced, whereas the final approval process related to loan applicants is not subject to outsourcing. Loan administration activities may be outsourced.

III. COVER ASSETS

Assets eligible as the basis for bond issuance:

Covered bonds – SDO	Covered mortgage bonds – SDRO	Mortgage bonds – RO
> Loans secured by real property > Exposures to public authorities > Exposures to credit institutions (up to a maximum of 15 %) > Collateral in ships (not an option for mortgage banks)	> Loans secured by real property > Exposures to public authorities	> Loans secured by real property > Exposures to public authorities

To serve as cover assets, mortgages must be entered in the Danish land register, which is kept by the Danish district courts. Digital land and loan registration was launched in September 2009 and crowns several years of cooperation in the Danish financial sector aimed at handling customers' loans faster and more efficiently.

With respect to SDO the cover pool may include exposures to credit institutions up to a statutory maximum limit of 15% of the nominal value of the outstanding amount of SDOs. Owing to various technical aspects regarding the lending activities of mortgage banks or commercial banks, a number of investments are not subject to this limit.

The difference between funding and lending may be hedged through derivatives, which are included in the cover pool assets.

In a capital centre in a mortgage bank the cover pool is dynamic as a result of the current addition and disposal of loans in connection with the granting and repayment of loans. In most capital centres assets may exclusively be transferred to or from the cover pool upon new lending and (p)repayment. On (p)repayment, the corresponding amount of issued bonds will be transferred from the capital centre. Each mortgage loan (cover asset) refers to specific ISIN codes and both cover assets and ISIN codes are assigned to specific capital centres. It is therefore not possible for the issuer to (i) change the cover pool unless in connection with new lending and (p)repayment nor (ii) transfer cover assets between different cover pools. Such cover pools are thus less dynamic than cover pools where existing mortgages can be transferred into and out of the cover pools. Cover assets must be identifiable, and the FSA supervises cover asset identification.

IV. VALUATION AND LTV CRITERIA

The Financial Business Act and the Mortgage Act contain provisions on property valuation.

Where loans are funded by the issuance of SDOs and SDROs, valuations are based on the open market value of a property. Where loans are funded by ROs, valuations are based on the mortgageable value. In Denmark, the mortgageable value will correspond to the open market value in the vast majority of cases, cf sections 10-15 of the Mortgage Act.

LTV limits - an overview

Loan Type / Property category	Covered bond – SDO	Covered mortgage bond – SDRO	Mortgage bond – RO
Residential property	80% or 75%1)	80% or 75%1)	80%
Holiday property	60%	60%	60%
Agricultural property	60%2)	60%2)	70%
Commercial property	60%2)	60%2)	60%

Note: 1) 80% for loans issued with up to 30 years maturity and 10 years interest-only period and 75% for loans with an unlimited maturity and interest-only period.
2) The LTV can be raised to 70% if the bank adds additional collateral.

In connection with the issuance of SDOs and SDROs, mortgage banks and commercial banks must ensure continuous LTV compliance - ie not just at disbursement of the loan as is the case for ROs. Where an LTV ratio exceeds the statutory limits, the bank must add supplementary security to the capital centre/register. Otherwise, the issues will lose their status as SDOs or SDROs. Where the LTV limit of 75% for owner-occupied dwellings etc is exceeded, supplementary security will be required when the LTV exceeds 80%.

Mortgaged property is valued (on-site inspection) as part of the processing of loan applications. If the customer applies for a supplementary loan, a new valuation will be performed. When a loan is granted, the LTV thereof is assessed on a case-by-case basis. A basic principle of the valuation regulations is that valuations must be performed by a valuation officer of an issuer. Provided that a number of conditions are met, valuations may be outsourced. The detailed conditions are set out in the Financial Business Act and the Mortgage Act.

All valuations of mortgaged property by the Danish mortgage banks are reported to the FSA. The FSA performs random checks of mortgage banks' valuations by way of on-site inspections. In 2005 the FSA approved the use of an automated valuation model (AVM) for the valuation of mortgaged property. The AVM was approved for specific property categories only. AVM valuations are also supervised by the FSA.

V. ASSET - LIABILITY MANAGEMENT

The Financial Business Act, the Mortgage Act and the Executive Order on bond issuance, balance principle and risk management require mortgage banks and commercial banks to observe a balance principle and a set of rules on risk management in connection with the issuance of RO, SDRO and SDO.

The Executive Order provides limits to the scope of differences allowed between on the one hand the payments from borrowers and on the other hand the payments to the holders of the issued ROs, SDROs and SDOs. The limits are adjusted by loss limits to the interest rate, foreign exchange, option and liquidity risks that follow from cash flow differences in the balance sheet. The Executive Order also contains a number of other provisions limiting financial risk.

For commercial banks, the balance principle is applicable at register level. For mortgage banks, the balance principle is applicable at the level of the individual capital centres and the institutions in general.

For each register/capital centre, mortgage banks and commercial banks must choose whether to comply with either the *specific balance principle* or the *general balance principle*. The choice of balance principle does not depend on the choice of bond type (RO, SDRO or SDO) issued out of the register/capital centre. The differences between the two balance principles are as follows:

Types of risk	Specific balance principle	General balance principle
Interest rate risk	Stress test on level and structure + Loss limit of 1 per cent of capital base + Risks in different currencies cannot be set off	Stress test on level and structure Loss limit for **mortgage banks** dependent of stress test: 1 per cent/ 5 per cent of capital adequacy requirement + 2 per cent/10 per cent of the additional excess cover Loss limit for **commercial banks** dependent of stress test: 10 percent/100 percent of excess cover
Currency risk	Exchange rate indicator 2 (few currencies) + Loss limit of 0.1 per cent of capital base	Simple stress test Loss limit for **mortgage banks**: 10 pct. of capital adequacy requirement + 10 per cent of the additional excess cover for EUR and 1 per cent of capital adequacy requirement + 1 per cent of additional excess cover of other currencies Loss limit for **commercial banks** 10 percent of excess cover
Option risk	Maximum term of 4 year + Structural limits on call options and index-linking	Stress test on volatility Loss limit for **mortgage banks**: 0,5 per cent of capital adequacy requirement + 1 per cent of the additional ex-cess cover No maturity or structural limits Loss limit for **commercial banks** 5 percent of excess cover No maturity or structural limits
Liquidity risk	Limitations on temporarily liquidity deficits 25 per cent (years 1-3) 50 per cent (years 4-10) 100 per cent (from year 11)	Limitations on interest payments: Interest (in) > Interest (out) (over a current period of 12 months) + Present value PV (in) > PV (out) (always)
Repayment of loans by bonds other than the underlying bonds	Max. 15 pct. Both own issued bonds and bonds from other credit institutions + Approximately same cash flow	Max. 15% from other credit institutions - Own issued bonds unlimited

Despite the risk limits of the balance principle, Danish mortgage banks have in practice structured their mortgage lending business in such a way that they do not assume significant financial risks with respect to lending and the underlying funding activities. Thus, the mortgage banks have nearly eliminated interest rate risk, foreign exchange risk and prepayment risk.

Loans granted by the Danish mortgage banks are funded exclusively through mortgage bond issuance. Proceeds from issuance according to the loan amount must therefore be available on the date of loan disbursement. The mortgage bank commonly achieves this through *tap issuance*. Each loan disbursed is linked to certain *amounts* of bonds (not certain *bonds*) in one or several specific ISIN codes currently open for issuance. Knowing which loans to disburse, e.g. the following day, the mortgage bank pools the bond amounts necessary for these loans. Having done this, the total tap amount for each open ISIN code is issued and – subsequently – sold to investors. The tap issuance thus ensures that the following key criteria are maintained day by day:

> Provision of liquidity for actual disbursement;

> Balance of mortgages and bonds outstanding on capital centre level;

> Balance of future payments on capital centre level.

The individual ISIN code can be open for issuance for an extended period of time. With tap issuance taking place virtually every day over a period of several years there is no strict distinction between primary and secondary markets in the Danish system. In other words: a liquid secondary market has a direct positive impact as a catalyst for smooth operation and tight pricing in the primary market.

The Danish commercial banks are also subject to the strict ALM rules. In practice the commercial banks operate under a general asset and liability management and do not offer pass-through products.

The FSA must be informed of any balance principle breaches without delay. Breaches are punishable by a fine imposed by the FSA. In case of severe or multiple breaches, the FSA may revoke the operating license and dismiss the management of the issuer.

According to the Financial Business Act, the capital base must represent at least 8% of risk-weighted assets and at least EUR 5m. Mortgage banks must observe the capital adequacy requirement both at individual capital centre level and at the level of the institution. Overcollateralisation forms part of the cover pool. If this requirement is not observed, the FSA must be informed without delay. In this case, the FSA will issue an order effecting suspension of payments and, if applicable, initiate bankruptcy proceedings against the issuer. The FSA may also grant the issuer time to secure an adequate capital base.

In addition, issuers are required to prepare comprehensive reports on asset-liability management for the FSA on a quarterly basis.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The issuer monitors the cover pool continuously. Data from every single loan offer from the Danish mortgage banks and thus all property valuations for new lending purposes are reported to the FSA on a quarterly basis.

There is no cover pool monitor officer. Instead, in the mortgage banks the internal auditors are required to monitor the existence of the mortgages in the capital centre on a current basis. The commercial banks report on a quarterly basis to the FSA on the assets in the register. The statement of the registered assets must be verified by the external auditor of the bank.

Banking supervision is carried out by the FSA. The FSA has the authority to issue an order with which the issuer must comply. In case of severe or multiple breaches of Danish law or of such orders, the FSA may revoke the operating licence and dismiss the management of the issuer, cf sections 373-374 of the Financial Business Act.

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

Capital centres of mortgage banks (regardless of whether the issuer has issued ROs, SDROs or SDOs):

Cover assets, mortgages and eligible securities are assigned to specific capital centres which constitute the cover pools of the bonds issued in accordance with Danish legislation. A capital centre consists of a group of series with joint liability and a joint series reserve fund. To become eligible as collateral, mortgages must be entered in the Danish land register or filed for registration in the register (under certain conditions). Mortgages are registered at a specific level employing a property identification code. Eligible securities are registered on an accounting basis. The registration is legally binding and will form the basis of any bankruptcy proceedings.

The issuer - which is subject to the supervision of the FSA - keeps the cover register. The land register is kept by the Danish district courts.

Cover assets are assigned to cover pools on an ongoing basis in accordance with Danish legislation, and no further steps to secure a segregation of assets are therefore required.

If bankruptcy proceedings have been initiated, a trustee appointed by the bankruptcy court will administer the cover assets. As mortgage bank creditors are essentially bondholders, no separate administrator is appointed. Bond investors have a primary secured claim against all assets in the cover pool. Derivative counterparties have a corresponding primary preferential right provided that the derivatives contract stipulates that the suspension of payments or bankruptcy of the institution does not constitute an event of default. Bonds issued to secure assets as compensation for LTV excess (also referred to as junior covered bonds) have a secondary preferential right to all assets of the capital centre. The trustee may re-establish the issuer, if possible, and is not necessarily required to dissolve the enterprise.

When a mortgage bank becomes subject to bankruptcy proceedings, the assets of a capital centre will be segregated to satisfy bondholders, etc, in accordance with their legal position as secured creditors[2].

Any excess funds will form part of the assets available for distribution immediately or subsequently.

Any outstanding claims against the capital centres[3] – also referred to as residual claims – are payable out of the assets available for distribution. In this case, bondholders and derivative counterparties are secured creditors ranking before ordinary creditors, including holders of junior covered bonds. Junior covered bond holders are thus secondary secured creditors in relation to the capital centre but ordinary creditors as regards the assets available for distribution.

The bankruptcy proceedings against a mortgage bank cannot be closed until the last creditors have been paid or all funds have been distributed. Note that no Danish mortgage bank has ever been subject to bankruptcy proceedings.

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2 The same segregation of assets takes place in the "mortgage bank in general" as regards bonds issued outside capital centres at the level of the institution. However, the value of such assets may not exceed the value of the mortgages under the bonds plus an amount equal to 8% of the risk-weighted value of the mortgages.

3 Including any claims by bondholders against the "mortgage bank in general".

The preferential position ensures that a bankruptcy scenario will only in exceptional cases affect bond investors and derivative counterparties, thereby rendering bonds bankruptcy remote.

Bankruptcy regulations applicable to Danish mortgage banks contain detailed guidelines which must be observed in a bankruptcy scenario. Key points of the guidelines are:

> A trustee will be appointed by the bankruptcy court to administer all financial transactions of the issuer;

> The trustee will be instructed to meet all payment obligations under bonds issued in due time despite any suspension of payments of the issuer;

> All new lending activities of the issuer will be suspended;

> The trustee may issue bonds to refinance maturing bonds and raise secured loans to obtain liquidity (cf below);

> The trustee may transfer an entire capital centre to another mortage bank;

> Payments on loans will not be accelerated, and therefore payments from borrowers will fall due according to the original payment schedule;

> The trustee will not meet the claims of other creditors until all payment obligations under the senior bonds have been met in full;

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

Bonds do not accelerate automatically. Payments fall due according to the original payment schedule.

The trustee is ordered by law to meet all payment obligations under senior bonds and the derivative contracts as they fall due.

If payments from cover assets (mortgages and overcollateralisation of minimum 8%) are insufficient to meet the payment obligations, the trustee has the authority to raise additional loans. If this fails, the issuer will ultimately default on its payments. The trustee may raise loans to meet the payments for bondholders and derivative counterparties and provide security for such loans in the form of assets other than the cover pool mortgages, ie the reserve fund assets. Security can also be provided in the form of collateralized funds from the upcoming borrower instalment. The lender will have a first priority secured claim against the assets provided as security but not against the mortgages.

Cover assets are assets on the issuer’s balance sheet, the issuer being the mortgagee of the mortgages. Cash flows from the cover assets must be used to meet the payment obligations under the bonds and the derivative contracts. Only the issuer as mortgagee, not investors, is entitled to foreclose on cover assets. Cash flows from cover assets must be used to meet firstly the payment obligations under senior bonds and the derivative contracts, secondly the obligations under junior covered bonds.

Commercial bank registers

A commercial bank may now set up a register segregating assets, which exclusively serve as SDO cover assets.

As is the case with mortgage banks, derivative counterparties have a primary preferential right in line with the SDOs provided that the derivatives contract stipulates that the suspension of payments or bankruptcy of a commercial bank does not constitute an event of default. Bonds issued to secure assets as compensation for LTV excess (also referred to as junior covered bonds) have a secondary preferential right to all assets of the register.

The register is kept by the commercial bank and must at all times contain all assets, guarantees received and derivatives contracts, clearly individualised. The commercial bank must submit statements of the assets to the FSA. The external auditor must perform continuous regular control of the register and at least twice a year make unannounced of register audits.

Where the FSA suspends the licence of a commercial bank to carry on banking business, the FSA or the bank files a bankruptcy petition, or the bank is adjudicated bankrupt following the petition of a third party, the FSA will decide whether the register is to become subject to administration by an administrator as an estate in administration. The administrator (and not the ordinary trustee) will be in charge of the assets of the register.

Any unsatisfied residual claims by SDO holders and derivative counterparties against the register may be proved against the assets available for distribution of the commercial bank, but – contrary to the proceedings related to mortgage banks – exclusively as ordinary claims. Residual claims from junior covered bonds may also be proved as ordinary claims against the assets available for distribution.

The register is – contrary to the capital centres of mortgage banks – not subject to any specific statutory minimum requirement as to capital adequacy. The 8% capital adequacy requirement must only be fulfilled at the level of the commercial bank.

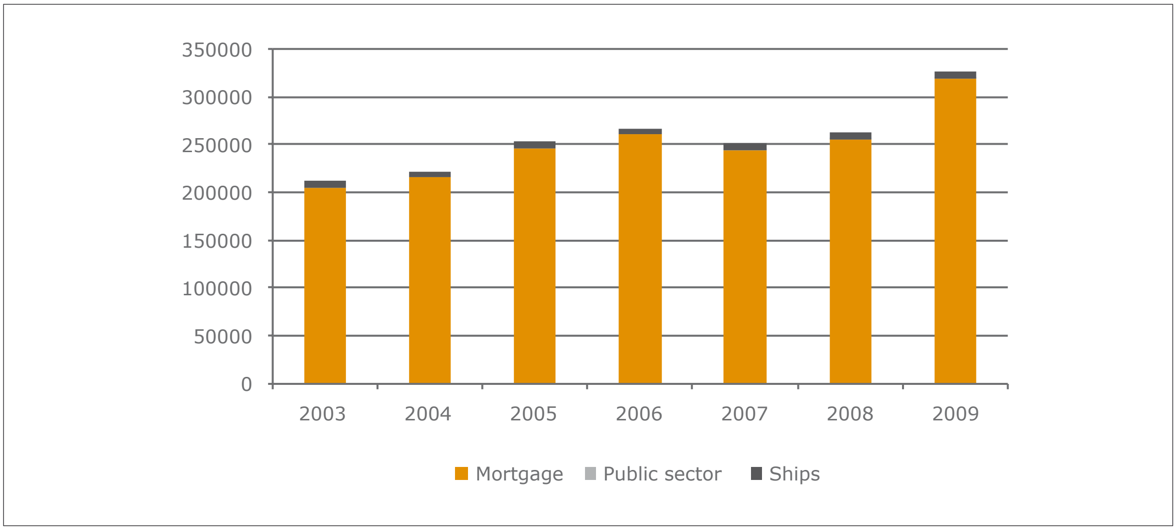
VIII. RISK WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

Most of the Danish covered bonds are listed on NASDAQ OMX in Copenhagen, which is a MiFID approved Stock Exchange. The covered bonds denominated in DKK are issued via VP Securities Denmark, the Danish CSD. The euro denominated Danish covered bonds are issued via VP Lux in Luxembourg. The reason for this is that only covered bonds issued within the euro zone are eligible as collateral in the ECB. VP Securities in Denmark are under supervision by the Danish FSA and VP Lux is under supervision by the FSA in Luxembourg. SDOs and SDROs qualify as covered bonds under the CRD. ROs issued before 1 January 2008 will maintain the low risk weighting of 10% throughout the maturity of the bonds in accordance with the grandfathering option under the CRD. ROs issued after 1 January 2008 carry a risk weight of 20%.

ROs, SDOs and SDROs are eligible for repo transactions and may be used as collateral for loans with the Danish central bank (Danmarks Nationalbank). Most EUR denominated ROs, SDOs and SDROs are also eligible for repo transactions with the ECB.

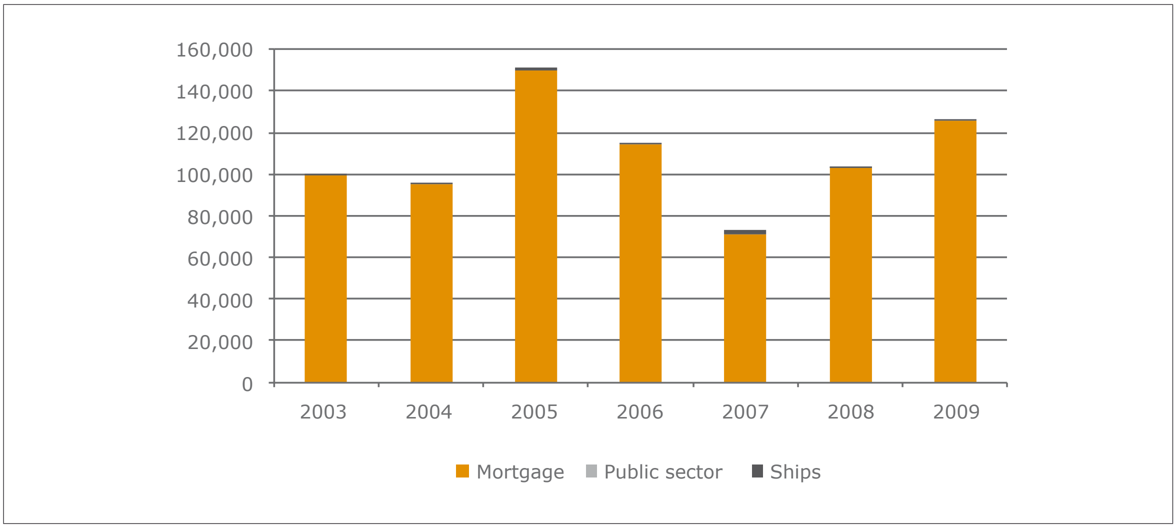
When investing in ROs, SDOs and SDROs, the Danish investment legislation allows pension funds etc to exceed the usual limits on exposures to a single issuer. thus acknowledging the reduced risk associated with covered bond assets (cf the Financial Business Act (for insurers) and the Act on Investment Associations and Special-Purpose Associations as well as other Collective Investment Schemes etc.).

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2009, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2009, €M



Source: EMF/ECBC

Issuers: Covered Bonds backed by real estate collateral are primarily issued by the specialised mortgage banks: BRFkredit a/s, DLR Kredit A/S, LR Realkredit A/S, Nordea Kredit Realkreditaktieselskab, Nykredit Realkredit A/S (incl. Totalkredit A/S) and Realkredit Danmark A/S. FIH Realkredit A/S ceased new lending and issuance in 2004. At the end of 2009 the mortgage banks' outstanding volume of covered bonds was EUR 327 bn Since the new Danish regulation on Covered Bonds entered into force on 1 July 2007 only one commercial bank, Danske Bank A/S, has utilised the possibility to issue covered bonds. Danske Bank has issued non-pass-through (euro-style) covered bonds of a value of around EUR 15 bn. Danish Ship Finance is the only Danish issuer of Covered Bonds backed by ship loans.

3.6 FINLAND

By Martti Porkka, Aktia Real Estate Mortgage Bank
and Ralf Burmeister, LBBW

Opening remark: The legislation on Covered Bonds in Finland is in the process of being amended by the time this article is produced. The new legislation has already passed the parliament and needs to be signed by the Finnish President, which is to be seen as a formal procedure. By the time of the publication of the ECBC Fact Book, the final and official law has not been available in an English translation. Therefore, the authors kept to the translation of the draft of the government bill HE 42/2010 as of 9th April 2010.

I. FRAMEWORK

In Finland, the legal basis for covered bond issuance is the Act on Mortgage Credit Bank Operations HE 42/2010 as mentioned in the opening remark. The new legal framework is scheduled to be in place on 1 August 2010. The new law will bring a major formal change in a way that the special banking principle will be abandoned and besides other technical changes, e.g. mixed pools will be allowed.

II. STRUCTURE OF THE ISSUER

The issuer of Finnish Covered Bonds can still be a specialized bank, but deposit banks or credit entities are entitled to apply for a license to issue covered bonds. The existing specialized banks tend to stay in business in the way they have been operating since being installed.

The issuer holds the cover assets on the balance sheet. A subsequent transfer of the cover assets to another legal entity is not taking place. A direct legal link between single cover assets and the Covered Bonds issued does not exist. All obligations from Finnish Covered Bonds are direct and unconditional obligations of the issuing bank as a whole. In the case of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved only for the claims of the holders of Finnish Covered Bonds.

Under the previous legal framework, only Bonds covered by mortgages were issued by Finnish mortgage banks. A separate cover pool was to be established if these banks were to start the issuance of public-sector backed Finnish Covered Bonds. Under the new law, mixed pools comprising mortgage loans as well as eligible public sector assets are allowed.

III. COVER ASSETS

The geographical scope of cover assets is restricted to the European Economic Area (EEA).

Residential mortgage loans, shares in housing companies as well as commercial mortgage loans up to 10% of the total pool are eligible as cover assets.

Public sector loans in accordance with the CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f) criteria are also eligible.

A new feature in the law is that a specialized mortgage credit bank can grant an intermediate credit to a deposit bank or a credit entity. This intermediate credit must be covered with eligible cover assets as stated above. These assets must also be recorded into the cover register.

Up to 20% of the mortgage cover pool is allowed to consist of substitute cover assets; bonds and other debt obligations issued by the State, a municipality or another public-sector organisation or another credit institution than one belonging to the same consolidation group as the issuer; a guarantee as for own debt granted by a public-sector organisation or credit institution referred above; a credit insurance given by an insurance company other than one belonging to the same group, referred to in the Act on Supervision of Finance and Insurance Groups; cash assets of the issuer deposited in the Bank of Finland or a deposit bank.

ABS or MBS tranches are not eligible for the cover pool.

Derivatives are eligible for the cover pools, if they are used for hedging purposes.

The nature of the cover pool is dynamic. The currency risk is perfectly matched as the law requires cover assets to be in the same currency as the covered bonds.

IV. VALUATION AND LTV CRITERIA

The property valuation within the legal framework for Covered Bonds in Finland is based on market values. There are different LTV levels for residential and commercial mortgage loans: 70% of the value of the residential property and 60% of the value of the commercial property accepted. This LTV is a relative limit, i.e. when a loan exceeds the 60%/70% limit, the part of the loan up to 60%/70% LTV remains eligible to the cover pool.

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 total amount of collateral of covered bonds shall continuously exceed by at least 2 per cent the total net present value of the payment liabilities resulting from the covered bonds

In case of a breach of one of these rules mentioned, the issuer might face sanctions from the FSA. Ultimately, the issuer might face the loss if its licence.

V. COVER POOL MONITOR AND BANKING SUPERVISION

The issuer carries out the monitoring of the cover pool. Therefore, the issuer reports to the FSA on a monthly basis. With regard to UCITS 22(4), this supervision of a specialized bank as issuer of the Covered Bond is compliant to the "special supervision". The FSA has the legal power to take appropriate measures. It is allowed to conduct inspections at the bank in question or to require documents. Also, the FSA could issue a public warning or admonition. Ultimately, it is up to the FSA to revoke the banking licence of the bank in question.

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

A cover register allows identifying the cover assets. The legal effect of a registration of assets into the cover register is to create the priority claim of Covered Bond holders to these cover assets in case of an insolvency of the issuer. The cover register is managed by the corresponding bank, which in turn is supervised by the FSA.

The cover register contains information about the principle amount of Covered Bonds issued, the mortgages and substitute assets covering these bonds as well as derivative transactions hedging these bonds.

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 derivates in case of an insolvency of the issuing bank depend on the relevant contracts.

Preferential treatment of Covered Bond holders

Covered Bond holders enjoy a preferential treatment as the law stipulates the separation of the cover assets on the one hand and the insolvency's estate on the other.

The satisfaction of the Covered Bond holders is not limited to the cover assets in the Finnish system. On the contrary, those creditors also participate in the insolvency proceedings in respect of the remaining assets of the bank.

A moratorium on the insolvency's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of Covered Bond holders.

Access to liquidity in case of insolvency

With the appointment of the cover pool administrator, this person acts on behalf of the Covered Bond holders. The pool administrator has access to the cover assets. Cover assets may only be disposed with the consent of the FSA. Additionally, the pool administrator has also the first access on cash flows generated by the cover assets. The law foresees a possibility for the pool administrator together with the bankruptcy trustee to take up a loan on behalf of the cover pool to create more liquidity.

Up to 20% of the cover pool may consist of liquid substitute cover assets. With the consent of the FSA, this limit may even be higher. As all cover assets entered into the cover register are ring-fenced in case of an insolvency of the issuer, this results also in the insolvency remoteness of voluntary overcollateralisation.

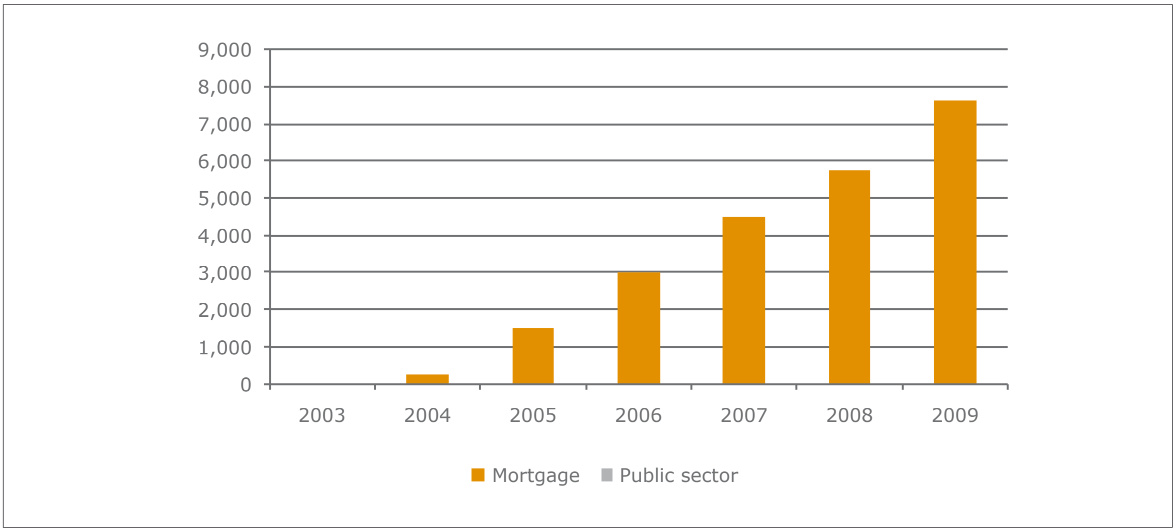
VII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Finnish Covered Bonds comply with the requirements of Art. 22 par. 4 UCITS Directive as well as with those of the CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f). Therefore, these bonds are 10% risk weighted in Finland. Following the common practice in Europe, they accordingly enjoy a 10% risk weighting in most European countries.

Finnish Covered Bonds are also eligible in repo transaction with national central bank, i.e. within the Euro-zone.

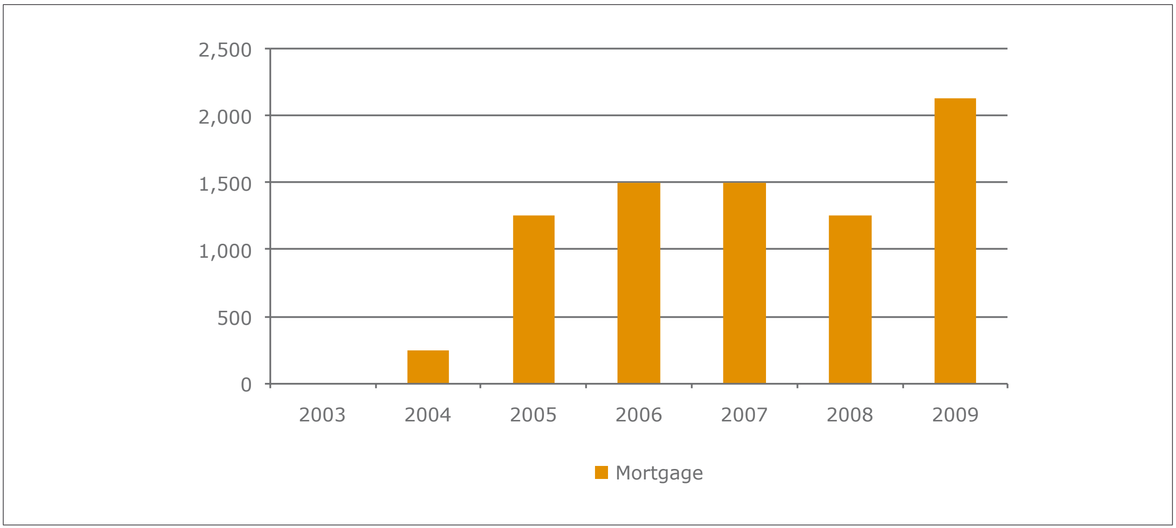
As far as the domestic issuers are aware, there are no further specific investment regulations regarding Finnish Covered Bonds.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2009, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2009, €M



Source: EMF/ECBC

Issuers: Finnish issuers at the end of 2009 were Aktia Real Estate Mortgage Bank, OP Group Mortgage Bank and Sampo Housing Loan Bank.

3.7 FRANCE

By Francis Gleyze, Caisse Centrale du Crédit Immobilier de France,
Henry Raymond, Caisse de Refinancement de l'Habitat – CRH,
and Cristina Costa, Natixis

Sociétés de crédit foncier and Caisse de Refinancement de l'Habitat are governed by a special legal framework.

French structured covered bonds issuers are governed by a legal framework based on French general law and especially those resulting from the implementation of the European Collateral Directive N° 2002/47.

A - OBLIGATIONS FONCIERES

By Francis Gleyze
Caisse Centrale du Crédit Immobilier de France

Unlike States that allow ordinary credit institutions to issue covered bonds provided that the cover pool is segregated in their balance sheet, France requires the setting up of an *ad hoc* company, the *société de crédit foncier* totally independent from the other companies of the group to which it belongs and specifically dedicated to the issuance of *obligations foncières* - the French special law based covered bonds.

Sociétés de credit foncier ("SCFs"), are credit institutions governed by a stringent legal framework in order to protect the holders of the bonds they issue. They operate under the close scrutiny of France's Banking Authority (Autorité de contrôle prudentiel), the banking industry supervisor, which requires compliance with management rules designed to ensure control over risks.

I. LEGAL FRAMEWORK

Sociétés de crédit foncier are governed by articles L.515-13 and seq. of the French Monetary and Financial Code (the "Code"). Licensed by the French Banking authority, they have a single purpose: to grant or acquire eligible assets, as defined by law, and to finance them by issuing *obligations foncières*, which benefit from a special legal privilege (the "Privilege"). They may also issue or contract other debts benefiting or not from the Privilege.

The legal framework of the *société de crédit foncier* was updated in 2007 according to the implementation of the European Capital Requirements Directive N° 2006/49 (the "CRD)", and, for the last time, on January 2009.

An update of this framework is under preparation and is expected to be adopted by the French Parliament and completed by the Ministry of Economy and Finance before the end of 2010.

II. COVER ASSETS

Only eligible assets, restrictively defined by law, are authorized on the balance sheet of the *sociétés de crédit foncier*. All assets on the balance sheet are part of the cover pool.

Assets eligible to the cover pool are:

> loans guaranteed by a first-ranking mortgage or by an equivalent guarantee;

> loans granted to finance real estate and guaranteed by a credit institution or an insurance company with shareholders' equity of at least € 12 million and that isn't a member of the group to which

belongs the *société de crédit foncier*. The amount of these loans cannot exceed 35% of the assets of the *société de crédit foncier*;

> exposures that are totally guaranteed by:

> central administrations, central banks, public local entities and their grouping, belonging to a member State of the European Community or party to the European Economic Area, or - under ratings conditions - central administrations and central banks belonging to a non member State of the European Community or to an non adherent to the European Economic Area;

> European Community, International Monetary Fund, Bank for international Settlements and multilateral developments banks registered by the French Ministry of Finances;

> others public sector entities and multilateral developments banks as more described in Article L.515-15 of the Code;

> senior units of securitisation funds or equivalent entities subject to the law of a Member State of the European Community or party to the European Economic Area 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 funds or equivalent entities may only consist of mortgage loans or public sector loans, 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 units or securities issued by the securitisation vehicle or similar entity must qualify as a minimum for the credit quality assessment step 1 by a rating agency recognised by the French banking supervisor. AAA rated senior units of securitisation funds may represent 100% of the outstanding covered bonds;

> mortgage notes representing loans that would be otherwise directly eligible to the cover pool and issued in accordance with Articles L.513-42 et seq. of the Code. The mortgage notes may not represent more than 10% of the assets of the *société de crédit foncier*;

> replacement assets up to 15 % of the amount of the outstanding covered bonds issued by the *société de crédit foncier*. Replacement assets are defined as sufficiently secure and liquid assets (i.e. securities, assets and deposits for which the debtor is a credit institution or an investment company qualifying for the step 1credit quality assessment).

Loans guaranteed by a first-ranking mortgage or by an equivalent guarantee and loans guaranteed by a credit institution or an insurance company are eligible for privileged debt financing up to a part of the financed or pledged real estate's value. Senior units of securitisation funds are subject to similar rules.

III. PRIVILEGE

Pursuant to article L.515-19 of the Code, holders of *obligations foncières* and other privileged debts have preferred creditor status and the right to be paid prior to all other creditors who have no rights whatsoever to the assets of the *société de crédit foncier* until the claims of preferred creditors have been satisfied in full.

This legal Privilege which supersedes the ordinary French bankruptcy law, has the following characteristics.

> The sums deriving from the loans, exposures, similar debts, securities, financial instruments, after settlement if applicable, and debts resulting from deposits made with credit institutions by *sociétés de crédit foncier* are allocated in priority to servicing payment of the covered bonds and other privileged debt;

> the judicial reorganisation or liquidation or amicable settlement of a *société de crédit foncier* does not accelerate the reimbursement of *obligations foncières* and other debt benefiting from the Privilege which continue to be paid at their contractual due dates and with priority over all other debts. Until the holders of privileged debts are fully paid off, no other creditor of the *société de crédit foncier* may avail itself of any right over that company's property and rights;

> the common provisions of French bankruptcy law affecting certain transactions entered into during the months prior the insolvency proceedings (the *période suspecte*) are not applicable to *sociétés de crédit foncier*.

IV. BANKRUPTCY REMOTENESS

As an exception to the general French bankruptcy law, bankruptcy proceedings or liquidation of a company holding share capital in a *société de crédit foncier* cannot be extended to the *société de crédit foncier*. As a result, *sociétés de crédit foncier* are, under a special law in accordance with a deliberate decision of the legislator, the only French companies being totally bankruptcy remote and enjoying full protection from the risks of default by their parent company or the group to which they belong.

V. COVERAGE RATIO

Under Article L.515-20 of the Code, the total value of the assets of a *société de crédit foncier* must at all times be greater than the total amount of liabilities benefiting from the Privilege, a condition that makes for a coverage ratio always greater than 100%.

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 is rated at minimum AA- (Fitch and S&P) or Aa3 (Moody's), weighted 50% if it is rated A- (Fitch and S&P) or A3 (Moody's), and weighted 0% if it is rated below these ratings ;

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

> public exposures and replacement assets are weighted 100%.

The coverage ratio is reported and published at regular intervals, in accordance with applicable laws and regulations.

As part of the future updating of the SCF legal framework, the minimum coverage ratio is expected to be raised from 100% to 102%.

VI. COVER POOL MONITOR

Sociétés de crédit foncier must appoint a registered auditor, with the agreement of the French banking regulator, to act as a "Specific Controller". To ensure independence, the specific controller may not be an employee of either of the 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 *société de crédit foncier* are eligible to the cover pool, and in the case of mortgage assets, that they are properly valued ;

> that the coverage ratio is above 100% at any moment ;

> that the *société de crédit foncier* comply with all the limits required by the regulation (i.e. the limit of the loans guaranteed by a credit institution or an insurance company, the limit of the mortgage promissory notes and the limit of the replacement assets) ;

> that the "congruence", i.e. the adequacy of maturities and interest rates of assets and liabilities, is at a satisfactory level ;

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

The Specific Controller certifies that the *société de crédit foncier* complies with coverage ratio rules on the basis of a quarterly issuance program, and for any issue of an amount equal or above 500 million euros. These coverage ratio affidavits are required to stipulate in issuance contracts that the debt benefits from the legal Privilege.

The Specific Controller reports to the French banking regulator. He attends shareholders' meetings, and may attend Board meetings.

Pursuant to article L.515-30, the Specific Controller is liable towards both the *société de crédit foncier* and third parties for the prejudicial consequences of any breach or negligence he may have committed in the course of his duties.

VII. BANKING SUPERVISION

SCFs operate under the constant supervision of the Banking Commission.

Like listed companies, SCFs must issue periodic financial information. Moreover, SCFs are also required to publish an annual report on the quality of their assets and the compliance with the limits, describing the characteristics and breakdown of loans and guaranties, the amount of defaults, the breakdown of receivables by amount and by class of debtors, the proportion of early redemptions, the list and characteristics of FCC securities and RMBSs that it holds, the volume and breakdown of replacement securities that it holds, the compliance with the limits and the extent and sensitivity of its interest-rate exposure. This report is filed with the Banking Commission and published in the *Bulletin des Annonces Légales Obligatoires*.

The coverage ratio must be published and reported to the Banking Commission every six months.

As credit institutions, SCFs are subject to Comité de la Réglementation Bancaire et Financière (CRBF) regulation 97-02 on internal control. Accordingly, they must set up a system for monitoring transactions and internal procedures, a system for handling accounting processes and data processing, as well as risk management and monitoring systems.

VIII. ASSET - LIABILITY MANAGEMENT

Under French regulations, *sociétés de crédit foncier* must manage and hedge market risks on their assets, liabilities and off-balance sheet items: interest rate risks, currency risks, liquidity and maturity mismatch between liabilities and assets. The surveillance of these points is part of the duties of the Specific Controller.

In application of French Regulation 97.02, a report on risk management must be sent to the French banking regulator, which is also transmitted to the auditors, the Specific Controller and the Board of Directors.

In order to give protection to the hedging system in place, article L.515-18 of the Code provides that financial instruments hedging the assets, *obligations foncières* and other debt benefiting from the Privilege, and financial instruments hedging the overall risk on assets, liabilities and off-balance sheet items, benefit from the Privilege. As a consequence, they are not to be terminated in the event of bankruptcy proceedings or liquidation.

As part of the expected update of the it legal framework, the SCF will be required to maintain at all times a positive liquidity gap over 180 days.

IX. TRANSPARENCY, ASSET VALUATION

Once a year, after the shareholders' General Meeting, the *société de crédit foncier* must publish in the *Bulletin des Annonces Légales Obligatoires*, a report describing (i) the nature and the quality of its assets and (ii) its interest rate exposure. The report is also sent to the French banking regulator. In addition, *société de crédit foncier* informs twice a year the French banking regulator of the amount of its coverage ratio and of the respect of the limits at 30 June and 31 December,

Among his duties, the Specific Controller controls the eligibility, composition, and valuation of the assets. Real estate valuations must be based on their long-term characteristics. Under banking regulation n° 97-02, property values are considered part of the risks of *sociétés de crédit foncier*. The valuations are made by independent experts in compliance with banking regulation.

X. COVERED BONDS LIQUIDITY

The French *sociétés de crédit foncier* which issue jumbo *obligations foncières* have together signed with 23 banks a specific standardised market-making agreement, which has become a national agreement.

XI. RISK- WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

Obligations foncières comply with the requirements of article 22 par. 4 UCITS directive, and with the CRD directive, Appendix VI, Pact 1, Paragraph 65 a) to f).

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

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

By Henry Raymond, Caisse de Refinancement de l'Habitat

I. LEGAL FRAMEWORK

CRH was created in 1985 by French Government with State explicit guarantee as a central agency in order to refinance French banks in the specific legal framework of art 13 of law 85-685 of July 1985.

Up to SFEF 's creation in October 2008, no other agency of that type was created in France. Since January 1st, 2010, CRH is appointed to control debt' service and collateral administration of SFEF.

Today, instead of State guarantee, the French law gives to CRH's bondholders a very strong privilege on CRH's secured loans to banks.

The Caisse de Refinancement de l'Habitat (previously Caisse de Refinancement Hypothécaire) is a specialized credit institution of which the sole function is to fund French banks housing loans to individuals.

CRH issues bonds and lends the borrowed amount to banks in the same conditions of rate and duration.

CRH loans take the form of promissory notes issued by the borrowing banks and held by CRH.

CRH's bonds are strictly regulated in order to offer bondholders a very high credit quality and benefit from a legal privilege.

They are governed by the article 13 of act 1985-695 of July 11, 1985 as complemented by article 36 of act 2006-872 of July 13, 2006.

CRH received approval to issue bonds under article 13 of act 1985-695 by letter of September 17, 1985 from the Minister for the Economy, Finance and Budget.

CRH's operations are governed by the provisions of art L. 313-42 to L. 313-49 of Monetary and Financial Code. CRH's loans to banks, i. e. notes held by CRH, are covered by the pledge of housing loans to individuals. In the case of a borrowing bank default, CRH becomes owner of the portfolio of housing loans without any formality notwithstanding any provision to the contrary.

II. COVER ASSETS

Eligible loans are only home loans to individuals defined by law: first-ranking mortgages or guaranteed loans.

Guaranteed loans are loans granted to finance real estate with the guarantee of a credit institution or an insurance company (the total amount of these loans cannot exceed 35% of the covering portfolio).

The geographical area for eligible loans is the European Economic Area in the law but "de facto" only France and Overseas territories.

No replacement assets are allowed. RMBS and other loans are not eligible .

III. PRIVILEGE

Pursuant to article 13 of act 1985-695 (complemented), when the guarantee of the French government is not accorded (this guarantee is no longer granted), the sums or amounts generated by the promissory notes are allocated, as a matter of priority and under all circumstances, to the payment of the interest and principal on CRH bonds.

The provisions of Book VI of the French commercial code, or those governing all legal or equivalent amicable proceedings engaged on the basis of foreign laws, do not constitute an obstacle to the application of these provisions.

These provisions give to CRH's bondholders a preferred creditor status and the right to be paid prior to other creditors.

IV. BANKRUPTCY REMOTENESS

CRH is a company independent from borrowing banks. Bankruptcy proceedings or liquidation of a borrowing bank, holding CRH's equity, cannot be extended to CRH.

V. COVERAGE RATIO

In compliance with article 13 of act 1985-695, the only aim of CRH is to issue bonds to fund banks mortgage loans. Then, CRH's debt amount and CRH's loans to Banks (represented by notes) must be equal.

According to the provisions of the law and of article R. 313-21 of Monetary and Financial code, CRH's statutes dictate that the covering portfolio amount (compound of home loans to individuals pledged to cover CRH's loans to banks) must exceed 125% of the amount of notes held by CRH, and then must exceed 125% of CRH's bonds.

VI. COVER POOL MONITOR

CRH is an independent credit institution that doesn't borrow for its own account but for the account of banks and doesn't charge any fee or interest margin on its refinancing transactions.

CRH regularly achieves, based on sampling, audits on the cover pool, carried out at the borrowing banks. If necessary, CRH asks borrowing banks to increase the cover pool to compensate for the shortfall identified or to pay back CRH by delivering CRH's bonds.

VII. BANKING SUPERVISION

As a credit institution, CRH is under the general supervision of the French banking authority *Commission Bancaire*. Furthermore, its operations are under a specific supervision of *Commission Bancaire* because of the provisions of the article L. 313-49 of Monetary and Financial Code.

CRH is also subject to audit by its shareholder banks.

VIII. ASSET - LIABILITY MANAGEMENT

As explained above, CRH's debts and loans (represented by notes) have exactly the same characteristics. CRH is not submitted to an interest rate risk. CRH is not affected by early repayment of loans included in the portfolio.

According to CRH internal regulation, the cover pool must be congruent with rate and duration of CRH's debt to protect CRH in the case where it becomes owner of the cover pool.

IX. TRANSPARENCY, ASSET VALUATIONS AND LOAN TO VALUE

Every year, the annual report publishes the size of the cover pool. This report confirms the characteristics (nature and quality) of home loans pledged and that CRH is not exposed to interest rate risk.

The rules for real estate valuations are the same as those of *sociétés de crédit foncier*.

Loan to value must not exceed 80% (de facto 90% because of the over-sizing of the covering portfolio by 25%).

X. CRH BONDS LIQUIDITY

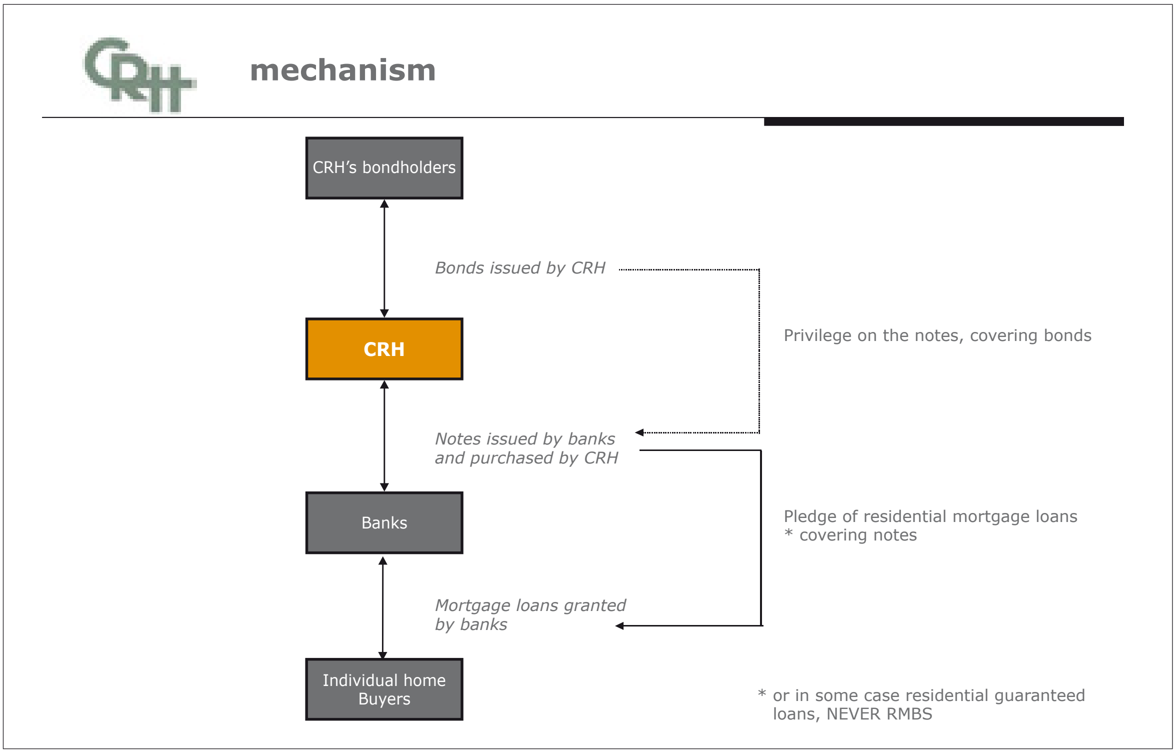
The size of CRH's bonds outstanding is very important. They are very liquid, listed on MTS and several banks are market makers for them .The average full CRH debt turnover ratio is very high. Two of CRH issues have a size of 5 euro billion.

XI. RISK - WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

CRH's debt has been rated AAA and Aaa (senior unsecured) by Fitch and Moody's since 1999.

CRH's bonds are compliant with criteria of article 22 par. 4 UCITS directive and with the Capital Requirements Directive (CRD) requirements. They are 10% weighted in standard approach.

They are included in securities accepted for the European Central Bank (E.C.B.) open market operations.



C - STRUCTURED COVERED BONDS

By Cristina Costa, Natixis

BNP Paribas introduced the first French structured covered bond programme in November 2006. This route was chosen to use the bank's collateral more efficiently, than the established legal framework for "*Obligations Foncières*". In particular, the 20% cap on guaranteed housing loans (which was [recently] increased to 35% in May 2007), had been a major obstacle, given that more than 50% of the bank's housing loans and circa two thirds of its new origination are secured by guarantees. With BNP Paribas' position reflecting overall trends in the French banking industry, other banks followed in BNP Paribas's footsteps: Credit Mutuel and Banque Populaire set up structured covered bond programmes in 2007, Groupe Caisse d'Epargne, HSBC France and Crédit Agricole in 2008, and Crédit Mutuel Arkéa in 2009. Today there are seven active covered bonds issuers in the French market.

I. FRAMEWORK

In addition to applying structured finance techniques, structured or common-law based covered bonds (this term will be used interchangeably throughout this chapter) make use of the implementation of the EU Collateral Directive 2002/47/EC in the French Banking Act, which allows for a segregation of the assets without an actual transfer of assets to the issuer. This directive was implemented into the French Code Monétaire et Financier (Article L. 211-38 of January 8, 2009[1]). Pursuant to the article L.211-38 of the French Monetary Code, the pledges and the cash collateral shall be enforceable, when the relevant collateral provider is subject to an insolvency proceeding.

Issuers of French common law-based covered bonds use a two-step structure. A bank originating collateral, transfers, pledges or assigns potential collateral to a subsidiary, which is a regulated French credit institution with limited purpose (e.g. issuing covered bonds for the purpose of providing financing to the sponsor bank(s)). The covered bonds proceeds are used to fund advances to the respective sponsor bank(s). The covered bonds are secured by a pledge on the issuer's assets, which are in turn secured by a pledge over cover assets which remain on the sponsor bank's balance sheet (and/or on the balance sheets of the respective subsidiaries, affiliates or group member banks). Upon a borrower enforcement notice (for example in case of default of the sponsor bank), the respective cover assets, including underlying securities, will be transferred to the covered bonds issuer.

Since such covered bond programs are conducted outside the obligations foncières framework, the key aspects of the structure, management principles and eligible assets have been agreed on a contractual basis.

II. STRUCTURE OF THE ISSUER

All issuers today are credit institutions regulated by the French banking regulator, "Autorité de Contrôle Prundentiel" (the former « *Commission Bancaire* » and « *Comité des Etablissements de Crédit et des Entreprises d'Investissement* »). These specialised credit institutions are usually an affiliate of the sponsor bank, with limited purpose. Find below details of the seven issuers (listed in alphabetical order):

> Banques Populaires Covered Bonds: the issuer was incorporated on 10 October 2007 as a French *société anonyme à conseil de surveillance et directoire* and is governed by the French Monetary and

1 As well as previously by ordinance N° 2005-171 of 24 February 2005.

Financial Code. The issuer is a special affiliate of the BPCE Group and has been licensed by the French banking regulator notably for the purpose of making Borrower Loans and issuing Covered Bonds.

> BNP Paribas Home Loan Covered Bonds: the issuer is a French limited-purpose credit institution ("*société financière*") which is 99.9%-owned by BNP Paribas, and was incorporated as a French *société anonyme à conseil de surveillance et directoire* and is governed by the French Monetary and Financial Code. The issuer is a special affiliate of the BNP Paribas Group and has been licensed by the French banking regulator.

> Crédit Mutuel Arkéa Covered Bonds: the issuer is a special affiliate of the Crédit Mutuel Arkéa group and has been licensed by the French banking regulator for the purpose of making Borrower Loans and issuing Covered Bonds.

> CM-CIC Covered Bonds: the issuer is a subsidiary of Banque Fédérative du Crédit Mutuel and licensed as a credit institution with limited and exclusive purpose.

> GCE Covered Bonds: the issuer is a subsidiary of BPCE Group and licensed as a credit institution with limited and exclusive purpose by the French CECEI.

> Crédit Agricole Covered Bonds: the issuer is a specialised credit institution which is 99.9% owned by Crédit Agricole S.A.

> HSBC Covered Bonds (France): the issuer was incorporated as a French *Société Anonyme à Conseil d'Administration* on 20 June 2008 and is governed by the French Monetary and Financial Code.

In all the common law-based CB programmes, the issuer is a ring fenced, bankruptcy-proof entity that will be unaffected by the insolvency of the group to which it belongs.

III. COVER ASSETS

The covered bonds are direct, limited recourse obligations of the issuer backed by related secured advances. Under the terms of a borrower facility agreement, the issuer grants advances to the sponsor bank. The terms and conditions of these advances are customarily designed to match those of the covered bonds. All covered bonds issued under the respective programme rank *pari passu* with each other and share equally in the security. Furthermore, the covered bonds are either fungible with an existing series, or constitute a new series with different terms.

In all existing French common-law based programmes, the collateral consists of French housing loans, which are being secured either by a mortgage or a guarantee by an eligible insurance company or credit institution. Being a structured program, geographical restrictions to date have been self imposed. Although the BNP Paribas and CM-CIC covered bonds programmes consist exclusively of French housing loans, their respective legal documentation allows for the inclusion of loans from other jurisdictions. In contrast, the programmes of Banque Populaire, Groupe Caisse d'Epargne, Crédit Agricole, Crédit Mutuel Arkéa and HSBC France that were set up more recently only allow the inclusion of French housing loans.

For all programs, the LTV limit is set at 80%. 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 are not. For all programmes, the LTV ratio of the mortgage loans cannot be more than 100% (however, the portion that is above 80% will be disregarded in the ACT). In addition, the ACT gives no value to the loans in arrears or defaults.

Substitution assets can be included in the cover pool. Their aggregate value can make up to a maximum of 20% of the cover pool and may consist of short-term (<1 year) investments, namely bank deposits, at least rated P-1, A-1+, F1+, RMBS notes or government debt, which all must be at least rated triple A.

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. Price decreases are fully reflected in the revaluation, while in the case of price increases, a 20% haircut is applied.

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. For all the existing contractual-based covered bonds programmes the maximum asset percentage applied in the ACT is 92.5%, which translates into a minimum OC of 8.1%. However, that being said all programmes currently exceed the minimum amount due to adjustments to the rating agency methodologies.

V. ASSET-LIABILITY MANAGEMEMT

All the French structured covered bonds programmes include a number of safeguards:

> Interest rate and currency risks need to be neutralised (the hedging strategy); 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 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 swap counterparties and account banks. There are also regular independent audits of the calculations undertaken on a regular basis.

As a default of the sponsor bank does not accelerate the covered bonds, an amortisation test has been created to ensure that no time subordination exists between the covered bonds series (this mechanism is supplemented by the inclusion of a SARA[2] clause). It only applies after a borrower enforcement notice has been delivered and, therefore, covered bondholders will be relying on the proceeds from the cover assets. The amortisation test will fail if the aggregate loan amount falls below the outstanding balance of all the covered bonds.

2 The Selected Assets Required Amount (SARA) clause prevents the alternative manager from liquidating additional cover pool assets (above the maturing covered bond's proportional share of total assets), post issuer default, to meet payments on short-dated covered bonds, which would result in fewer assets being available for covered bonds that are maturing later.

VI. COVER POOL MONITOR & BANKING SUPERVISION

The issuer is a regulated French financial institution, which is subject to regulation, supervision and examination by the French banking regulator (*Autorité de Contrôle Prudentiel*). In its role as collateral security agent, the issuing bank is responsible for the monthly pool monitoring, with the asset coverage test calculation being checked by an independent asset monitor: 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.

VII. SEGREGATION OF COVER ASSETS & BANKRUPTCY REMOTENESS

In all French structured covered bonds programmes, the cover assets are owned by the covered bond funding entity. As creditors of the issuer, the covered bondholders benefit from the automatic segregation of assets in case of insolvency of the sponsor bank.

There are a number of trigger events for default in the French structured covered bond structure, the first being a borrower event of default. This can occur in a number of situations including the following:

> Failure to pay any interest or principal amount when the borrower advance is due;

> Bankruptcy or legal proceedings being taken by the borrower;

> Failure to rectify any breach of the asset coverage test;

> Failure to rectify any breach in the pre-maturity test;

> Failure to rectify any breach of reserve funding requirement; or

> Failure to enter into hedging agreements following a downgrade of the sponsor bank below a predefined level.

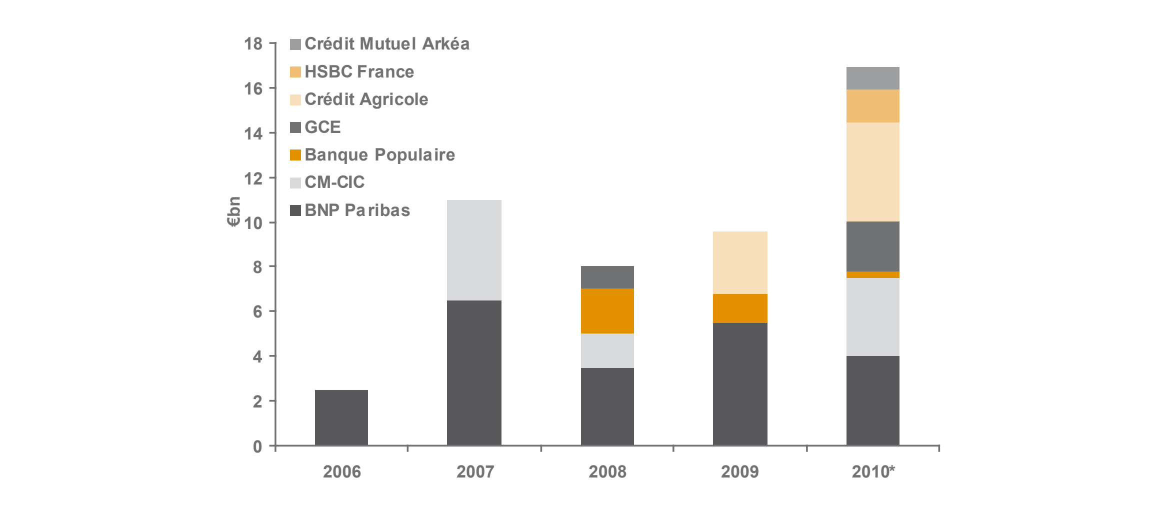
A borrower event of default would not accelerate payments to covered bondholders, but would allow the issuer's security agent to start proceedings against the borrower and enforce securities over cover assets in an orderly fashion.

The second event of default is the issuer event of default. This would arise after a borrower event of default if the issuer failed to make any payments when due, legal proceedings were started against it, or if an amortisation test failed. This would cause the acceleration of payments to covered bondholders and their early redemption at the amount relevant to that particular covered bonds serie.

VIII. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

In France and abroad, French common-law based covered bonds have a 20% risk-weighting under the CRD Standard Approach.

French Common-law based Covered Bond Euro benchmark Issuance 2006-2010*, €bn



* as of end-June 2010

Sources: market data, Natixis

D - OBLIGATIONS A L'HABITAT

By Cristina Costa, Natixis

The *Obligations Foncières* Framework is currently being modified and complemented (introduction of a new Section 5 of Chapter V of book 5 of the French Monetary and Financial Code) to introduce a new type of issuer "*les sociétés de financement de l'habitat*" (Art. L.515-34 and seq.), issuing a new type product "*obligations à l'habitat*" (Art. L. 515-36) with the aim to set up a legal framework to the current structured covered bonds to which they will be substituted.

The draft text makes reference to articles L515-14, L515-16, L515-17, to L515-32-1 of the French Monetary and Financial Code (articles concerning Obligations Foncières) and adds new articles concerning the possibility to either transfer the assets or pledge them (Art L515-35-I, 1°) as well as non-application of the limit on the inclusion of guaranteed home loans (Art L515-35-II, 2°). Thus, it is intended that Obligations à l'Habitat (OH) will be fully UCITS-compliant French covered bonds in order to exclusively finance home loans , without a limit to amount of guaranteed loans (as opposed to the 35% limit in the Obligations Foncières). Furthermore, the law envisages the appointment of specific controller (Art L515-37), who would be in charge of monitoring respect of the law and cover assets as for OF-programmes.

The regulatory framework (under discussion) also envisages introducing for both OF and OH-programmes, inter alia:

(i) A minimum coverage ratio of 102%;

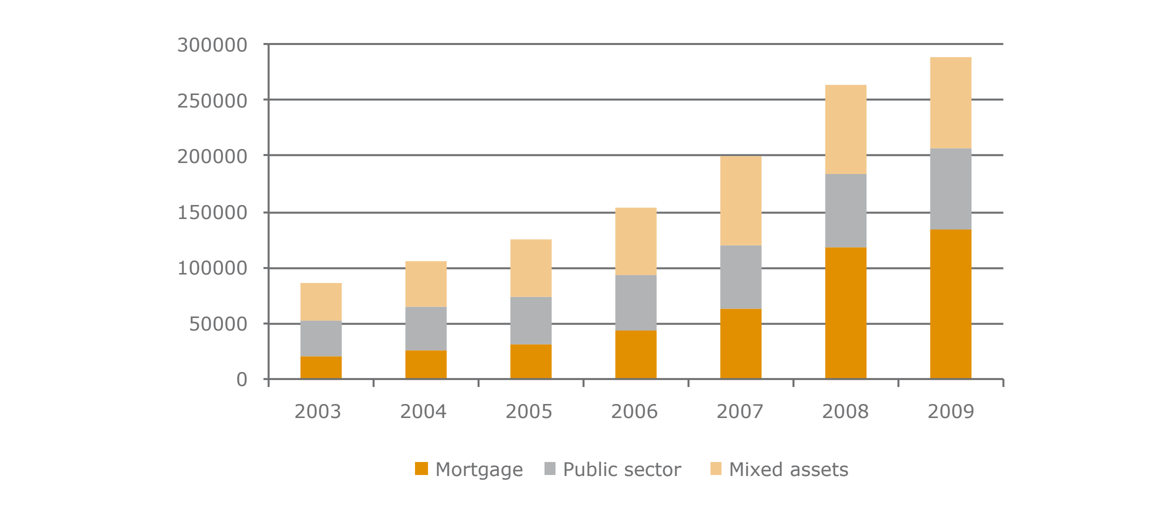
(ii) A minimum 180-day liquidity rule to ensure all issuers have at all times sufficient liquidity available to cover all liquidity needs for the next 180 days;

(iii) The possibility for issuers to auto-subscribe their own bonds and place them with the Banque de France (French central bank), in the event of an acute liquidity crisis.

On 10th June 2010, the Lower House of the French Parliament ("*Assemblée Nationale*") adopted the draft law on banking and financial regulation, which includes an amendment to Section 5 of Chapter V of France's Monetary and Financial Code (i.e. the section dealing with the creation of sociétés de financement de l'habitat and obligations à l'habitat). The financial reform package is expected to be tabled before the French Senate in September. Once the law has been passed, the regulatory framework will be implemented thereafter, with a view to entry into force by end-2010.

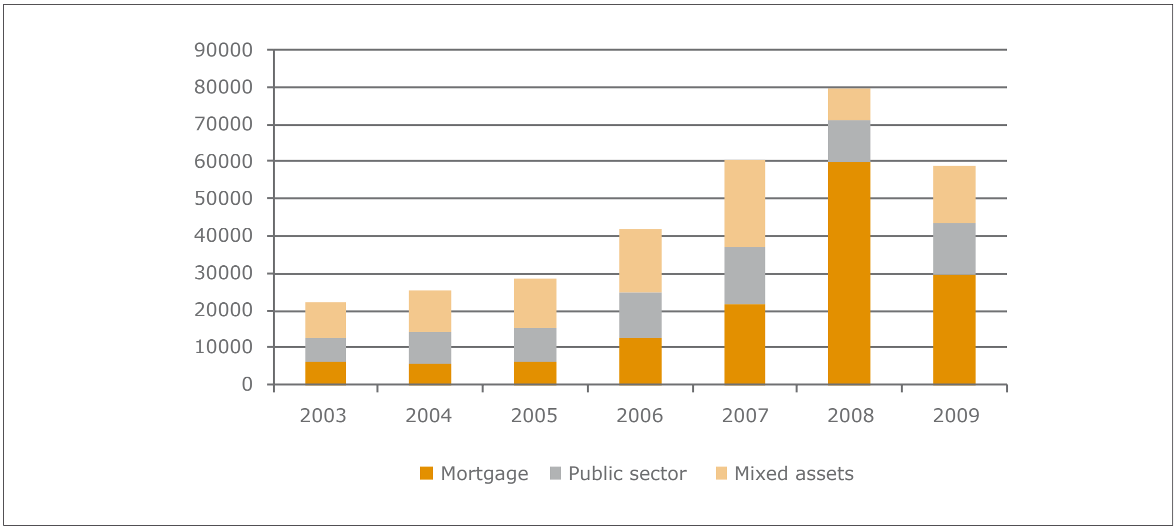
Once the law is passed, it is expected that certain French common-law based covered bonds will seek to operate as a Société de Financement de l'Habitat (SFH) provided compliance with the new legal framework.

> Figure 1: Covered Bonds Outstanding 2003-2009, €m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2009, €m



Source: EMF/ECBC

Note: For CFF, the mortgage and public sector assets are put in the same pool. As such, the cover pool acts as global coverage for privileged liabilities, i.e. no specific asset is linked to a specific bond issue. Therefore, CFF Covered Bonds are under the "mixed assets" category.

Issuers: There are currently 14 covered bond issuers in France: BNP Paribas Home Loan Covered Bonds; BNP Paribas Public Sector SCF; Cie Financement Fonciers (CFF); CIF EuroMortgage; Credit Agricole ; Credit Foncier et Communal d'Alsace et Lorraine (CFCAL); Credit Mutuel Arkea Covered Bonds; Credit Mutuel CIC Covered Bonds; CRH; DEXIA Municipal; General Electric SCF; Groupe Caisse d'Epargne; HSBC Covered Bonds (France); and Société Générale SCF.

3.8 GERMANY

By Wolfgang Kälberer and Otmar Stöcker
Association of German Pfandbrief Banks

I. FRAMEWORK

In Germany, the legal basis for Covered Bond issuance is the German Pfandbrief Act (PfandBG – Pfandbriefgesetz) dated 22nd of May 2005. It supersedes the general bankruptcy regulation (§§ 30-36 of the Pfandbrief Act).

In addition and for historic reasons, three further legal frameworks are existing in German law for the issue of Covered Bonds (DZ-Bank Covered Bonds, DSL Covered Bonds and Landwirtschaftliche Rentenbank Covered Bonds). The range of cover assets is slightly different compared to Pfandbriefe (they may include for instance a much higher portion of claims against credit institutions), but their insolvency regime is rather similar to the Pfandbrief rules. For more details, see 'Das Pfandbriefgesetz', Textsammlung und Materialien, edited by the Association of German Pfandbriefbanks, Frankfurt a.M. 2005, page 277-280.

On 26 March 2009 amendments of the PfandBG came in force introducing a new Pfandbrief category, the Aircraft Pfandbrief, and furthermore enhancing the attractiveness of Pfandbriefe for investors. Among many improvements, a further liquidity safeguard has been implemented by introducing a special liquidity buffer of 180 days. Since spring 2010, further amendments have been discussed in Parliament in order to strengthen the position of the special cover pool administrator; they probably will come in force in the end of 2010 (see below).

II. STRUCTURE OF THE ISSUER

Since 2005, the issuer of Pfandbriefe is no longer required to be a specialised bank. Instead, Pfandbrief issuers are allowed to exercise all activities of a credit institution, although a special licence for Pfandbrief issuance is required. The minimum requirements to obtain and keep the special licence are as follows:

> core capital of at least 25 million euros

> general banking licence which allows the issuer to carry out lending activities

> suitable risk management procedures and instruments

> business plan showing regular and sustainable issues as well as necessary organisational structure

Since the German outsourcing guidelines of the BaFin do not allow for the outsourcing of important and decision-making sections of the credit institution, the issuer is required to have its own employees. In addition, the PfandBG requires Pfandbrief banks to manage their own risk and take their own credit decisions on their own.

The issuer holds the cover assets on his balance sheet. A subsequent transfer of the cover assets to another legal entity does not take place. Given that a direct legal link between single cover assets and Pfandbriefe does not exist, all obligations relating to Pfandbriefe are obligations of the issuing bank as a whole, to be paid from all the cover assets of the issuer, recorded in the cover register. In the case of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved for the claims of the Pfandbrief holders. Even then, Pfandbrief holders still have a claim against the general insolvency estate.

III. COVER ASSETS

Cover assets are produced by mortgage lending, public sector lending, ship and aircraft financing activities. ABS/MBS are not eligible. A specific class of Covered Bonds corresponds to each of these cover asset classes: Hypothekenpfandbriefe, Öffentliche Pfandbriefe, Schiffspfandbriefe and Flugzeugpfandbriefe. The respective Pfandbrief must be fully secured by its specific cover asset class (§ 4 PfandBG). Detailed transparency requirements are regulated in § 28 PfandBG, enhanced by the amendments 2009 and 2010.

Up to 10% of the nominal volume of Pfandbriefe outstanding may consist of money claims against the European Central Bank, central banks in the European Union or against suitable credit institutions, which fulfil the requirements of credit quality step 1 according to Table 1 of the Annex VI of Directive 2006/48/EC.

The geographical scope of eligible mortgage assets is restricted to EU/EEA countries, to Switzerland, USA, Canada and Japan. Public sector loans to these countries are eligible for the cover of Öffentliche Pfandbriefe (§ 20 PfandBG). The total volume of loans granted in non-EU countries where it is not certain that the preferential right of the Pfandbrief creditors extends to the cover assets, may not exceed 10 % of the total volume of the cover loans (§§ 13 I 2, 20 I 2 PfandBG) and 20 % for ship and aircraft mortgages (§§ 22 V 2, 26b IV PfandBG).

Derivatives are eligible for cover pools under certain conditions. They must not exceed 12% of the cover assets when calculated on a net present value basis (§ 19 I 4. PfandBG).

IV. VALUATION AND LTV CRITERIA

Property valuation is regulated in § 16 PfandBG. This provision refers to the mortgage lending value (Beleihungswert) which is, in contrast to the market value, based on sustainable aspects of the property. Details about the valuation process and the qualifications of valuers are regulated in a specific statutory order on the mortgage lending value (Beleihungswertermittlungsverordnung, BelWertV), § 16 IV PfandBG.

Monitoring requirements result from the Capital Requirements Directive (once a year for commercial real estate and once every three years for residential real estate). In addition, § 27 BelWertV requires a review of the underlying assumptions when the market has declined substantially; a review of property values is also necessary when the loan has defaulted.

The BelWertV requires personal and organisational independence of the valuer (internal or external valuer)

For both commercial and residential property, the LTV limit is 60 % of the mortgage lending value of the property. This LTV is a relative limit, i.e. when the loan exceeds the 60% limit, the part of the loan up to 60% LTV remains eligible for the cover pool.

V. ASSET - LIABILITY MANAGEMENT

§ 4 PfandBG stipulates that the total volume of Pfandbriefe outstanding must be covered at all times by assets of at least the same amount. Thus, the nominal value of the cover assets must permanently be higher than the respective total value of the Pfandbriefe.

In addition, the Pfandbrief Act requires that Pfandbriefe are covered on a net present value basis even in the event of severe interest rate changes or currency fluctuations. The issuer has to provide an over-collateralisation of at least 2% after stress tests which have to be carried out weekly. Both the maturity of outstanding Pfandbriefe and the fixed-interest periods of the cover pool are disclosed on a quarterly basis. Details about the calculation are regulated in a special statutory order Net Present Value (Barwertverordnung).

Furthermore, each day Pfandbriefbanks have to calculate the maximum liquidity need within the next 180 days. This amount has to be covered by liquid assets (§ 4 Ia PfandBG).

Every quarter, the stress-tested NPV of outstanding Pfandbriefe, the cover pool and the overcollateralisation have to be published (§ 28 I PfandBG). The stress tests apply not only to interest rate risks but also to foreign exchange risks.

Cash flow mismatch between cover assets and covered bonds is furthermore reduced by the prepayment rules applicable to fixed interest rate mortgage loans. Prepayments of mortgages during fixed rate periods are only permitted in cases of 'legitimate interest' of the borrower or after a period of ten years. If the mortgage is prepaid, the borrower has to compensate the damage of the lender caused by the prepayment (§ 490 II German Civil Code).

VI. COVER POOL MONITOR AND BANKING SUPERVISION

A cover pool monitor (Treuhänder) supervises the cover pool. He is appointed by the BaFin and must possess the expertise and experience necessary to fulfil all duties. A qualification as a certified auditor suggests that the necessary expertise is provided.

The monitor has to ensure that the prescribed cover for the Pfandbriefe exists at all times and that the cover assets are recorded correctly in the cover register, §§ 7, 8 PfandBG. Without his approval, no assets may be removed from the cover pool. The BaFin has published a specific statutory order on details of the form and the contents of this cover register (Deckungsregisterverordnung – DeckRegV), § 5 III PfandBG.

In addition, BaFin carries out a special supervision on Pfandbrief banks. The former division on mortgage banks (Referat Hypothekenbanken) was transformed into the divison "Pfandbriefkompetenzcenter I - Grundsatzfragen", which is responsible for all fundamental issues regarding the PfandBG. In January 2006, the BaFin set up a special division for cover pool audits ("Pfandbriefkompetenzcenter II – Deckungsprüfungen").

Furthermore, the BaFin has to monitor the cover pool on average every two years (§ 3 PfandBG) and to this end it may appoint auditors with special knowledge in this area. Finally, BaFin carries out the general banking supervision on German Pfandbrief banks.

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

A cover register (Deckungsregister) permits the identification of the cover assets, § 5 PfandBG. The register records the cover assets being used to cover the Pfandbriefe as well as claims under derivatives (§ 5 I 1 PfandBG).

The legal effect of registration is that in the case of insolvency of the issuer, the assets which form part of the cover pool can be identified: All values contained in the register would not be part of the insolvency estate.

While the bank carries out the daily administration of the cover register, it is the cover pool monitor who supervises the required cover und registration in the cover register, § 8 I, II PfandBG. Copies of the cover register shall be transmitted to the supervisory authority on a regular basis.

Asset segregation

The cover pool is a part of the general estate of the bank as long as the issuer is solvent. If insolvency proceedings are launched, by operation of law, the assets recorded in the cover registers are excluded from the insolvency estate (§ 30 I 1 PfandBG). Those assets will not be affected by the launching of the insolvency proceedings (§ 30 I 2 2. HS PfandBG).

After the launching of the insolvency proceedings, a special cover pool administrator (Sachwalter) carries out the administration of the cover assets (§ 30 II 1 PfandBG). Through the appointment of the cover pool administrator by the court, on proposal of the BaFin, the right to manage and dispose of the recorded assets will be transferred to him automatically by law (§ 30 II 2 PfandBG). Regarding cover assets and timely payment of Pfandbriefe, the cover pool administrator represents the Pfandbriefbank (§ 30 II 5, 6 PfandBG). He is allowed to use premises and staff of the Pfandbriefbank (§31 VIII PfandBG).

The cover pool administrator may even be appointed before the insolvency proceedings have been launched (§ 30 V PfandBG).

Impact of insolvency proceedings on Covered Bonds and derivatives

Covered Bonds do not automatically accelerate when the issuing institution is insolvent, but will be repaid at the time of their contractual maturity. The same applies to derivatives which are registered in the cover register and form part of the cover pool. Accordingly, the German master agreements for cover derivatives stipulate that the bankruptcy of the Pfandbrief issuer does not signify a termination event. Article 13 N° 6 DeckregV stipulates that the collateral provided by the derivative counterpart or the Pfandbrief bank has to be registered in the cover register. The consequence of such registration is that the collateral belongs to the separate legal estate.

Preferential treatment of Covered Bond holders

Covered Bond holders enjoy preferential treatment as the law stipulates the separation of the cover assets on the one hand and the insolvency estate on the other, § 30 I PfandBG.

The satisfaction of the Pfandbrief creditors is not limited to the cover assets. On the contrary, these creditors also participate in the insolvency proceedings with respect to the Pfandbrief bank's remaining assets.

Only in the case of over-indebtedness or insolvency of the cover assets, the BaFin may apply for a special insolvency procedure relating to the cover pool and Covered Bonds (§ 30 VI PfandBG). Insolvency of the cover pool is the only reason, which might trigger acceleration of Pfandbriefe.

As long as the cover pool is solvent, a moratorium on the insolvency estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of Covered Bond holders.

Access to liquidity in case of insolvency

Through the appointment of the cover pool administrator, the right to manage and dispose of the recorded assets is transferred to him by law (§ 30 II 2 PfandBG). Thus, the cover pool administrator has first access to the cover assets and collects the cash flows according to their contractual maturity (§ 30 III 2 PfandBG).

No explicit regulation exists with respect to the insolvency remoteness of voluntary overcollateralisation (OC). However, the insolvency administrator may only demand that the overcollateralisation be surrendered to the insolvency estate if those amounts will obviously not be necessary as cover for the respective Pfandbrief category (§ 30 IV 1 PfandBG). The burden of proof that OC will never be necessary for the timely payment of the Pfandbriefe, lays with the insolvency administrator.

The cover pool administrator is entitled to contract loans in order to obtain liquidity. According to § 30 II, 5 PfandBG, the cover pool administrator may carry out legal transactions with regard to the cover pools in so far as this is necessary for an orderly settlement of the cover pools in the interest of the full and timely satisfaction of the Pfandbrief creditors.

Pfandbriefbank with limited business activities

The amendment of the PfandBG 2010 is focusing on the legal nature of cover pools in the event of a Pfandbrief bank's insolvency and on the access of a cover pool administrator to liquid funds during difficult times. A cover pool will be given the status of a non-insolvent part of the bank of the insolvent Pfandbrief bank. Thus, the cover pool administrator could act as head of a bank in respect of transactions with the Deutsche Bundesbank; he would also be entitled to issue Pfandbriefe.

More precisely, § 2 IV PfandBG stipulates that the banking license will be maintained with respect to the cover pools and the liabilities covered there from until the Pfandbrief liabilities have been fulfilled in their entirety and on time.

A revised version of § 30 PfandBG addressing the ring-fencing of the cover assets from the insolvency estate confirms this new approach by introducing the new heading 'segregation principle' and by referring to the cover assets as 'insolvency-free estates'. Consistently, the amended PfandBG incorporates the term 'Pfandbrief bank with limited business activities'.

Thus, the amendments ensure that the cover pool administrator acts on behalf of a solvent Pfandbrief bank that is in possession of a license to engage in banking business in general and in Pfandbrief business more specifically, even if the bank itself is insolvent and the general banking license withdrawn. Hence, the Pfandbrief bank with limited business activities is treated as a solvent bank in order to comply with the eligibility criterion 'counterparty' for central bank open market operations 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.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

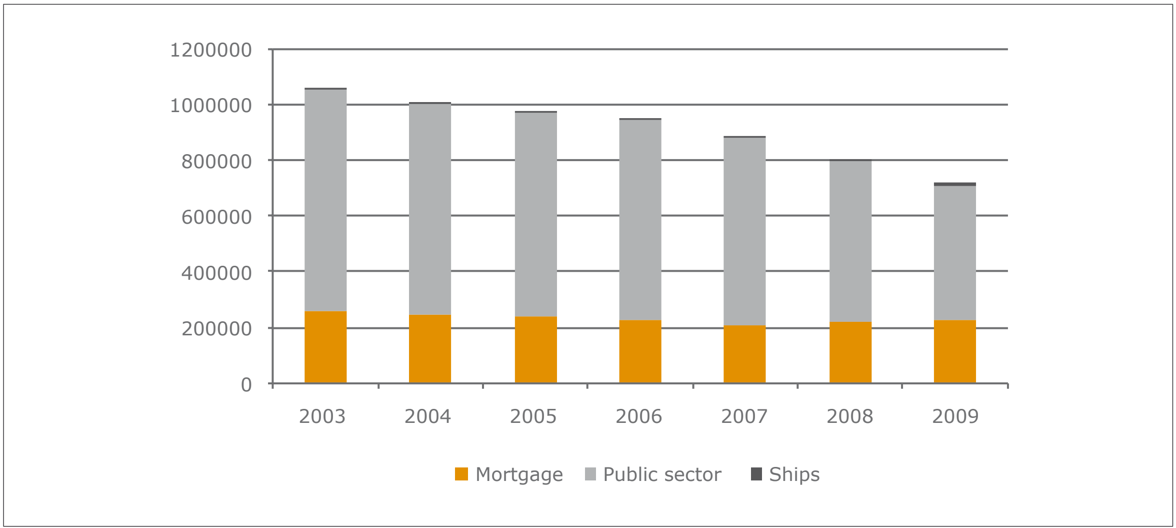
The risk weighting of Covered Bonds (German Pfandbriefe and foreign Covered Bonds) is regulated by Article 20a Kreditwesengesetz (KWG) and the Solvabilitätsverordnung (SolvV), transposing the Capital Requirements Directive into German law.

German Pfandbriefe comply with the requirements of Art. 22 par. 4 UCITS Directive as well as with those of the CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f). Therefore, they enjoy a 10% risk weighting. Foreign Covered Bonds enjoy a 10% risk weighting in Germany, provided that they comply with the requirements of § 20a KWG.

Derivatives which are part of the cover pool are now 10% risk weighted, granting the derivative partners the same risk weighting as Pfandbriefe (§ 25 VIII SolvV).

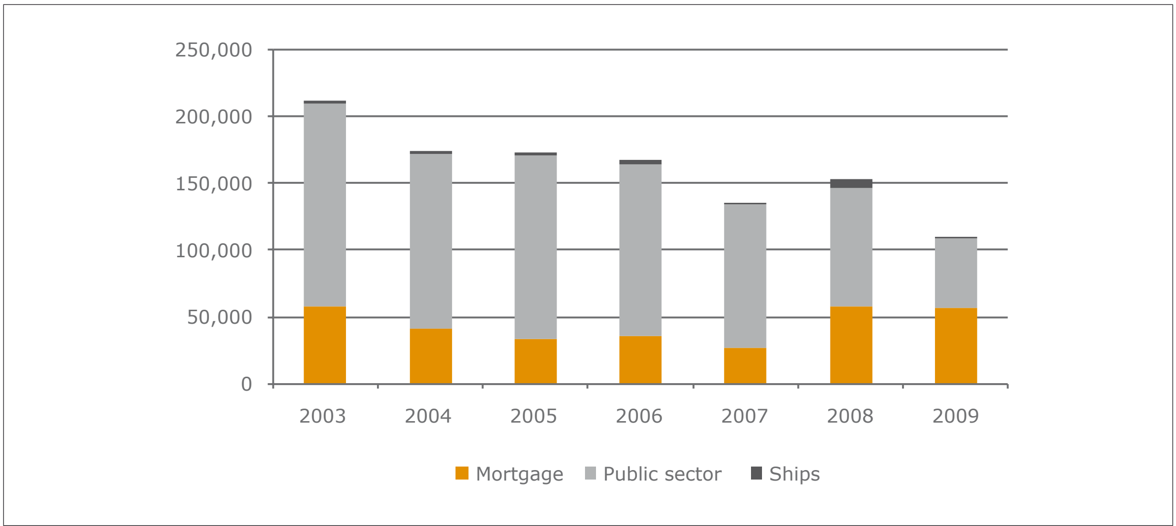
Finally, German investment legislation allows investment funds to invest up to 25% of the fund's assets in Pfandbriefe and furthermore in Covered Bonds issued by credit institutions complying with the requirements of Art. 22 par. 4 UCITS Directive (Article 60 par. 2 German Investment Act).

> Figure 1: Covered Bonds Outstanding 2003-2009, €m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2009, €m



Source: EMF/ECBC

Issuers: There are currently about 70 Pfandbrief banks in Germany, including banks from all three pillars of the German banking industry (private banks, public banks and co-operative banks). They include 18 former mortgage banks, 10 Landesbanks and circa 30 savings banks. Also, an increasing number of private universal banks became Pfandbrief banks within the last years.

3.9 GREECE

By Alexander Metallinos, Karatzas & Partners Law Firm

I. FRAMEWORK

In Greece, the primary legal basis for Covered Bond issuance is article 91 of Law 3601/2007 "On the Undertaking and Exercise of Activities by Credit Institutions, Sufficiency of Own Funds of Credit Institutions and Investment Services Undertakings and Other Provisions", which entered into force on 1 August 2007 (the "Primary Legislation"). The Primary Legislation supersedes general provisions of law contained in the Civil Code, the Code of Civil Procedure and the Bankruptcy Code. By way of implementation of the Primary Legislation and pursuant to an authorization provided by the latter, the Governor of the Bank of Greece has issued Act nr. 2598/2.11.2007 (the "Secondary Legislation"). Finally the legislative framework in Greece is supplemented by Law 3156/2003 "On Bond Loans, Securitization of Claims and of Claims from Real Estate" (the "Bond Loan and Securitization Law"), to the extent that the Primary Legislation cross-refers to it.

II. DIRECT AND INDIRECT ISSUANCE OF COVERED BONDS

The Greek legislative framework permits the issuance of Covered Bonds in two ways, either directly by a credit institution, or indirectly by a subsidiary of a credit institution. In the direct issuance structure the Covered Bonds are issued by a credit institution and the segregation of the cover pool is achieved through a statutory pledge over the cover pool assets. 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. While 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, there are still vast amounts of notes issued under the old programmes, rendering the direct issuance of Covered Bonds by most Greek banks impractical, until such notes have been repaid.

III. PREREQUISITES FOR THE ISSUANCE OF COVERED BONDS

According to the Primary Legislation, Covered Bonds may be issued by credit institutions having Greece as home member state. However, in case of issuance of Covered Bonds by a credit institution having as home state another member state of the European Economic Area (EEA) and provided that they are characterized as covered bonds in accordance with the law of such member state, the provisions of the Primary Legislation on the creation of a statutory pledge will apply in relation to claims governed by Greek law, as well as the tax exemptions which apply to Greek bonds. Therefore foreign banks established within the EEA having a significant loan portfolio in Greece may use the loans of such portfolio as part of the cover pool.

The Secondary Legislation sets additional prerequisites for the issuance of Covered Bonds. Specifically the credit institutions issuing Covered Bonds:

(a) must have certain minimum risk management and internal control requirements including suitable policies and procedures for the issuance of Covered Bonds, organizational requirements, IT infrastructure and a policy for the reduction and management of risks deriving from the issuance of Covered Bonds, such as interest rate risk, counterparty risk, operational risk, FX risk and liquidity risk; and

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

IV. COVER ASSETS

Cover assets are primarily residential mortgage loans, loans secured by a mortgage on commercial properties, loans secured by a mortgage on ships and loans to or guaranteed by state entities. Residential and commercial mortgage loans may only be included in the cover pool if the property subject to the mortgage is situated in Greece and hence is governed by Greek law. The loans may be secured by mortgage prenotations instead of full mortgages (as is the practice for cost reasons in Greece) provided the credit institution has adequate internal procedures to ensure the timely conversion of mortgage prenotations into mortgages. In addition openings to credit institutions and investment services undertakings may be included in the cover pool up to an aggregate limit of 15% of the nominal value of the outstanding covered bonds. Derivatives may also be included in the cover pool to the extent that they are used exclusively for the purpose of hedging the interest rate, FX or liquidity risk. To the extent that the counterparties to such derivatives are credit institutions and investment services undertakings (as opposed to state entities or central counterparties in organized markets), the net present value of derivatives included in the pool is included in the above 15% limit. Finally, the cover assets may be substituted by certain tradable assets but only up to the amount by which the aggregate nominal value of the cover assets including accrued interest exceeds the nominal value of the outstanding covered bonds including accrued interest.

V. VALUATION AND LTV CRITERIA

Loans secured by residential mortgages are required to have a loan to value (LTV) ratio of 80%, whereas loans secured by mortgages over commercial properties and ships are required to have an LTV ratio of 60%. Loans with a higher LTV ratio may be included in the cover pool, but they are taken into account for the calculation of the statutory tests described below only up to the amount indicated by the LTV ratio. Thus by way of example a loan of 900.000 Euros secured through a residential mortgage over a property valued at 1.000.000 Euros may be included in the cover pool but will be deemed for the purposes of the calculation of the statutory tests to be equal to 800.000 Euros.

The valuation of properties must be performed by an independent valuer at or below the market value and must be repeated every year in relation to commercial properties and every three years in relation to residential properties.

VI. STATUTORY TESTS

The Secondary Legislation provides for the following statutory tests:

(a) The nominal value of the Covered Bonds including accrued interest may not exceed at any point in time 95% of the nominal value of the cover assets including accrued interest.

(b) The net present value of obligations to holders of Covered Bonds and other creditors secured by the cover pool may not exceed the net present value of the cover assets including the derivatives used for hedging. This test must be met even under the hypothesis of a parallel movement of the yield curves by 200 basis points.

(c) The amount of interest payable to holders of Covered Bonds for the next 12 months must not exceed the amount of interest expected to be received from the cover assets over the same period. For the assessment of the fulfilment of this test derivatives entered into for hedging purposes are taken into account.

Tests (b) and (c) are performed on a quarterly basis. In case any of the tests is not met, the credit institution is obliged to immediately take the necessary measures to remedy the situation.

The results of the tests (a) to (c) above and the procedures used to monitor the compliance with such tests are audited on a yearly basis by an auditor independent of the statutory auditors of the credit institution.

VII. PROTECTION OF DEPOSITORS

In order to not jeopardize the interests of depositors in case of insolvency of a credit institution due to the segregation (discussed below) of high quality assets in favour for the holders of Covered Bonds, the Secondary Legislation provides that, in case the cover assets exceed significantly the amount of 20% of the available assets of the credit institution on an unconsolidated basis, the Bank of Greece may impose additional capital adequacy requirements. For the purposes of this calculation available assets are considered to be all assets of the credit institution excluding (i) assets subject to securitization, (ii) assets subject to reverse repo agreements and (iii) assets encumbered in favour of third parties. In exercising its discretion to impose additional capital adequacy requirements the Bank of Greece will take into account qualitative considerations such as (i) any deterioration of the average quality of the remaining available assets after the issuance of covered bonds, (ii) the increase of the liquidity of the credit institution combined and any positive effects it may have on its credit rating and prospects and (iii) the results of additional stress tests.

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

In case of a direct issuance the cover assets are segregated from the remaining estate of the credit institution through a pledge constituted by operation of law (statutory pledge). In case of assets governed by a foreign law (which will typically include inter alia claims from derivative contracts) a security interest must be created in accordance with such foreign law. The statutory pledge and the foreign law security interest secure claims of the holders of Covered Bonds and may also secure (in accordance with the terms of the Covered Bonds) other claims connected with the issuance of the Covered Bonds, such as derivative contracts used for hedging purposes. The statutory pledge and any foreign law security interest is held by a trustee for the account of the secured parties.

The claims constituting cover assets are identified by being listed in a document signed by the issuer and the trustee. A summary of such document is registered in the land registry of the seat of the issuer. Claims may be substituted and additional ones may be added to the cover pool through the same procedure.

The Primary Legislation creates an absolute priority of holders of Covered Bonds and other secured parties over the cover pool. The statutory pledge supersedes the general privileges in favour of certain preferred claims (such as claims of employees, the Greek state and social security organization) provided for by the Code of Civil Procedure. Furthermore upon registration of the summary of the document listing the claims included in the cover pool, the issuance of the Covered Bonds, the establishment of the statutory pledge and the foreign law security interest and the entering into of all contracts connected with the issuance of the covered bonds are not affected by the commencement of any insolvency proceedings against the issuer.

In case of an indirect issuance 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.

X. 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. However, this legislative aim was put in question due to the introduction shortly before the Primary Legislation of the new Bankruptcy Code. Article 26 of the latter provides that creditors secured by a pledge may not apply to rank as unsecured creditors in the liquidation of the remaining assets of an insolvent creditor, unless they waive their rights under the pledge. While it is arguable that this provision is unconstitutional (because it imposes disproportionate conditions on the exercise of the right to apply for ranking in the proceeds of the liquidation of the remaining bankruptcy estate, which is part of the constitutionally protected right to judicial protection) and hence unenforceable and that in any case it does not apply to the statutory pledge, the existence of article 26 rendered it impossible to issue unqualified legal opinions on directly issued covered bonds. In order to solve this problem a draft law has been prepared to specifically exclude Covered Bonds from this provision and is expected to be submitted to Parliament soon.

It should be noted that article 26 does not affect indirectly issued Covered Bonds, because the holders of Covered Bonds in that case do not have a pledge over assets belonging to the credit institution and therefore have the right to appear as unsecured and unsubordinated creditors in the liquidation of the estate of the credit institution.

XI. 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. In such a case a servicer is appointed who collects the proceeds of the cover assets for the purpose of servicing the Covered Bonds. 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.

XII. ACCESS TO LIQUIDITY IN CASE OF INSOLVENCY

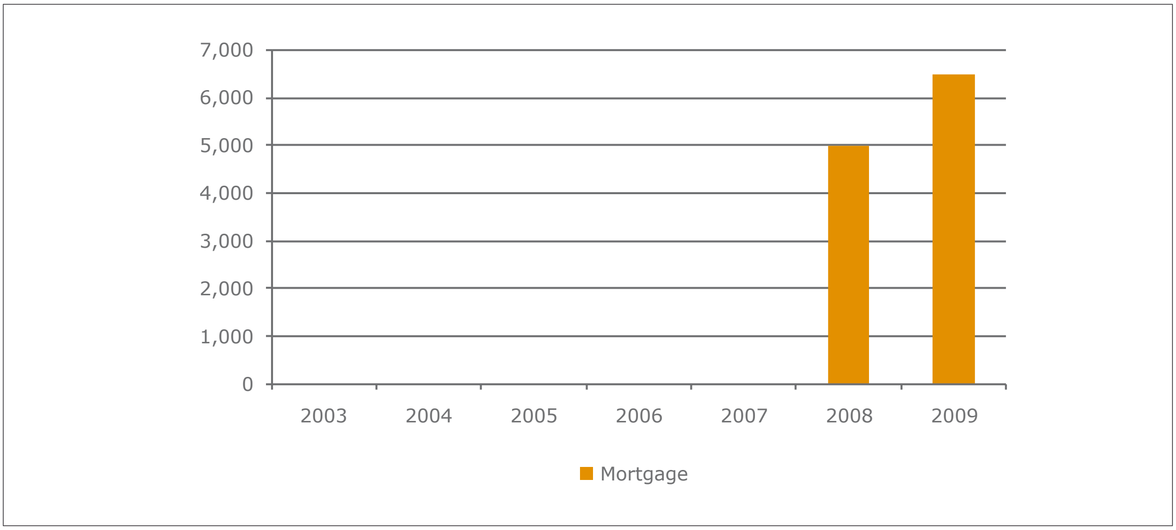
According to article 1254 of the Civil Code, the pledgee of a claim has the right upon default to either collect it on maturity, or to assign it to himself at the face value, but not to dispose of it in another way. Therefore, as a matter of the law of pledge, the trustee for the Covered Bondholders cannot cause the sale of part of the pool to provide liquidity in case of insolvency of the credit institution. However, as a contractual matter and provided the relevant contracts are subject to a foreign law, the issuer may agree to consent to the sale of part of the cover assets to provide liquidity. In a direct issuance, however, such a contractual clause would not be enforceable against the bankruptcy representative (syndikos) of the credit institution and for this purpose the draft law intended to amend the primary legislation specifically provides for an exemption from article 1254. Indirect issuances with special purpose entities established outside of Greece can be structured in a way that ensures the effectiveness of such contractual arrangements.

XIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk weighting of Covered Bonds (both Greek and foreign) is regulated by Part B par. 8 2588/20.8.2007, transposing part of the Capital Requirements Directive into Greek law. According to this bonds falling within the provisions of art. 22 par. 4 of the UCITS Directive are considered to constitute Covered Bonds, provided that the cover pool consists of the assets enumerated in the Capital Requirements Directive. By way of exception, bonds issued before the 31st December 2007 and falling within the provisions of art. 22 par. 4 of the UCITS Directive are considered as Covered Bonds, even if the cover assets do not comply with the Capital Requirements Directive. Covered Bonds have a risk weighting of 10%, if openings to the issuing credit institution have a risk weighting of 20%, and a risk weighting of 20%, if openings to the issuing credit institution have a risk weighting of 50%.

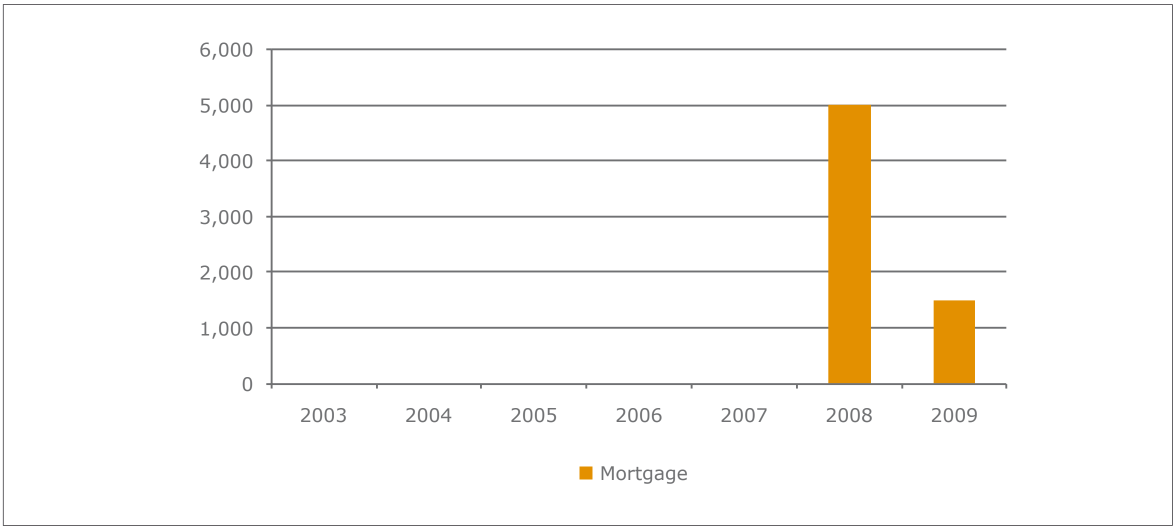
Directly issued Greek Covered Bonds comply with both the UCITS Directive and the Capital Requirements Directive and therefore have the reduced risk weighting mentioned above in Greece and should also have it in other EU member states. In relation to indirectly issued Covered Bonds it must be noted that they do not fall within the letter of art. 22 par. 4 of the UCITS Directive, because they are not issued by a credit institution, but according to a purposive interpretation of such directive they should be deemed to fall within its scope, as they offer protection to the holders of the Covered Bonds, which is fully equivalent to that of holders of Covered Bonds issued directly by credit institutions.

> Figure 1: Covered Bonds Outstanding 2003-2009, €m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2009, €m



Source: EMF/ECBC

Issuers: There are three issuers in Greece: Alpha Covered Bond Plc, Marfin Egnatia Bank S.A. and National Bank of Greece.

3.10 HUNGARY

By András Gábor Botos, Association of Hungarian Mortgage Banks

I. LEGAL FRAMEWORK

Act No. XXX of 1997 on Mortgage Banks and Mortgage Bonds (Mortgage Bank Act) contains the specific rules applicable to mortgage banks and mortgage bonds. Act No. CXII of 1996 on Credit Institutions and Financial Enterprises is applicable generally to the establishment, operation, supervision and liquidation of mortgage banks, unless otherwise provided by the Mortgage Bank Act.

II. STRUCTURE OF THE ISSUER

Mortgage banks are specialized credit institutions in Hungary whose business activity is restricted in principle to mortgage lending and auxiliary financial services: mortgage banks grant financial loans secured by mortgages – including independent mortgage liens – on real estate property located on the territory of the Republic of Hungary and other EEA countries. Funds will be raised by way of issuing mortgage bonds. In the Hungarian banking sector only mortgage banks are entitled to issue mortgage bonds ("*jelzáloglevél*"). Cover assets will be held on the balance sheet of the mortgage bank. All the mortgage bonds of a single mortgage bank are covered by the same coverage pool which is only open to changes with the prior permission of the coverage supervisor, acting in the interest of mortgage bond holders.

III. COVER ASSETS

The Mortgage Bank Act provides that mortgage banks shall always possess cover surpassing the principal of outstanding mortgage bonds and the interest thereon both on a nominal basis and based on present value calculation. Decree No. 40/2005. (XII. 9.) of the Minister of Finance contains the detailed provisions on the present value calculation of cover assets and the methodology of stress tests to be published on a regular basis. Furthermore, mortgage banks shall prepare a manual of keeping the register of cover assets ("*fedezet-nyilvántartás*"), which also needs the approval of the Hungarian Financial Supervisory Authority (HFSA) and the coverage supervisor.

Loans secured by a residential real estate can be taken in cover up to 70 per cent of the mortgage lending value of the property. In case of loans secured by commercial real estate the limit is 60 per cent.

Mortgage bonds are covered by loans secured by mortgages ("*jelzálogjog*"), independent mortgage liens ("*önálló zálogjog*") or by joint and several surety assumed by the Hungarian State ("*állami készfizető kezességvállalás*"). Supplementary coverage may exclusively consist of liquid assets listed in the Mortgage Bank Act and may not exceed 20 per cent of the coverage. Pursuant to the Mortgage Bank Act, cover assets must be entered into the register of cover. The availability and quality of cover assets is permanently monitored by the coverage supervisor, reports on availability and quality of cover assets are disclosed on a daily basis.

According to Section 14 (5) of the Mortgage Bank Act, in case mortgage bonds and their coverage are not denominated in the same currency, the mortgage bank is obligated to hedge the currency exchange risk by entering into derivative transactions. Section 3 (10) of the Mortgage Bank Act provides that mortgage banks are entitled to conclude such transactions exclusively for hedging purposes, i.e. risk management and liquidity. The Mortgage Bank Act entitles mortgage banks to include derivatives in the ordinary coverage as well.

IV. VALUATION AND LTV CRITERIA

The rules of calculation of the mortgage lending value ("*hitelbiztosítéki érték*") are included in the Decree of the Minister of Finance No. 25/1997. on the Calculation Methods of the Mortgage Lending Value of Real Estate not Qualifying as Agricultural Land and the Decree of the Minister of Agriculture No. 54/1997 on the Calculation Methods of the Mortgage Lending Value of Real Estate Qualifying as Agricultural Land. Both decrees prescribe the use of comparative methods, and prescribe the application of the principle of carefulness in the valuation process. Furthermore, they also determine the validity of the valuation report.

Mortgage banks may also provide appraisal services to determine the market value and the mortgage lending value of real properties.

Mortgage lending value calculation provisions refer to the sustainable aspects of the property. The mortgage bank's internal regulation for determining mortgage lending value is based on methodological principles defined in the above decrees. Such internal regulations are also subject to the former approval of the HFSA.

V. ASSET - LIABILITY MANAGEMENT

As indicated above, the Mortgage Bank Act provides that mortgage banks shall always possess cover surpassing the principal of outstanding mortgage bonds and the interest thereon. Mortgage banks shall comply with the above requirements as follows:

> The aggregate amount of the outstanding principal claims considered as coverage, reduced by the amount of any value adjustments, shall exceed 100 per cent of the amount of the nominal value of the outstanding Mortgage Bonds; and

> The aggregate amount of interest accrued on the outstanding principal claims considered as coverage, reduced by the amount of any value adjustments, shall exceed 100 per cent of the amount of interest accrued on the nominal value of the outstanding mortgage bonds (Section 14 (2) of the Mortgage Bank Act).

Mortgage banks shall publish the amount of the nominal value and the accrued interest of the outstanding mortgage bonds as well as the value of the coverage assets in a national daily newspaper and in the Exchange Journal as of the last day of each quarter, before the last day of the next month. Such figures need to be certified by the coverage supervisor and disclosed to the HFSA as well.

Under Section 14 (4) of the Mortgage Bank Act the amount of coverage for mortgage bonds shall always be calculated and published at their present value as well.

Cash flow mismatch between cover assets and cover bonds is furthermore reduced by the prepayment rules of the Mortgage Bank Act. Pursuant to Section 7, mortgage banks may claim their costs emerging in connection with the prepayment.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The coverage supervisor (cover pool monitor) shall be appointed by the mortgage bank and approved by the HFSA. According to Section 16 of the Mortgage Bank Act, a company auditor or an auditor may be appointed; however, the coverage supervisor may not be identical with the auditor of the mortgage bank.

As a matter of fact, Hungarian mortgage banks have had one of the "big four" audit companies as coverage supervisor from the beginning of their operations. The coverage supervisor is responsible for monitoring and certifying, on a permanent basis:

> the existence of eligible security; and

> the registration of the eligible security in the coverage register. In accordance with Section 11 (2) (n) of the Mortgage Bank Act, a certificate from the coverage supervisor shall be attached to each mortgage bond regarding the existence of the coverage.

According to section 16 (7) of the Mortgage Bank Act, a coverage supervisor may be appointed for a fixed period of time, not exceeding five years, however, he may be re-appointed following the termination of the period of his appointment. Although the contract of appointment concluded between the mortgage bank and the coverage supervisor is governed by civil law, it may not be lawfully terminated without the approval of the HFSA. Within the scope of his coverage supervision activities, the coverage supervisor may not be instructed by the mortgage bank.

The HFSA is responsible for verifying the compliance of the credit institutions, including the mortgage banks, with the Credit Institutions Act and other acts e.g. the Mortgage Banks Act, and applicable banking regulations. The HFSA is entitled to impose various sanctions on credit institutions, including warnings of non-compliance, withdrawing licences and imposing fines on credit institutions and their management. Section 22 and 23 of the Mortgage Bank Act provides that the Hungarian Financial Supervisory Authority shall exercise special supervision over mortgage banks in addition to the provisions of the Credit Institutions Act and the provisions of the Capital Markets Act. Within the framework of such special supervision, HFSA shall draw up an analysis schedule and conduct on site audits of mortgage banks according to the analysis schedule it compiles.

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

The sophisticated regulation effective since 1 January, 2007 should provide for the timely satisfaction of principal and interest claims of bondholders and derivative partners in case of a possible insolvency situation. The cover pool administrator will only safeguard the interests of bondholders and derivative partners and will also have an access to the part of assets not qualifying as coverage and those not recorded in the cover register. The transfer of the portfolio or parts of it to another mortgage bank may grant for liquidity, however, the transfer of the portfolio or parts of it requires the prior written consent of the HFSA in order to avoid "cherry picking".

As a general rule, Section 20/A (4) of the Mortgage Bank Act declares that the cover pool administrator is obliged to maintain the liquidity of the pool on a constant basis, allowing transfer of the pool or parts of it to another mortgage bank and to enter into derivative transactions. Within two years after the commencement of the liquidation procedure, both the cover pool administrator and the bondholders may request the court to complete the cover from the general insolvency estate. The cover pool administrator shall be entitled to receive remuneration for his work and refund of appropriate expenses. Although holders of the mortgage bonds, derivative partners or the coverage supervisor may inform HFSA or the only competent Metropolitan Court Budapest on issuer default, after proving all relevant circumstances, it is only the HFSA who is entitled to initiate an insolvency proceeding against the mortgage bank.

Hungarian legal provisions also provide for a wide-range of measurements, including extraordinary measurements, to be taken by the HFSA prior to any insolvency situation.

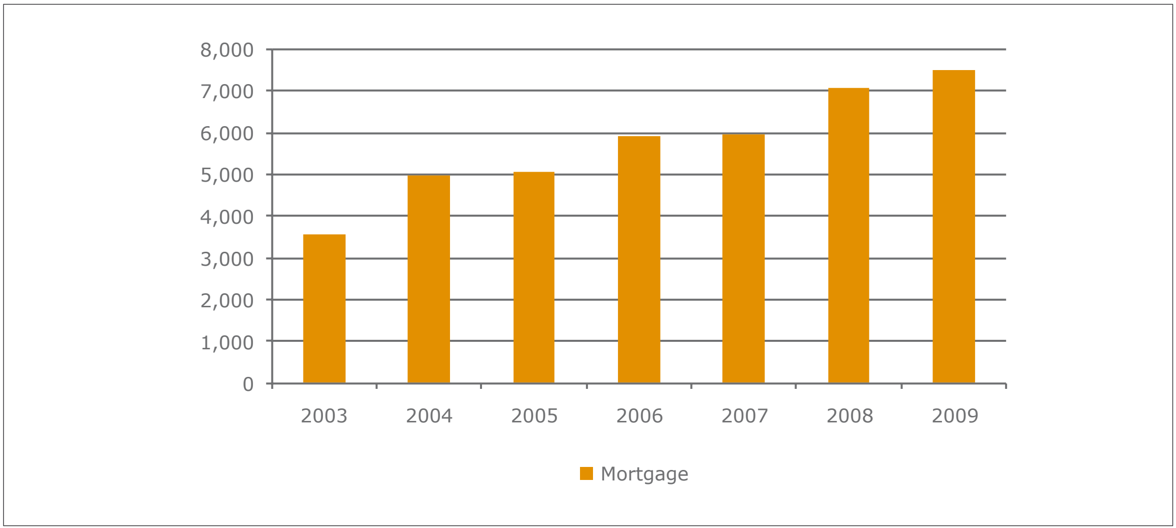
For example, the HFSA is entitled to delegate a Supervisory Commissioner to the mortgage bank. This extraordinary measurement may be taken by the HFSA prior to the commencement of any insolvency procedure – in accordance with Section 157 (1) of the Credit Institution Act. In this case both the rights of the owners of the mortgage bank and the rights of the management of the mortgage bank will be restricted in order to guarantee the satisfaction of the claims of the mortgage bank's creditors, e. g. bondholders' and derivative partners' claims.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Hungarian mortgage bonds comply with the requirements of Art. 22 par. 4 of the UCITS Directive as well as with those of the CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f) as have been reported to the Commission in accordance with Article 63 of the Directive 2000/12/EC and published on its website.

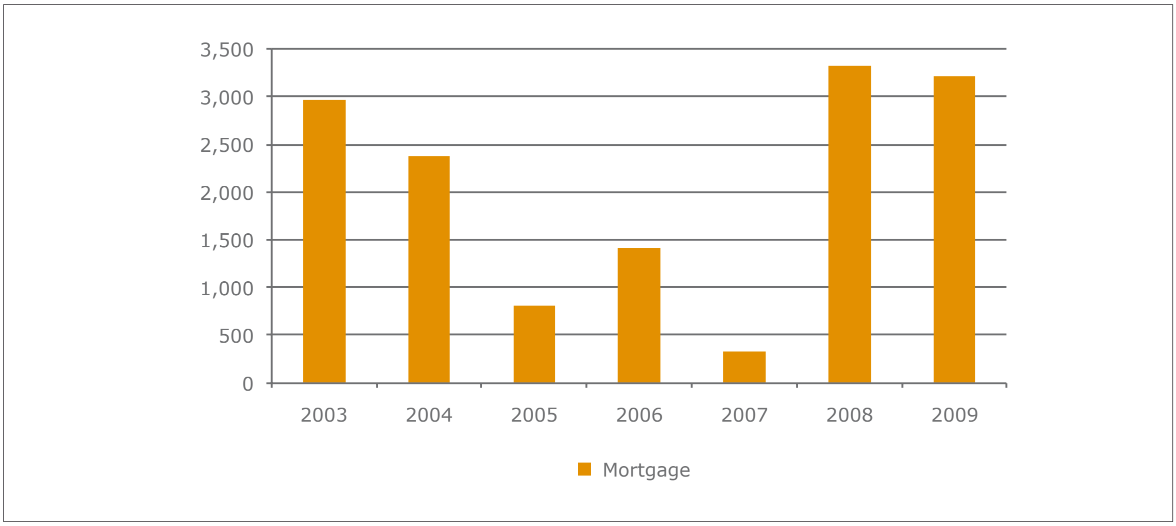
Hungarian covered bonds issued in euro zone countries qualify as ECB eligible; furthermore, in February 2008 one of the Hungarian mortgage banks successfully closed its debut transaction in the "Jumbo" covered bond market.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2009, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2009, €M



Source: EMF/ECBC

Issuers: There are three mortgage banks issuing mortgage bonds on the Hungarian market: OTP Jelzálogbank Zrt. (OTP Mortgage Bank Ltd.), FHB Jelzálogbank Nyrt. (FHB Mortgage Bank Ltd.) and UniCredit Jelzálogbank Zrt. (UniCredit Mortgage Bank Ltd).

3.11 IRELAND

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

I. LEGAL FRAMEWORK AND STRUCTURE OF THE ISSUER

Irish covered bonds benefit from the protection of specialist covered bond legislation under the Irish Asset Covered Securities Act, 2001 and the Asset Covered Securities (Amendment) Act 2007 (the "**ACS Act**") and the regulations thereunder. The ACS Act follows the specialist banking principle by requiring an Irish asset covered securities issuer (an "**ACS Issuer**") to have, or to obtain, a banking licence and to limit the scope of its banking activities. As a bank an ACS Issuer is regulated by the Irish Financial Regulator. Furthermore each ACS Issuer must be registered as a designated credit institution to issue asset covered securities ("**ACS**") in accordance with the ACS Act. Each ACS Issuer will be registered as one or more of the following: a designated public credit institution (authorised to issue public credit covered securities); a designated mortgage credit institution (authorised to issue mortgage credit covered securities) or a designated commercial mortgage credit institution (authorised to issue commercial mortgage credit covered securities).

The ACS Issuer holds the assets backing the ACS on its balance sheet. The collection of either mortgage credit assets, commercial mortgage credit assets or public credit assets (the "**cover assets**") backing the issue of ACS (the "**cover pool**") is described as dynamic or open in the sense that the ACS Issuer may move cover assets in and out of the cover pool provided they do so in accordance with the controls and other terms and conditions set out in the ACS Act. One such control is that the ACS Issuer must maintain a register (a "**cover register**") of all ACS issued, all cover asset hedge contracts and the cover assets (including any substitution assets and any assets providing 'over-collateralisation') and any amendment to the cover register can only be effected with the approval of a cover-assets monitor (the "**CAM**") which is an independent professional third party.

Statutory Preference

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

Restriction on business activities

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

The ACS Act provides that an ACS Issuer may not carry on a business activity other than a permitted business activity as set out in the ACS Act. Under the ACS Act permitted business activities are restricted to dealing in and holding public credit, mortgage credit assets or commercial mortgage credit assets and limited classes of other assets, engaging in activities connected with the financing and refinancing of such assets, entering into certain hedging contracts, holding pool hedge collateral and engaging in other activities which are incidental or ancillary to the above activities. The ACS Act limits the scope of non-core ACS business that an ACS Issuer can undertake by restricting its dealing in or holding of financial assets that are not otherwise eligible for inclusion in the cover pool to 10% of the total of all the ACS Issuer's assets. There is also a similar 10% limit imposed on the volume of non cover pool eligible OECD assets that an ACS Issuer can acquire.

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

II. COVER ASSETS

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

For a designated public credit institution eligible public credit assets are financial obligations (including obligations given as a guarantor or surety, and may be indirect or contingent) in respect of money borrowed or raised (whether in the form of a security that represents other public credit that is securitised or not) where the person who has the obligation is any one of the following:

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

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

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

(d) Multilateral development banks or international organisations (which qualify for the purposes of the Capital Requirement Directive, also known as the Codified Banking Directive, "CRD").

Risk weighting and credit worthiness tests apply to the categories of cover assets outside the EEA countries to comply with the CRD Covered Bond eligibility requirements. This means that any Sovereign or Sub-sovereign entity within a Non-EEA country must have an independent credit rating of at least A-/A3 and any Sub-sovereign entity within a Non-EEA country must have, in addition, a risk weighting at least equal to that of a financial institution (i.e. 20% or lower). In addition the aggregate nominal value of any such assets included in the cover pool from Non-EEA countries with credit ratings below AA-/AA3 (but at least A-/A3) cannot exceed 20% of the total aggregate value of the cover pool.

Eligible assets for a designated mortgage credit institution include mortgage credit assets which are financial obligations in respect of money borrowed or raised that are secured by a mortgage, charge, or other security on residential or commercial property that is located in any of the EEA or Non-EEA countries described above. A mortgage credit institution is limited in the amount of mortgage credit assets secured on commercial property that it can include in a cover pool. Such commercial mortgage credit assets cannot exceed 10% of the total prudent value of all mortgage credit assets and substitution assets in the cover pool. A mortgage credit institution may also include securitised mortgage credit subject to certain credit quality criteria and limits as to percentage of the cover pool.

Furthermore a mortgage credit asset may not be included in a cover pool if a building related to that mortgage credit asset is being or is to be constructed until the building is ready for occupation as a commercial or residential property, or if it is non-performing.

Eligible assets for a designated commercial mortgage credit institution are financial obligations in respect of money borrowed or raised that are secured by a mortgage, charge, or other security on commercial property that is located in any of the EEA or Non-EEA countries described above.

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

III. COVER ASSET MONITOR AND BANKING SUPERVISION

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

There are strict eligibility requirements for a CAM. A CAM must be a body corporate or partnership, comprising personnel or partners who are members of a professional representative body. They must demonstrate to the Regulator that they are experienced and competent in (i) financial risk management techniques, (ii) regulatory compliance reporting and (iii) capital markets, derivatives, public credit business. The CAM must demonstrate that it has sufficient resources at its disposal, sufficient academic or professional qualifications and experience in the financial services industry to satisfy firstly the designated credit institution and secondly the Financial Regulator, that it is capable of fulfilling this role.

The CAM is responsible for monitoring the cover pool, the ACS Issuer's compliance with specific provisions of the ACS Act and to report breaches to the Financial Regulator. The CAM issues regular reports to the ACS Issuer (every 1-4 weeks) and submits a report on a quarterly basis to the Financial Regulator.

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

The Financial Regulator is responsible for supervising each ACS Issuer. The Financial Regulator may, with the consent of the Minister for Finance, revoke the registration of an ACS Issuer and/or suspend its business if an ACS Issuer breaches any provision of the ACS Act.

IV. VALUATION AND LTV CRITERIA

Mortgage ACS Issuers

For a mortgage ACS Issuer the maximum prudent LTV levels for mortgages in the cover pool are 75% for residential and 60% for commercial. Prudent LTV levels for loans in the cover pool can exceed the 75% threshold, however the balance of the loan above the 75% is disregarded for valuation purposes. The inclusion in the mortgage cover pool of mortgage credit assets secured on commercial property is restricted to 10% of the prudent market value of all mortgage credit assets and substitution assets included in the Pool at any time.

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

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

Commercial Mortgage ACS Issuers

For a commercial mortgage ACS Issuer the maximum prudent LTV levels for mortgages in the cover pool is 60%. Prudent LTV levels for loans in the cover pool can exceed the 60% threshold, however the balance of the loan above the 60% is not considered for eligibility purposes.

The prudent market valuation of a commercial property asset is its market value at the time of origination or, where relevant, the most recent independent valuation of the property asset, reduced to take account of any declines in the designated commercial property reference index since the valuation was carried out.

The market value of a commercial property asset must be reviewed by an independent valuer where the reference index falls by more than 7% in any 6 month period or where information indicates that the value of the property asset has declined materially relative to general market prices. For commercial mortgage loans greater than €3million, the valuation must be reviewed by an independent valuer at least every 3 years.

A commercial mortgage ACS Issuer is required to calculate the prudent market value of each property asset at the time of inclusion in the cover pool and at least once every 3 months thereafter.

V. ASSET-LIABILITY MANAGEMENT

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

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

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

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

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

Interest rate risk control: The net present value changes on the balance sheet of an ACS Issuer arising from (i) 100bps upward shift, (ii) 100bps downward shift and (iii) 100bps twist, in the yield curve, must not exceed 10% of the ACS Issuer's total own funds at any time.

Hedge contracts

Hedge contracts are used in the cover pool to minimise risks on interest rates, currency exchange rates, credit or other risks that may adversely affect the ACS Issuer's business activities that relate to an ACS or cover asset. All such hedge contracts are entered on the cover register. Hedge counterparties rank as preferred creditors, pari passu with the ACS holders, provided they are not in default of any of their financial obligations. Upon an ACS Issuer insolvency the hedge contract will remain in place subject to the terms of the underlying hedge contract. No collateral can be posted by an ACS Issuer to a hedge counterparty. Any collateral posted under a hedge contract by a hedge counterparty will be maintained on a separate register within the cover pool.

Over-collateralisation

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

Cover Asset Register

Each ACS Issuer must maintain a cover register including the details of the ACS in issue, the cover assets and substitution assets backing the ACS and any cover asset hedge contracts in existence. The cover register is important as a cover asset or a cover asset hedge contract cannot be described as such unless and until it is recorded on the register. Their registration is prima facie evidence of such assets and hedge contracts being in the cover pool entitling the ACS holders and hedge counterparties to benefit from the insolvency protection specified in the ACS Act. It further means that their removal from the pool can be achieved only with the permission of the CAM as entries or amendments to the cover register can only be made with the consent of the CAM or the Financial Regulator.

Impact of Insolvency Proceedings on ACS and Hedge Contracts

Upon insolvency of an ACS Issuer all ACS issued remain outstanding and all cover asset hedge contracts will continue to have effect, in both cases subject to the terms and conditions of the documents under which they were created.

Upon an ACS Issuer becoming insolvent the claims of ACS holders on the cover pool are protected by operation of law. Cover assets and hedge contracts that are included in a cover pool are not liable to interference by a bankruptcy custodian or similar person whether by attachment, sequestration or other form of seizure, or to set-off by any persons, that would otherwise be permitted by law so long as claims secured by the insolvency provisions of the ACS Act remain unsatisfied. ACS holders have recourse to cover assets ahead of all other non-preferred creditors regardless of whether the claims of such other creditors are preferred under any other enactment or any rule of law and whether those claims are secured or unsecured.

The Role of the Manager and Access to Liquidity in case of Insolvency

The ACS Act makes provision for the management of the cover pool upon an ACS Issuer insolvency through the services of the Irish National Treasury Management Agency ("NTMA"). If no suitable manager can be found by the Financial Regulator or the NTMA then the NTMA will attempt to locate an appropriate body corporate as a new parent entity for the ACS Issuer. Failing that the Financial Regulator will appoint the NTMA to act as a temporary manager until a suitable manager or new parent is found. Upon their appointment the manager will assume control of all the cover assets of the ACS Issuer and its ACS business. The manager shall manage the ACS business of the ACS Issuer in the commercial interests of the ACS holders and the hedge counterparties. The manager shall have such powers as may be divested to it by the Financial Regulator under its notice of appointment. It is possible for such manager to obtain a liquidity facility through the use of a hedge contract which would rank such facility provider pari passu with the bondholders and other hedge counterparties.

Preferential Treatment of ACS holders

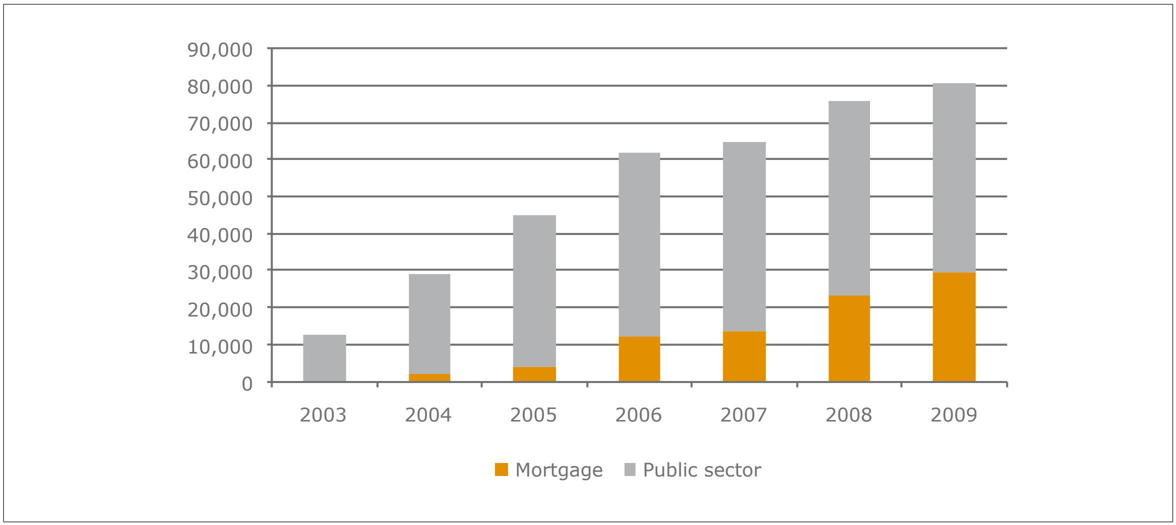
ACS holders are preferred creditors in relation to the cover assets (ranking after the CAM and the NTMA and equally with the hedge counterparties). Cover assets included in a cover pool do not form part of the assets of the ACS Issuer for the purposes of insolvency until such time as the creditors benefiting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

If the claims of the ACS holders (and other parties benefiting from insolvency protection including the hedge counterparties) are not fully satisfied from the proceeds of the disposal of the cover assets, such parties are, with respect to the unsatisfied part of their claims, to be regarded as unsecured creditors in the insolvency process.

VI. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

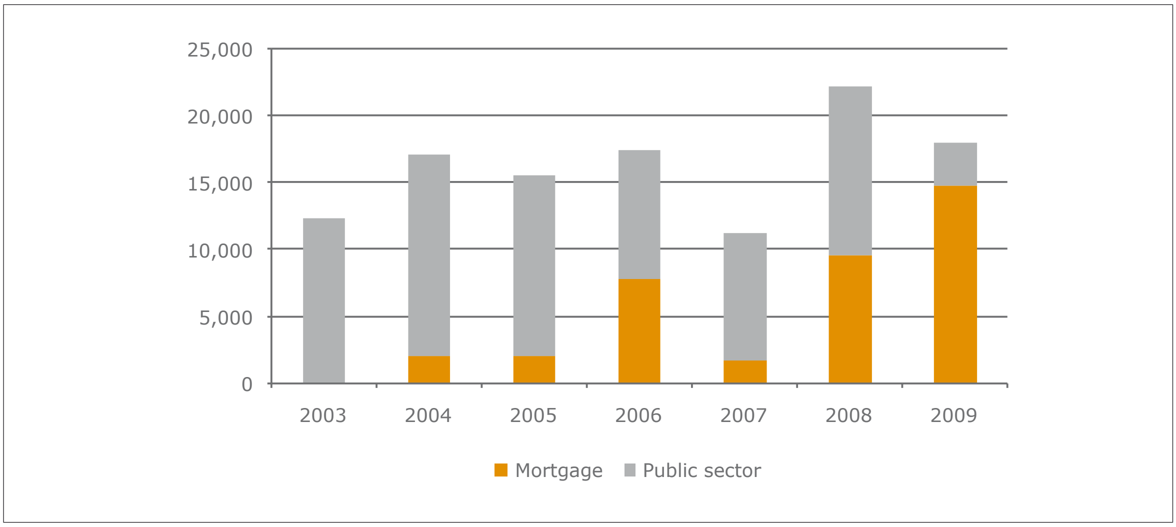
The ACS meet the requirements of UCITS 22(4) and currently benefit from a risk-weighting of 10% as applied by the Financial Regulator. The eligibility of cover assets set out in the ACS Act also match the criteria for the preferential risk weighting of covered bonds set out in the CRD.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2009, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2009, €M



Source: EMF/ECBC

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

3.12 ITALY

By Alfredo Varrati, Italian Bankers Association

I. FRAMEWORK

The Italian Legislator enacted a new regulation (Law no. 80/2005) in May 2005, by means of which two specific articles (article 7-*bis* and article 7-*ter*) were inserted into the existing Italian securitization law (Law no. 130/1999), providing for covered bonds.

The legislator decided to supplement Law no. 130/99 rather than adopt a separate and autonomous law/legal framework, in light of the markets' and international operators' positively assessing Italian securitization law. They found that the law introduced an established and reliable legal framework (e.g. from a standpoint of "bankruptcy remoteness").

Pursuant to paragraph 5 of the first of the two articles mentioned above, on 14 December 2006, the Ministry of Economy and Finance issued secondary rules in relation to some key issues of the structure. In particular, implementing rules have been enacted with respect to the type of assets eligible for the cover pool, the maximum allowed ratio between transferred assets and issuable securities, the type of guarantee to be provided to bondholders by the SPV.

As for the last procedural step, which formally allows Italian banks to start issuing covered bonds, the Bank of Italy enacted its implementing measures on 17 May 2007, in relation to the requirements to be complied with by issuing banks, the criteria to be adopted to evaluate the cover assets and the relevant formalities to integrate such assets, as well as the formalities to check that the banks are complying with their obligations under the same article 7-*bis*, also through auditors.

II. STRUCTURE OF THE ISSUE OF COVERED BONDS

Pursuant to the abovementioned article 7-*bis*, the structure of a covered bond transaction is as follows:

1. a bank transfers eligible assets to a special purpose vehicle (SPV), whose sole corporate purpose is the purchase of such assets and the granting of a guarantee for the issued securities over which bondholders have a senior claim;
2. the SPV purchases the transferred assets by means of a loan granted or guaranteed to it by a bank (not necessarily the same bank transferring the assets);
3. the bank transferring the assets (or another bank) issues covered bonds;
4. the assets purchased by the SPV are applied to satisfy the rights attaching to the covered bonds and the counterparties of derivative agreements entered into for hedging the risks related to the assets, and to pay the costs of the transaction.

According to the Bank of Italy's regulation, covered bonds can be issued only by banks with the following prerequisites:

> a consolidated regulatory capital not lower than EUR 500 mln

> a total capital ratio not lower than 9%

It is also provided that these requisites must be fulfilled by the transferring banks as well (i.e. cover pool providers), if they are not the issuers.

There are no business restrictions to the issuer's activity, hence there is no special banking principle that needs to be enforced. Bondholders hold a preferential claim on the cover assets and the covered bonds are direct, unconditional obligations of the issuer.

III. COVER ASSETS

As provided for by paragraph 1 of Article 7-*bis* of the securitization law, the eligible assets as coverage for covered bonds are:

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

b) claims owed by (or guaranteed by) the following entities, up to 10% of the cover pool:

- public entities of EEA member countries and Switzerland with a maximum risk-weight of 20%;
- public entities of non-EEA member countries with a risk weight of 0%;
- other entities of non-EEA member countries with a risk weight of 20%.

c) notes issued under a securitisation transaction backed (for a minimum of 95%) by the claims under the abovementioned letters a) and b) with a maximum risk weighting of 20%.

As regards the transferring of such eligible assets to the SPV, the Bank of Italy sets different limits according to the different regulatory capital levels of the issuer (see Table 1)

> TABLE 1

Regulatory capital level		Transfer limitations
Class A	Total capital ratio ≥ 11% and, Tier 1 ratio ≥ 7%	No limitations
Class B	Total capital ratio ≥ 10% and < 11% and Tier 1 ratio ≥ 6.5%	Eligible assets can be transferred up to 60% of total
Class C	Total capital ratio ≥ 9% and < 10% and Tier 1 ratio ≥ 6%	Eligible assets can be transferred up to 25% of total

As provided for by the secondary legislation enacted by the Italian Ministry of Economy, assets must at least equal liabilities both on the nominal and NPV bases, and the revenues arising from cover assets must be sufficient to pay coupons to bondholders and to cover the cost of derivative transactions.

The integration of cover assets can be performed through:

1. the transfer of additional eligible assets to the pool;
2. the opening of deposit accounts at banks located in an EEA member country, or in other countries with a 0% risk-weight;
3. the transfer of banks' own debt securities (with maturity of less than 1 year) to the pool.

It is also provided that integration through assets under points 2 and 3 is allowed only up to 15% of the cover pool's nominal value. With respect to such provisions, the Bank of Italy established that integration is allowed only to:

> maintain the ratio of issued bond to cover assets up to the abovementioned level provided for by the Ministry of Economy;

> in case of voluntary over-collateralisation, maintain the ratio of issued bond to cover assets up to the contractually-agreed limit;

> respect the abovementioned 15% limit for eligible supplementary assets.

IV. ASSET-LIABILITY MANAGEMENT

In order to allow the SPV to fulfil its obligations, issuing banks are required to adopt proper asset-liability management techniques and to perform specific controls at least every 6 months, to ensure that the proceeds from the cover pool assets are always sufficient to pay the coupons on the covered bonds, and the overall cost of the transaction.

V. COVER POOL MONITOR AND BANKING SUPERVISION

As far as regulatory supervision is concerned, the Bank of Italy sets and monitors, on an ongoing basis, the abovementioned specific eligibility requirements for issuing banks which are stricter than those provided for traditional banking activities. These parameters require, in particular, a consolidated supervisory capital of at least €500 million and a consolidated total capital ratio of at least 9%. It is also provided that eligible assets may be assigned to the SPV only subject to a series of restrictions, graduated based on the total capital ratio and Tier 1 ratio at the consolidated level.

Although in some European countries the issuance of covered bond is subject to a "licence" granted by the Supervisory Authority upon the fulfilment of specific requirements, the Italian legislator has decided to make a different choice. Rather than introducing a "licence" system, it has defined a series of requirements and limitations to issuance which together can be de facto considered as the objective basis upon which to grant an issuance authorization. Moreover, it must be considered that such requirements and limitations are in most cases stricter than those required by other regulatory frameworks.

Furthermore, Italian regulation prescribes that the monitoring of the regularity of the transaction and of the integrity of the collateral securing investors must also be performed by an external asset monitor (AM) appointed by the issuer. The AM must be an auditing firm possessing the professional skills required to perform such duties and must be independent from the bank engaging it (e.g. it cannot be the same firm appointed to audit the accounts of the issuing bank) and of any other person participating in the transaction. It has to report at least once a year to the Board of Directors and to the internal audit department of the bank.

Although no specific reporting to the Bank of Italy is prescribed by law, in practice the AM will report to the Supervisor any material anomaly found. It must also be considered that the AM's report is reviewed by the bank's auditor which reports regularly to the Bank of Italy. Should such report contain negative evaluations, the bank's auditor is obligated to bring the issue to the Bank of Italy's attention.

In general terms, specific control requirements on banks issuing covered bonds find their primary source from EU and national legislation. Additionally, in consideration of the peculiarities of a covered bond transaction, the Bank of Italy assigns to issuers the primary responsibility to evaluate the risk involved in the operations, to arrange a proper control mechanism and to ensure its functioning through the time. In particular, at least every six months and for each operation, issuers have to check: i) the quality of the cover pool; ii) compliance with the predetermined ratio between outstanding covered bonds and cover assets; iii) compliance with transfer limitations and asset integration requirements; iv) the performance of any derivative agreement entered into in order to hedge risks.

As far as information flows are concerned, it is provided that issuing/transferring banks shall acquire, from all the parties involved in the structuring of the covered bonds, information relating to:

- the possessory titles of the transferred assets (in order to be able to track down each borrower whose loan has been transferred to the SPV);
- the performance of the transferred assets (in order to monitor the "health" of the cover assets).

This information is necessary to issuing/transferring banks in order to perform both the abovementioned controls in terms of cover pool monitoring and the regulatory reporting (i.e. reporting of defaulted loans to the Bank of Italy's Centrale dei Rischi).

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

As provided for by the secondary legislation enacted by the Italian Ministry of Economy, the guarantee granted by the SPV to the covered bondholders, must be irrevocable, first-demand, unconditional and independent from the issuing bank's obligations on the covered bonds. It will be callable upon non-payment and bankruptcy of the issuing bank, and it will be limited to cover pool asset value to ensure bankruptcy remoteness of the SPV.

The SPV is a financial intermediary, registered in the "special list" provided for by article 107 of the Banking Law, and therefore subject to the Bank of Italy's supervision.

Covered bondholders will have the right, represented exclusively by the SPV, to file a claim with the issuing bank for full repayment of the covered bonds. In case of liquidation of the issuing bank, the SPV will be exclusively responsible to make payments to covered bondholders (as well as other counterparties) and will represent covered bondholders in proceedings against the issuing bank.

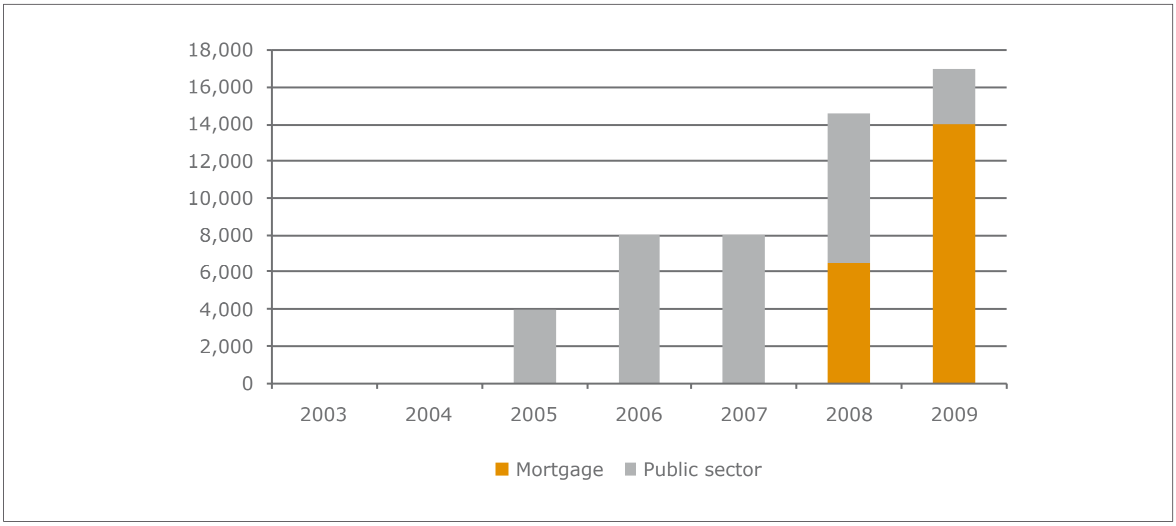
All the amounts obtained as a result of the liquidation procedure will become part of the cover pool and therefore used to satisfy the rights of covered bondholders. The redemption of the subordinated loan granted by the issuer of the covered bonds to the SPV is junior to any outstanding claims of covered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

In case the proceeds obtained as a result of the liquidation procedure are insufficient to meet the obligations to bondholders in full, investors would still have an unsecured claim against the issuer for the shortfall.

VII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

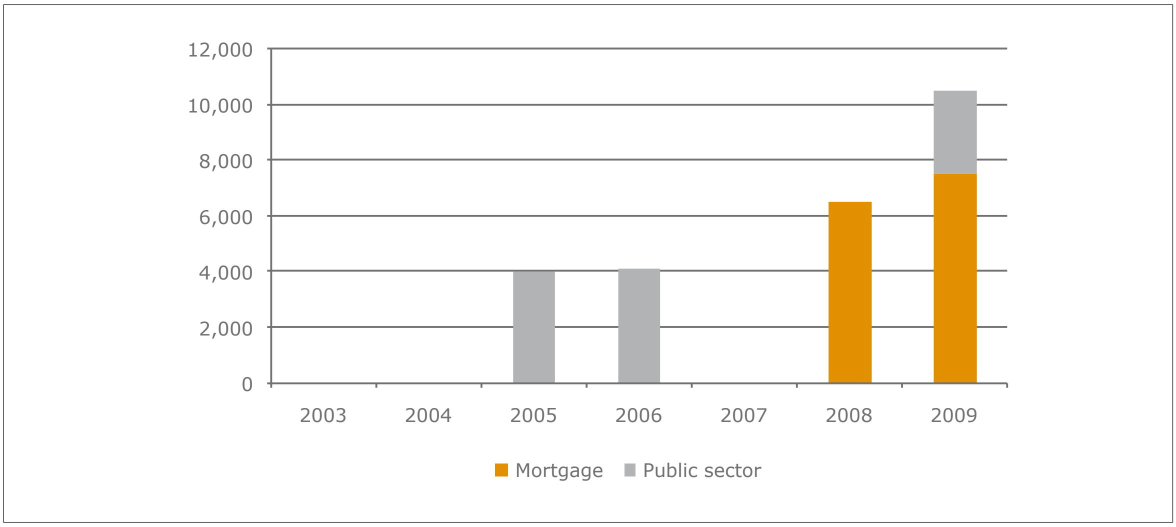
Italian covered bonds fulfil both the criteria of UCITS 22(4) and Annex VI, Part 1, Paragraph 68 (a) to (f) of the Capital Requirements Directive. They are also eligible in repo transactions with the Bank of Italy. The risk-weight is 10%.

> Figure 1: Covered Bonds Outstanding 2003-2009, €m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2009, €m



Source: EMF/ECBC

Note: Figures for the years 2005 and 2006 relates to public sector covered bonds issued by Cassa Depositi e Prestiti.

Issuers: There are 5 active issuers in Italy: Banca Carige SpA, Banca Popolare die Milano, Intesa Sanpaolo, UBI and UniCredit.

3.13 LATVIA

By Kaspars Gibeiko
Mortgage and Land Bank of Latvia

I. FRAMEWORK

In Latvia, the legal basis for Covered Bond issuance is the Law on Mortgage Bonds (HKZL – Hipotekāro ķīlu zīmju likums) from 10th of September 1998 and subsequent amendments to the HKZL (1^{st} of June 2000, 5^{th} of July 2001, 6^{th} of November 2002 and 25^{th} of October 2006). The insolvency and bankruptcy procedure is captured both by the HKZL (Section 4) and the Law on Credit Institutions (Articles 56^1, 161 and 191).

II. STRUCTURE OF THE ISSUER

There is no specialised banking principle in Latvia. As a result every registered bank can issue mortgage-backed Covered Bonds. The minimum requirements a bank must fulfil in order to issue mortgage bonds are as follows:

> Tier1 and Tier2 capital should be not less than stated in the Law on Credit Institutions;

> Provision of the banking services specified in Article 1, Clause 4 of the Law on Credit Institutions without any restrictions imposed by the Financial and Capital Market Commission (FCMC);

> Submission of rules approved by the bank's supervisory board regarding the valuation of the real estate to be mortgaged and the management of the mortgage bond cover register to the FCMC.

The issuer holds the cover assets on his balance sheet and the cover assets are not transferred to a different legal entity. All obligations from mortgage bonds are obligations of the issuing bank as a whole, to be paid from all the cover assets of the issuer. In the case of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved for the claims of the mortgage bond holders.

The HKZL does not prescribe the issuing bank to have separate employees to manage the cover pool, but it prescribes that the cover assets are managed separately from other assets of the issuer. Therefore, if employees of the bank are involved both in the management of the cover assets and the management of non-cover assets, separation of the duties and responsibilities should be clearly stipulated in the bank's by-laws and internal procedures. There are also no specific requirements regarding the outsourcing of the management of cover assets in the Latvian Covered Bond legislation.

III. COVER ASSETS

Cover assets can be eligible mortgage loans or loans secured by either guarantees of the Latvian Government or guarantees of the local governments.

Up to 20% of the nominal volume of outstanding mortgage bonds and interest expenses (substitute cover) may consist of

(a) cash,

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

(c) securities issued and guaranteed by the EU member state's government 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 15^1 (introduced by the amendment to the HKZL on 25^{th} of October 2006) stipulates that the market value of property registered in the EU member state is determined by the persons who have received professional, real estate valuation, licence according to the legislation of particular EU member state.

The issuer is responsible for the monitoring of the property value. The frequency of monitoring is not defined by the HKZL, but it is prescribed by the regulations of the FCMC and by-laws of the issuer.

Article 14 of the HKZL stipulates that a mortgage loan together with debts previously registered with the national property register may not exceed 75% of the market value of residential property and 60% of the market value of other type of property.

V. ASSET - LIABILITY MANAGEMENT

Article 9 of the HKZL stipulates the following requirements to the asset-liability management of the cover pool:

> the total volume of the cover assets must be larger than the total volume of outstanding mortgage bonds at their face value by at least 10% of the risk weighted value of the cover assets, where risk weighted value of the cover assets is calculated based on specific weights of each type of the cover assets;

> The currency of the cover assets and that of the outstanding mortgage bonds may differ only if the issuer has taken all the necessary measures to prevent the currency risk in the cover pool;

> The total interest income from the cover assets must exceed the total interest expenses on outstanding mortgage bonds;

> The cash-flows from the outstanding mortgage bonds (in accordance with the mortgage prospectus) must always be covered by the cash-flows from the cover assets in terms of volumes and maturities.

The issuer of the Covered Bonds has to prepare a report on the cash-flow mismatches and submit it to the FCMC on a semi-annual basis.

The latest amendment to the HKZL stipulates that the issuer should separate loans secured by a mortgage and loans secured by central or municipal governments. This requirement was introduced in order to separate mortgage bonds and public sector bonds.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The Latvian Covered Bond legislation does not require the appointment of a special entity to monitor the cover pool. Instead, the cover pool is managed by the issuing bank and it is the issuing bank's responsibility to set up a system to ensure that the cover pool is managed properly. In some banks, monitoring of the cover pool is executed by the internal audit department

The FCMC supervises cover pools. It inspects cover pool (quality and eligibility of the cover assets, quality of the asset-liability management) during regular banking supervisory audits which are carried out on average every two years.

The FCMC has the right to suspend the issue of mortgage bonds under the following circumstances:

> The issuing bank does not comply with the conditions laid down in the Law on Mortgage Bonds;

> The issuer does not ensure that the redemption and interest payments on outstanding mortgage bonds are always covered by the principal and interest payments of the cover assets of a higher value;

> By-laws on the valuation of properties securing the mortgage assets and by-laws on the management of cover pool submitted to the FCMC are not followed.

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

A cover register facilitates the identification of the cover assets, because all the cover assets, including substitute cover as well as derivatives, are recorded in the cover register. The type and scope of the information recorded regarding the cover assets in the cover register are determined by FCMC regulations

The legal effect of registration is the fact that in the case of insolvency of the issuer, the assets which form part of the separate legal estate can be identified and all assets recorded in the cover register qualify as part of this separate legal estate.

Asset segregation

A cover pool is a part of the general estate of the issuing bank as long as the issuer is solvent. If the insolvency proceedings are opened, by operation of law, the assets recorded in the cover register are excluded from the insolvency estate of the issuer. Those assets will not be affected by the opening of the insolvency proceedings, but automatically form a separate legal estate.

After the opening of the insolvency proceedings, a special cover pool administrator initiated by the FCMC and appointed by court carries out the administration of the cover assets.

Impact of insolvency proceedings on Covered Bonds and derivatives

Covered Bonds do not automatically accelerate when the issuing institution becomes insolvent, but will be repaid at the time of their contractual maturity. The same applies to derivatives which are registered in the cover register and form part of the cover pool. During an insolvency procedure, derivatives' counterparties have the same rights as the holders of mortgage bonds.

Preferential treatment of Covered Bond holders

Covered Bond holders enjoy a preferential treatment as the HKZL and the Law on Credit Institutions stipulates the separation of the cover assets in a case of the insolvency of the issuing bank. According to Article 191 of the Law on Credit Institutions, mortgage bond holders have the first access rights to the cashflows generated by the assets recorded in the cover register

In the case of insolvency of the issuer, it is forbidden to modify the content of the cover register and all cash flows from the cover assets must be accrued within it. As long as there is sufficient cover, a moratorium on the insolvency's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of Covered Bond holders.

Only in the case of over-indebtedness or insolvency of the cover assets shall the FCMC file an application to court regarding the insolvency of the cover register (Article 26 of the HKZL). Insolvency of the cover pool is the only catalyst which could the trigger acceleration of Covered Bonds.

Access to liquidity in case of insolvency

With the appointment of the cover pool administrator, the right to manage the cover assets is transferred to him by law. Thus, the cover pool administrator has first access to the cover assets and collects the cash flows according to their contractual maturity.

The cash-flows from the cover assets may only be used for the following purposes and the use of assets in any other manner is inadmissible:

> Disbursements to mortgage bond holders if the term for interest payments or mortgage bond redemption has become due

> Purchase of mortgage bonds issued by the issuer itself with their subsequent redemption in the public securities market at a price not exceeding the face value of the mortgage bonds if the remaining cover assets are sufficient to cover outstanding mortgage bonds

> Payments under derivatives' agreements concluded on the cover asset risk mitigation, provided that the contracting parties have met the conditions of such agreements.

The cover pool administrator is permitted, in case of the insolvency of the issuer, to exceed the substitute cover limit.

No specific regulation exists with respect to the insolvency remoteness of voluntary overcollateralisation. However, the cover pool administrator is not allowed to use voluntary overcollateralisation until all payments to mortgage bond holders are made fully and on time.

The cover pool administrator may carry out legal transactions in respect of the cover pools in so far as this is necessary for an orderly settlement of the cover pool and for the full and timely satisfaction of the cover pool's creditors.

Sale and transfer of mortgage assets to other issuers

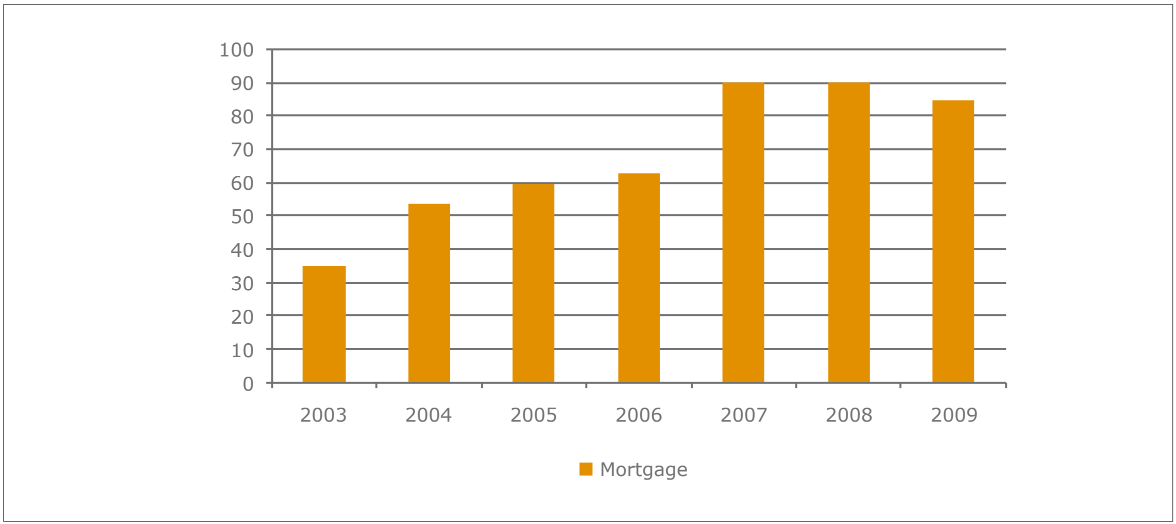
The HKZL and the Law on Credit Institutions provide that the cover assets in a case of insolvency of issuer are transferred to other bank chosen by the FCMC. The bank to which the cover assets are transferred, also takes responsibility for all the obligations arising from outstanding mortgage bonds.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Latvian mortgage bonds comply with the requirements of Art. 22 par. 4 UCITS Directive as well as with those of the CRD Directive. The current risk weight applied to mortgage bonds in Latvia is 20%.

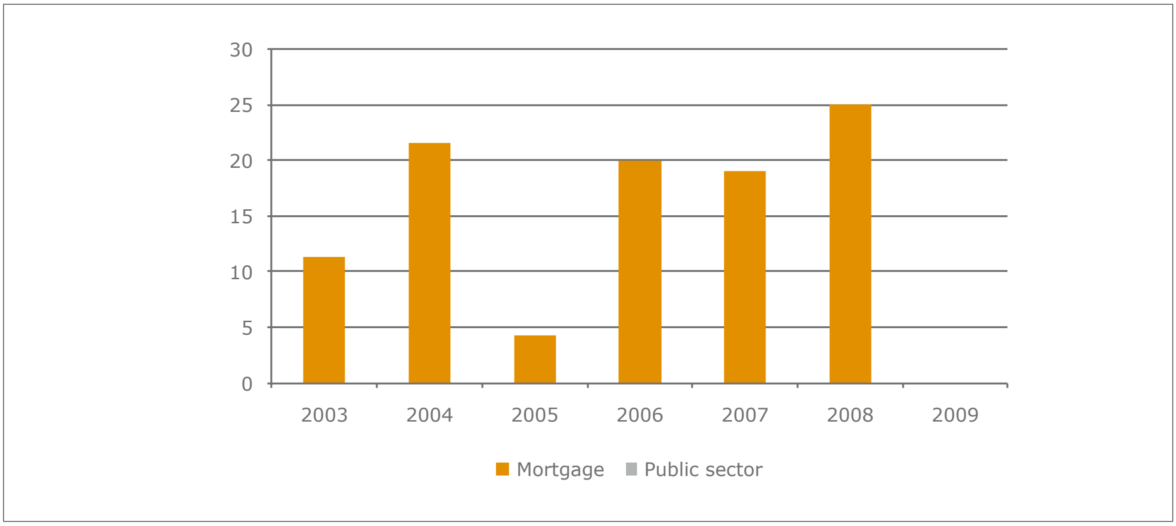
Latvian investment legislation allows mutual funds to invest up to 25% of their assets in mortgage bonds and pension funds – up to 10% of their assets.

> Figure 1: Covered Bonds Outstanding 2003-2009, €m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2009, €m



Source: EMF/ECBC

Issuers: At the end of 2009, there were five issuers in Latvia: A/S Privatbank (Parex Bank),GE Money, Latvijas Kraij, Mortgage and Land Bank of Latvia and Trasta.

3.14 LUXEMBOURG

By Frank Will, RBS
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I. FRAMEWORK

The issuance of Lettres de Gage is regulated by Articles 12-1 to 12-9 of the Financial Sector Act of 5 April 1993 (the Financial Sector Act). These Articles were introduced by the Act of 21 November 1997 for banks issuing mortgage bonds and amended by the Act of 22 June 2000 and by the Act of 24 October 2008. The Lettres de Gage regulations are supplemented by the CSSF (Commission de Surveillance du Secteur Financier) Circular 01/42 which lays down the rules for the appraisal of real estate and CSSF Circular 03/95 which defines the minimum requirements for the maintenance and control of the cover register, for the cover assets and for the issuance limit for outstanding Lettres de Gage. The CSSF is the supervisory authority in Luxembourg.

The amendments in October 2008 include an increase of the loan-to-value limit for residential mortgage loans from 60% to 80%, the stipulation of a minimum over-collateralisation level of 2% and the permission to include securitised assets. The most important modification, however, has been the introduction of a new form of Lettres de Gage backed by movable assets including ships, aircrafts and trains.

II. STRUCTURE OF THE ISSUER

The Lettres de Gage issuers have to be credit institutions with a specialist bank licence. Their business activities are restricted: In the past, the bank's principal activities were limited to mortgage lending and public sector financing which were primarily funded by issuing Lettres de Gage Hypothécaires and Lettres de Gage Publiques. According to the last covered bond law amendments, the Luxembourg issuers are also allowed to issue Lettres de Gage backed by movable assets (Lettres de Gage Mobilières). Moveable assets can be mortgage loans on ships, aircrafts and trains. However, other classes of movable assets are possible as well provided that they are registered in a public register. Consequently, the permitted principal activities of an issuer have been widened to allow the origination of those movable assets. The issuers may only engage in other banking and financial activities if these activities are accessory and auxiliary to their main business.

The issuer holds the cover assets on its balance sheet in separate registers. Each class of Lettres de Gage has its own register: one for assets which are allocated to the Lettres de Gage Hypothécaires, another one for the cover assets backing the Lettres de Gage Publiques and potentially several more for the various forms of Lettres de Gage Mobilières. Each moveable asset class requires a separate cover pool register, i.e. ship Lettres de Gage would be backed by a segregated pool of ship mortgage loans while aircraft Lettres de Gage would be backed by a pool of aircraft exposures. The cover assets remain on the balance sheet of the issuer. They are not transferred to another legal entity (special purpose vehicle) like in a securitization. All obligations arising from Lettres de Gage are direct, unconditional obligations of the issuer. In the case of issuer insolvency, the cover pools are segregated by law from the general insolvency estate and are reserved for the claims of the Lettres de Gage holders. There is no direct legal link between a single asset in the cover pool and an outstanding Lettre de Gage. Interest and principal payments of the outstanding Lettres de Gage Hypothécaires, Lettres de Gage Publiques and the various forms of Lettres de Gage Mobilières (including any derivatives benefiting from the preferential treatment) are backed by the assets in the respective cover pools.

Lettres de Gage issuers employ their own staff. The issuers have to be banks and according to the Financial Sector Act they need to have sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms which restrict the extent of outsourcing legally possible. In addition, the way of permitted outsourcing is described in detail in different CSSF Circulars.

III. COVER ASSETS

The eligible cover pool assets are defined in Article 12-1 of the Financial Sector Act of 5 April 1993. Since the amendments of the covered bond legislation in October 2008, there are three asset classes: mortgage assets, public sector exposures and moveable assets, i.e. mortgage loans on ships, aircrafts, trains or other classes of movable assets. In each of the various cover pools the assets may be replaced by up to 20 % of the nominal value of the outstanding Lettres de Gage by substitution assets, for example cash, assets with central banks or with credit institutions whose head office is in a member state of the EC, EEA or OECD or bonds satisfying the conditions set out in article 43 (4) of the law of 20 December 2002 concerning undertakings for collective investments.

The geographical scope of the cover assets is restricted to the member states of the EU, EEA and the OECD. There is no further limit in place. It is also possible to hold the cover assets indirectly through a third-party bank located in a member country of the EU, the EEA or the OECD.

The Lettres de Gage Mobilières are backed by movable assets, i.e. mortgage loans on ships, aircrafts, trains or other classes of movable assets. In order to be cover pool eligible, the movable assets and the charges on the property of those assets need to be registered in a public register within the European Union (EU), the European Economic Area (EEA) or the OECD.

In addition, securitised assets are cover pool eligible if they comply with the eligibility criteria laid down for the various types of Lettres de Gage. The amount of securitised assets that are not cover pool eligible per se will be limited to 10% of the collateral pool. This can be achieved in two ways: One option would be that at least 90% of the assets of each securitisation (vehicle) are cover pool eligible. The other option would be that at least 50% of the assets of each securitisation (vehicle) are cover pool eligible. In that case, the percentage of securitisation assets shall not exceed 20% of the total collateral pool. The issuer can choose one of the two options for each type of Lettre de Gage but cannot combine the two options. Moreover, the securitisation tranches should have a minimum rating of Aa3 from Moody's or a rating of AA- from S&P or Fitch. The law allows only true sale transactions and synthetic securitisations are explicitly excluded.

Moreover, the amended law clarifies that any kind of obligations from public sector institutions including public private partnerships (providing a controlling public sector stake; other public private partnership structures are subject to the above mentioned 10% limit) are cover pool eligible.

There is no limitation on the volume and the types of derivatives used as long as they are employed as hedging instruments.

The cover pools are dynamic. Assets can be included, excluded and exchanged as long as the requirements of the law are not breached.

There are no explicit transparency requirements regarding cover pools. However, there is common understanding among the five Lettre de Gage issuers that a broad range of information should be provided on a voluntary basis in the interest of bond holders.

IV. VALUATION AND LTV CRITERIA

The property valuation methods are defined by a CSSF Circular 01/42 and are based on the mortgage lending value of the property. A special auditor, who may not simultaneously hold the position of company auditor, has the responsibility of determining whether the property valuation has been undertaken according to the valuation rules.

The LTV limit for residential property has been increased from 60% to 80% of the estimated realisation value. The LTV ratio of 60% will remain in force for all other immovable and movable properties including commercial real estate loans. The actual loan, however, can exceed the 60% limit (or 80% limit in case of residential mortgages). In those cases, only the first 60% (80%, respectively) of the mortgage lending value is eligible for the cover pool.

V. ASSET-LIABILITY MANAGEMENT

The new law has introduced a minimum overcollateralisation level of 2% on a nominal basis as well as on a net present value basis. The Luxembourg regulator has the right to review and adjust these overcollateralisation levels. Any mismatches in terms of currency or interest rate risk have to be hedged and the respective hedge instruments have to be included in the collateral pool. In addition, there are the requirements imposed by the rating agencies.

The special auditor has to ensure that there is always sufficient collateral in the pool. This has to be certified by the special auditor when Lettres de Gage are be issued. Cover assets may only be removed from the cover pool when the prior written consent of the special auditor has been received and provided that the remaining cover assets are sufficient to guarantee the legally protected cover.

The calculation of the nominal value and of the net present value of the collateral pool as well of the outstanding Lettres de Gage volume must be reported to the supervisory authority on a monthly basis.

Moreover, the law changes removed the current restriction of the outstanding volume of Lettres de Gage to 60 times the issuer's equity.

There is no obligation for the issuers to publish specific information referring to the collateral pool. However, there is a voluntary practice by the Lettres de Gage issuers to publish specific cover pool data on their respective internet pages.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The supervisory authority of covered bond issuers is the general banking regulator "Commission de Surveillance du Secteur Financier (CSSF)". The CSSF has a specialised department which is responsible for supervising the Lettres de Gage issuers. It is entitled to demand relevant reports and intercede if liquidity problems have been identified at a bank. The Commission de Surveillance du Secteur Financier (CSSF) is also responsible for the approval of the various types of covered bonds secured by movable assets. Definitions, the details on which types of moveable assets qualify and other practical issues will be clarified in a separate CSSF Circular.

For the independent control of the cover pool a special auditor which is recommended by the Lettres de Gage issuer has to be approved by the supervisory authority. Only auditing firms which satisfy the conditions set forth in the law of 2009 regarding réviseurs d'entreprises (independent auditors) can be appointed as special auditors. The issuer communicates the names of the partners of these auditing firms who will fulfil the function to CSSF. The special auditor must have a suitable qualification and must be able to call upon the experience and technical expertise of a recognized international auditing firm.

The special auditor is continuously responsible for monitoring the collateral pool and the outstanding Lettres de Gage. He must ensure that there are sufficient assets in the collateral pool to service the obligations resulting from the outstanding Lettres de Gage up to the final maturity of the last outstanding bond. He is obliged to inform the supervisory authority immediately should any of the prudential limits be violated. The Lettres de Gage issuer is also obliged to immediately inform the supervisory authority of the violation of any limits.

Rating agencies do not play any mandatory role in the monitoring process. The issuers comply with the rating agencies' requirements on a voluntary basis.

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

The cover registers for mortgage, public sector and moveable assets include all necessary data to identify the assets and the derivatives included. As soon as an asset or derivative product is registered in the official cover register it forms part of the collateral pool.

The cover register is managed by the issuer but regularly monitored by the special auditor. The special auditor is obliged to inform the CSSF of any irregularities and provide an annual report.

Asset segregation

In the case that a Lettres de Gage issuer is declared bankrupt, the assets and derivatives in the collateral pool are separated from the other assets and liabilities of the bank. The respective collateral pools remain unchanged and are administered by the CSSF up to the final maturity of the last outstanding Lettre de Gage. By law the derivative counterparties rank pari passu with the Lettres de Gage creditors.

Impact of insolvency proceedings on Lettres de Gage and derivatives

Lettres de Gage do not automatically become due when the issuing bank becomes insolvent. Interest and principal are paid as per their original due dates. The same applies to derivatives registered in the cover register which are part of the cover pool. The net present value of the derivatives after netting ranks pari passu with the claims of the Lettres de Gage holders.

Preferential treatment of Covered Bond holders

Lettres de Gage holders benefit from a preferential treatment in case of an issuer insolvency. The registration of the cover assets in the cover register provides the Lettres de Gage holders with a preferential right, above all other rights, preferences and priorities of any nature whatsoever, including those of the Treasury. The general bankruptcy administrator has no direct access to the assets in the collateral pool.

If the assets in the collateral pool are insufficient to meet the demands of the Lettres de Gage creditors, the bondholders may draw on the bankruptcy estate and the ordinary rules of collective liquidation will apply, but restricted to the amount which has not been satisfied by the cover assets. In this case, the Lettres de Gage holders participate in the general bankruptcy procedure and have an unsecured claim against the issuer ranking pari passu with other senior unsecured investors.

Access to liquidity in case of insolvency

The CSSF administers the cash flows resulting from the cover assets and according to the Article 12-8 (5) it can transfer the administration of the cover assets and the Lettres de Gage to another bank.

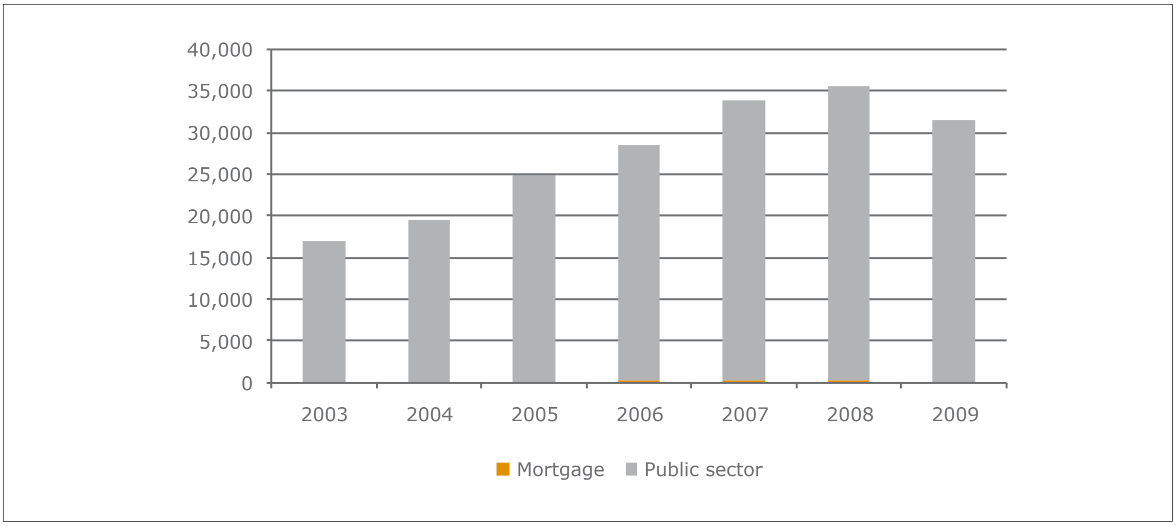
There is no explicit provision in the law regarding any voluntary overcollateralisation. However, Article 12-8 (5) stipulates that assets remaining after the creditors enjoying the preferential rights have been paid off in full, those assets shall be transferred to the general pool of assets comprised in the liquidation of the bank. From this regulation the conclusion can be drawn that the voluntary overcollateralisation is only available to the non-privileged creditors when the claims of the last outstanding Lettre de Gage holders have been satisfied.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The Luxembourg Covered Bond legislation fulfils the criteria of Art. 22 (4) of the UCITS Directive (Council Directive of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)) and Lettres de Gage enjoy therefore a 10% risk weighting under Basel I rules in Europe. Derivatives included in the cover pool are currently 0-20% risk-weighted according to the risk weighting of the counterparties. In its current format, the Lettres de Gage legislation does not fulfil the requirements set out in Annex VI, Part 1, Article 68 a) to f) of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), the Capital Requirements Directive (CRD). The recent amendments of the Luxembourg covered bond legislation did not make the Lettres de Gage legislation CRD-compliant. However, it should be possible for issuers to make their outstanding Lettres de Gage 'CRD compliant' by limiting their cover pool exposure.

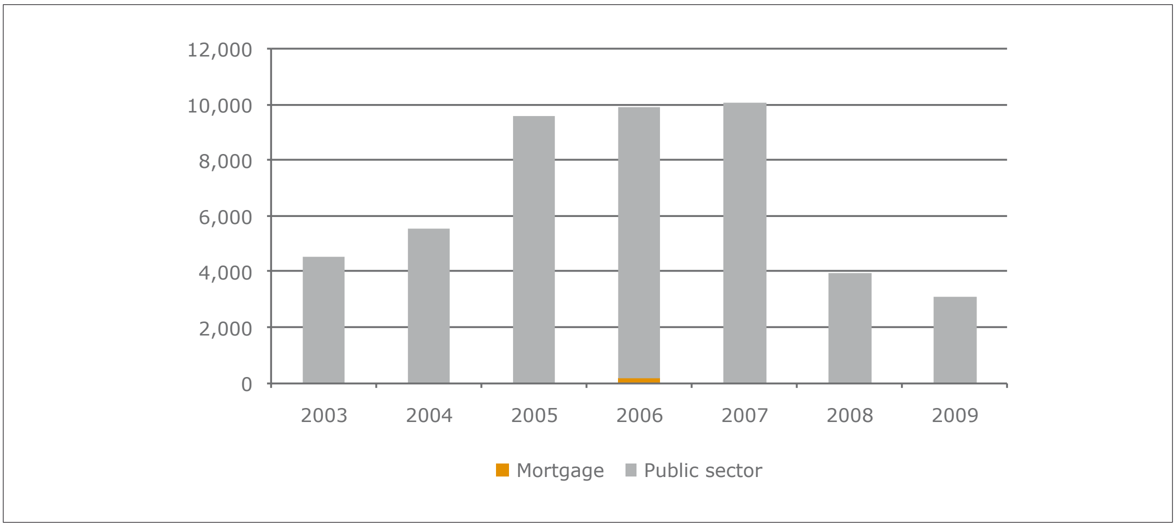
Lettres de Gage are principally eligible for repo transactions with the European central bank. But this applies only to Lettres de Gage issued in Euro and in New Global Note format for Euro-System eligibility.

> Figure 1: Covered Bonds Outstanding 2003-2009, €m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2009, €m



Source: EMF/ECBC

Issuers: There are five issuers in Luxembourg: Dexia LdG Banque S.A., Erste Europäische Pfandbrief- und Kommunalkreditbank AG in Luxemburg S.A., EUROHYPO Europäische Hypothekenbank S.A., Hypo Pfandbrief Bank International S.A. and Nord/LB Covered Finance Bank S.A.

3.15 THE NETHERLANDS

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

The Dutch regulation for covered bonds (the "**Regulation**") came into force in the Netherlands on 1 July 2008. The Regulation aims to:

> provide Dutch issuers with a level playing field with other issuers of covered bonds within the European Union;

> facilitate a market in safe instruments in accordance with the applicable European directives; and

> impose solid conditions to protect covered bondholder interests.

The Regulation embraces a segregated structure, that is a structure where the cover assets are segregated from the issuer and owned by a covered bond company (the "**CBC**"). Under the Regulation, asset segregation takes place on the basis of the Dutch Civil and Bankruptcy Codes. The applicable statutory provisions are relatively creditor-friendly and have enabled the Dutch legislator to take a time-efficient and principles-based approach without having to amend the Dutch Civil or Bankruptcy Code.

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

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

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

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

II. STRUCTURE OF THE ISSUER

Under the Regulation the issuer needs to be a bank (that is a credit institution as meant in article 4(1)(a) BCD) that is licensed by the Dutch Central Bank (*De Nederlandsche Bank N.V.*; "**DNB**"). General banking supervision by DNB on the solvency, liquidity, business operations et cetera of the issuer falls outside the scope of this chapter.

The covered bonds are guaranteed by the CBC owning the cover assets, thus creating dual recourse for the covered bondholders. The CBC is a special purpose vehicle set up as a bankruptcy-remote, orphan entity, as follows. It is a private company with limited liability (*besloten vennootschap met beperkte aansprakelijkheid*) wholly owned by a foundation (*stichting*), with independent directors provided by a corporate services provider and no employees. It has a limited corporate objects clause, so that any third party dealing with the CBC will be able to see that it is dealing with a special purpose vehicle. Non-petition and limited recourse wording is agreed with all transaction parties that are creditors of the CBC under the transaction documents. Any remaining third party creditors not signing up to such non-petition and limited recourse provisions are listed high in the relevant priority of payments, so as to procure they are timely paid. An insolvency of the issuer does in itself not result in an insolvency of the CBC.

The cover assets are owned by the CBC, but from an accounting perspective the assets remain on the consolidated balance sheet of the issuer, which continues to carry the credit risk of the cover assets. The CBC pledges the cover assets to a security trustee, which is a foundation especially established to act as a security trustee in relation to the relevant covered bonds. The security trustee receives the rights of pledge in its own name, but acts in the interest of the covered bondholders and certain other transaction parties that are creditors of the CBC.

III. COVER ASSETS

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

> cash; or

> subject to minimum rating and maximum percentage requirements (this differs per programme), other assets eligible under the CRD to collateralise covered bonds.

All programmes allow for inclusion of non-Dutch residential mortgage loans, subject to certain restrictions. In practice all cover pools consist of Dutch residential mortgage loans and, in one programme, German residential mortgage loans.

Although the Solvency Requirements FSA contain detailed provisions on cover assets as prescribed by the CRD, the Regulation only lists the general requirements of article 22(4) of the Undertakings for Collective Investment in Transferable Securities Directive (85/11/EC; "**UCITS**"). The Regulation therefore regards CRD-compliance as an option, and not as a requirement. It allows issuers of (and thus investors in) Dutch covered bonds the flexibility to choose whether they wish to issue (or invest in) covered bonds which are either:

> UCITS-compliant; or

> both UCITS- and CRD-compliant.

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

UCITS- and CRD-compliance of Dutch covered bonds can only be achieved if the relevant covered bonds are registered by DNB under the Regulation. The DNB register indicates whether the relevant covered bonds are CRD-compliant. All covered bonds registered by DNB are in principle UCITS-compliant. The requirements for, and status of, registration of Dutch covered bond programmes will be set out in paragraph VI below.

IV. VALUATION AND LTV CRITERIA

The above feature of CRD-compliance as an option, should be seen against the background that the CRD prescribes that covered bonds may be backed by residential mortgage loans only up to the lesser of (a) the principal amount of the relevant mortgage right and (b) 80% of the value of the underlying mortgaged property. However, relevant Dutch residential mortgage loans may in practice have a loan-to-value ("**LTV**") ratio of up to 125%. To date all Dutch covered bond programmes take a two-step approach towards LTV-ratio's of Dutch residential mortgage loans, as follows:

> the loan is only eligible as cover asset if its principal amount did not exceed 125% (subject to some exceptions in some programmes; the "**Eligibility Percentage**") of the value of the mortgaged property at origination; and

> once a loan forms part of the cover assets, the maximum value attributed to it in valuing the cover assets is a certain percentage (this differs per programme; the "**LTV Cut-Off Percentage**") of the value of the underlying mortgaged property at such time. For example, if (a) the relevant LTV Cut-Off Percentage is 80% and (b) a residential mortgage loan has a principal amount of 110 and is backed by mortgaged property with a value of 100, then such loan would be valued at no more than 80 in the asset cover test determining the value of the cover assets. The 30 excess value of the loan would serve as extra credit enhancement in Dutch covered bond programmes. That would not be the case in integrated covered bond structures used in other countries applying prescriptive (that is rule-based rather than principles-based) regulations.

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

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

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

> notwithstanding the percentages mentioned in the previous two paragraphs, 100% or a different percentage for residential mortgage loans that have the benefit of a Dutch National Mortgage Guarantee (*Nationale Hypotheek Garantie*).

The CRD does not (nor does the Regulation) prescribe which value of the underlying mortgaged property should be taken into account when calculating the LTV-ratio: the foreclosure value or the market value. To date under the Dutch covered bond programmes:

> the Eligibility Percentage is applied to the foreclosure value at origination; and

> the LTV Cut-Off Percentage is applied to the market value of the mortgaged property at the relevant time. The market value is in turn calculated at 85-90% (this differs per programme) of the applicable foreclosure value at origination, subject to indexation. As to indexation, (a) if prices go up, the property value is increased by 85-100% (this differs per programme) of the increase and (b) if prices go down, the value is reduced by 100% of the decrease.

V. ASSET - LIABILITY MANAGEMENT

Under all current Dutch covered bond programmes a total return swap is entered into at inception of the programme in relation to the cover assets. The total return swap basically swaps the different types of interest to be received on the cover assets to 1 month's EURIBOR. In addition, an interest rate swap or structured swap is entered into each time a series of covered bonds is issued. The interest rate/structured swap basically swaps 1 month's EURIBOR/euro's to the interest rate/currency payable under the relevant series of covered bonds.

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

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

> a pre-maturity test which is taken on each business day during the following number of months preceding the maturity of the relevant covered bonds:

  (a) in the case of S&P, 6 or 12 months; or

  (b) in the case of Moody's and Fitch, 12 months.

  The pre-maturity test is failed if on the relevant test date the issuer's short term rating is or falls below P-1/F1+/A-1+. A breach of the pre-maturity test requires (a) the issuer to cash-collateralise hard bullet maturities or (b) the CBC to procure alternative remedies such as a guarantee of the issuer's obligations, a liquidity facility and/or a sale or refinancing of cover assets; or

> a one-year maturity extension. The possible extension applies only to the CBC and only to any final redemption amount payable by the CBC in relation to a series of covered bonds under the guarantee.

For all Dutch covered bond programmes a minimum level over-collateralisation is required, which is measured by applying an asset cover test with asset percentages ranging from approximately 70 to 80%.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

Under all Dutch covered bond programmes the issuer is obliged to frequently send out investor reports that contain detailed information about, among other things, the cover assets and the performance of a monthly asset cover test. The accuracy of the asset cover test calculation is required to be tested at least annually by an independent auditor. Each year the CBC is required to produce audited financial statements.

When reviewing a Dutch covered bond programme submitted to it for registration under the Regulation, DNB requires:

> a valid safeguarding of sufficient cover assets for the covered bondholders. The assets must be validly transferred by the issuer to the CBC and pledged by the CBC to the security trustee;

> the covered bonds to have a credit rating of at least AA-/Aa3;

> a healthy ratio between the programme/issuance amount on the one hand and on the other hand (a) the value of the cover assets, (b) the value of the remaining assets of the issuer eligible for addition to the cover assets and (c) the consolidated balance sheet of the issuer (the latter to protect other stakeholders); and

> the issuer to have solid and effective strategies and procedures for verifying and procuring the sufficiency of the cover assets, taking into account the composition of the cover assets, the over-collateralisation and the applicable risks and stress tests.

To date the ABN AMRO, ING, NIBC and SNS covered bond programmes have been registered by DNB. The register is available on-line and can be found at http://www.dnb.nl/openboek/extern/id/en/go/41-194648.html (click on: Search in in the Register).

Once a Dutch covered bond programme is registered by DNB, the issuer will have ongoing administration and reporting obligations towards DNB. If the covered bonds no longer meet the requirements set by the Regulation or if the issuer no longer complies with its ongoing administration and reporting obligations towards DNB, there are likely to be short communication lines between the issuer and DNB. If it comes to sanctions, it may be that an issuance-stop is imposed on the issuer, which may be disclosed by DNB in its register. DNB is entitled to ultimately strike the registration of a covered bond. In practice it is not very likely that DNB would ever exercise its deregistration authority. Apart from verbal assurance this is confirmed by the explanatory notes to the Regulation, which in short state:

> that deregistration will only occur (a) after due consideration of the interests of the issuer and the covered bondholders and (b) in the exceptional circumstance that DNB's supervision is no longer in the interest of the issuer and no longer grants protection to covered bondholders; and

> that the interests of the issuer and the covered bondholders include that the registration and supervision be maintained.

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

The regulations enabling the segregation of the cover assets and bankruptcy-remoteness of the CBC are set out in the Dutch Civil and Bankruptcy Codes.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

As explained above, Dutch covered bonds registered by DNB under the Regulation are registered either as UCITS-compliant or as UCITS- and CRD-compliant. Dutch covered bonds which are not registered under the Regulation are neither UCITS- nor CRD-compliant.

It differs per type of investor whether investing in a certain category of covered bonds provides regulatory special treatment. For ease of reference such regulatory treatment is set out in more detail below, focusing on Dutch covered bonds registered under the Regulation:

Dutch covered bond category Type of investor		**UCITS -compliant**	**UCITS- and CRD-compliant**
UCITS and insurers		Higher investment limits	Higher investment limits
Banks and investment firms using:	Standardised Approach	None	- Higher investment limits - Lower risk weighting
	Foundation Internal Ratings Based (IRB) Approach	None	- Higher investment limits - Lower loss given default value
	Advanced IRB Approach	None	Higher investment limits

A further regulatory special treatment which is not reflected in the above diagram, is available to CRD-compliant Dutch covered bonds in the context of banks and investment firms entering into repurchase transactions (repo's) with the Dutch covered bond issuing banks. If the issuing Dutch bank posts its own CRD-compliant covered bonds as collateral under the repo, then such covered bonds qualify as financial collateral under the Solvency Requirements FSA for the purpose of mitigating the credit risk of the bank/investment firm on the issuing Dutch bank as its repo counterparty if such covered bonds are CRD-compliant.

Finally, if Dutch covered bonds are UCITS-compliant, they receive special treatment from the European Central Bank ("**ECB**") in determining their eligibility for monetary policy operations (such as the marginal lending facility to obtain overnight liquidity from national central banks), including:

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

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

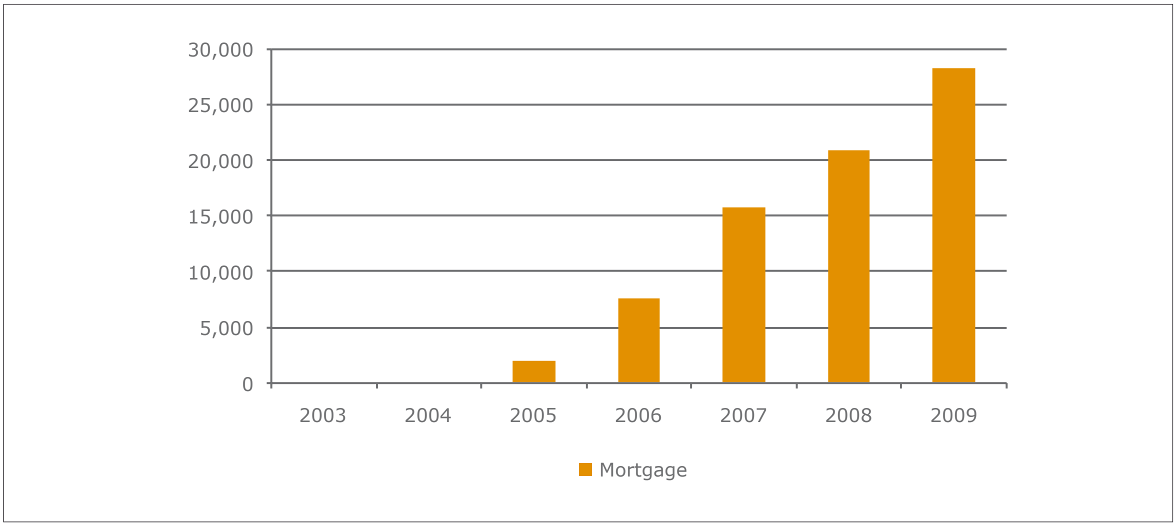
> unlike other asset-backed securities:

(a) they are not eligible for an exemption from the general rule that debt instruments must have a fixed, unconditional principal amount;

(b) they may be backed by credit-linked notes or similar claims resulting from the transfer of credit risk by means of credit derivatives; and

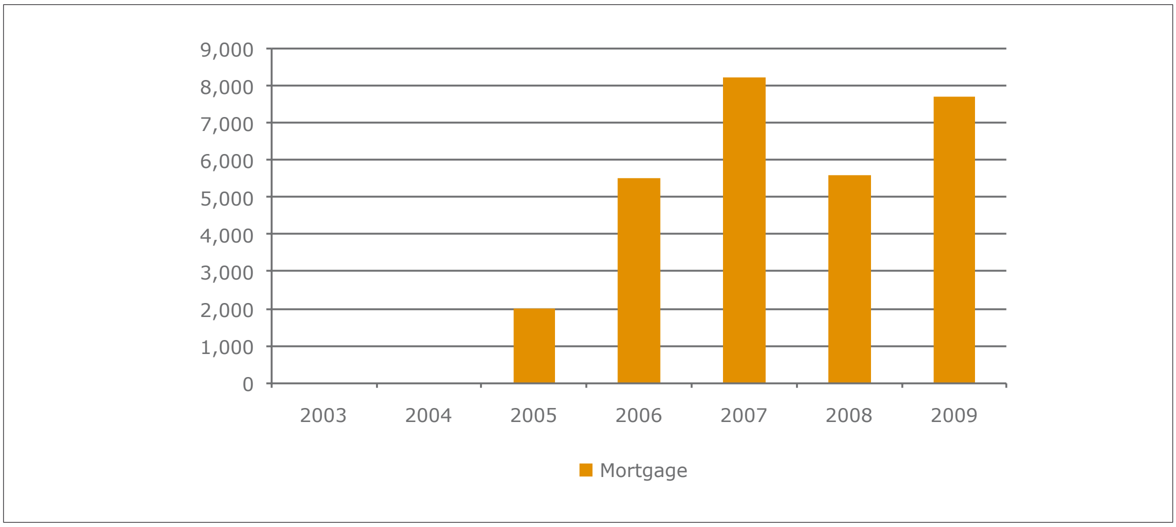
(c) they are exempt from certain true sale requirements. In addition, they are exempt from certain credit quality thresholds. However, these exemptions are of lesser relevance for Dutch UCITS-compliant covered bonds because the Regulation requires a segregated structure as well as a credit rating of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

> Figure 1: Covered Bonds Outstanding 2003-2009, €m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2009, €m



Source: EMF/ECBC

Issuers: There are five issuers in the Netherlands: ABN AMRO Bank N.V., Achmea Hypotheekbank N.V., ING Bank N.V., NIBC Bank N.V. and SNS Bank N.V.. Except for Achmea all issuers are registered at DNB.

3.16 NORWAY

By Bernd Volk, Deutsche Bank

I. FRAMEWORK

The Norwegian covered bond legislation was adopted in June 2007. It was written in close dialogue between the authorities, the financial sector and rating agencies. Thus it is a modern and up to date legislation that provides investors with protection from the cover pool.

The legislation on covered bonds permits only specialised credit institutions to raise loans by issuing covered bonds. These institutions are licensed credit institutions, supervised by The Financial Supervisory Authority of Norway – Finanstilsynet and are subject to the ordinary Norwegian regulation of credit institutions which is in line with the corresponding EU rules.

Already, in Dec 2002 the Norwegian legal framework for covered bonds was established by amendments to the Law on the Financing Business. However, the necessary secondary legislation was only established in 2007. The specialist banking principle, allowing only specialised institutions restricted in their business to issue covered bonds, applies in Norway. These specialized credit institutions, so called Kredittforetak, are limited to origination/holding of eligible assets and refinancing these assets by issuing Norwegian covered bonds. These institutions are licensed credit institutions, supervised by the Financial Supervisory Authority (Kredittilsynet) of Norway, in accordance with European banking legislation. A commercial bank or a savings bank cannot be allowed to issue such bonds in its own name, but has to establish a mortgage institution as a wholly owned subsidiary.

The subsidiary can also be jointly owned by banks (Sparebank1 and Terra). Existing mortgage institutions have to restrict the scope of their business in order to comply with the law. The term 'covered bonds' (Obligasjoner met fortrinnsrett) or literally 'bonds with preferential claim' is protected by law. In line with the UCITS 22(4) requirements, the issuer will be subject to specific public supervision. Issuers have to inform the regulator Kredittilsynet no later than 30 days before the first issue. The regulator may refuse the mortgage credit institution the right to issue covered bonds due to credit quality reasons.

II. COVER ASSETS

Similar to the French and Swedish legal framework for covered bonds, mixed pools of public sector and mortgage assets are allowed.

Eligibility Criteria

The cover pool may only consist of the following assets:

> loans secured on residential property, on a document of proprietary lease of a housing unit or on a certificate showing that the lessee owns a share in the housing cooperative that owns the housing structure of which the unit forms part (residential mortgages), loans secured on other real estate (commercial mortgages);

> loans secured on other registered assets;

> loans to municipalities and loans guaranteed by the State, a municipality or corresponding public;

> body in other states (public sector loans);

> assets in the form of derivative contracts which meet further requirements set in regulations; and
> assets which constitute substitute collateral under the Norwegian law.

Mortgage lending

Eligible mortgage assets are: Loans secured on residential property, on a document of proprietary lease of a housing unit or on a certificate showing that the lessee owns a share in the housing cooperative that owns the housing structure of which the unit forms part (residential mortgages) loans secured on other real estate (commercial mortgages) and on other registered assets. Residential mortgage loans qualifying for the cover pool may be secured on property to a maximum LTV of 75%, commercial loans with 60%. Lending activity is restricted to EEA and the OECD in case of mortgage loans. Loans with a higher LTV are allowed in the cover pool, however only accounted for up to the specified LTV limit. The Norwegian law does not require non-performing loans to be removed from the cover pool. However, only performing loans are accounted for in the matching calculation. LTV's in excess of 75% and defaulted loans create some hidden OC.

Public sector lending

Loans to municipalities and loans guaranteed by the state, a municipality or corresponding public body in other states (public sector loans), assets in the form of derivative agreements which meet further requirements set in regulations. Public sector loans can only be included if they are extended to states or local governments in the EEA or in the OCED. As Norwegian public bodies have very little debt and the banks are not very active in international public sector lending, public sector cover assets will not be important in Norwegian covered bonds.

Property valuation

The valuation of cover assets must be carried out in a prudent manner not exceeding the market value and the assessment must be on an individual basis by an independent valuer prior to their entry in the pool.

MBS/Covered bonds

In accordance with the CRD, RMBS/ CMBS are eligible as cover assets if backed by eligible cover assets qualifying for credit quality step 1 and limited to 20% of the cover pool.

Substitute assets

Only particularly liquid and secure assets may be employed as substitute collateral. Substitute collateral may constitute up to 20% of the cover pool at any and all times (or up to 30% with the consent of the supervisor), and have to be of the same quality as the other cover assets. Claims (exposures) on institutions, etc. as mentioned in the CRD section 5-6, which qualify for credit quality step 1, shall in aggregate not exceed 15% of the nominal value of outstanding covered bonds. Amounts due to operation and management of the cover pool, including settlement of loans, and transfers of payments to preferential creditors shall not be included for the purpose of the 15% limit. The same applies to covered bonds issued by other institutions (fourth paragraph). Claims on institutions within the EEA with a maturity of up to 100 days shall qualify for credit quality step 2 or better.

Taking derivatives in cover

Derivatives are allowed as cover pool assets for hedging reasons, i.e. with the intention to meet the matching requirements. Derivative contracts may be entered into with the following types of counter-party:

1. Clearing houses established in the EEA or the OECD area.
2. States and central banks in the EEA or OECD area 3. Credit institutions established in the EEA or OECD area Derivative counterparties' claims rank pari passu with those of covered bond holders in case of issuer insolvency. Derivatives ensuring the balance principle are allowed to be part of the cover pool. If the derivative agreement is net present value positive, it will be part of the cover pool, if negative, the derivative counterparties will have a preferential claim over the pool, pari passu with the holders of covered bonds.

Transparency requirements

Mortgage credit institutions have to report the register on a regular basis to the Norwegian banking regulator, which checks the adequacy of cash flows, the market risk exposure and the evaluation of cover pool assets. Most issuers regularly publish cover pool data on a voluntary basis.

Cover register

The mortgage institution shall maintain a register of the covered bonds it issues, and of the cover assets assigned thereto, including derivative agreements.

III. COVER POOL MONITOR

The independent cover pool inspector (gransker) has to be appointed by the Norwegian supervisory authority. The inspector checks on a quarterly basis the issuer's compliance with the requirements stipulated in the law and reports directly to the supervisory authority.

IV. COVER POOL RISK MANAGEMENT

Matching requirements

The law establishes a strict balance principle, i.e. the value of the cover pool assets including derivatives must at all times exceed the value of the covered bonds with a preferential claim over the pool. According to the law, loans, interest rates and foreign exchange contracts, and substitute assets, hence the cover pool assets shall be valued at prudent market value. Issued bonds and future interest coupon payments shall be valued at net present value. Accordingly, the fair market value of the cover pool shall at times exceed the net present value of the secured liabilities. On top of this, e.g. DNB NOR Boligkreditt committed itself to nominal matching, i.e. that the nominal value of the cover assets will not at any time be less than the nominal value of the issued covered bonds. 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 will have to adopt strict internal regulations with respect to liquidity, interest rate and currency risk. The law does not explicitly require hedging of all currency risk. However, issuers are expected to fully hedge the currency risk. Issuers of Norwegian covered bonds have to model prepayment risk and if necessary have to build a liquidity reserve. The issuer must also set limits for interest rate risk under the consideration of 100 bp parallel shifts and twists of the yield curve (divided into maturity classes). Also, stress tests for the whole balance sheets are required. The Norwegian legal framework contains a 5% maximum exposure limit to reduce concentration risk. This borrower limit on a cover pool basis is unique in covered bond legislations. Loans to the same borrower and loans secured on the same collateral can only be included up to 5% of the total value of the cover pool. The Norwegian regulator Kredittilsynet can define exceptions to the 5% limit in cases where additional collateral exists.

Although overcollateralization is not explicitly stipulated, the secondary legislation contains some details, clarifying the rather general term "the value of the cover pool shall at all times exceed the value of covered bonds with a preferential claim over the pool". Regarding interest rate risk, a mortgage credit institution may not take greater risk than is prudent at any and all times. The mortgage credit institution is obliged to establish a limit on the interest rate risk resulting from a parallel shift of 100 bp in all interest rate curves and resulting from distortion of the interest rate curve. The limit on interest rate risk applies to each cover pool and to the institution as a whole. In respect to liquidity risk, periodic stress tests are stipulated to document a satisfactory liquidity reserve and that the legal requirements are met. In Section 11 of the secondary legislation, the requirements in respect to the register and the independent inspector are described in detail. A mortgage credit institution has to establish a register of loans, interest rates and foreign currency contracts, substitute collateral and covered bonds for each cover pool. The independent inspector has to check the fulfilment of legal requirements at least quarterly.

Liquidity risk

The mortgage credit institution shall establish a liquidity reserve to be included in the cover pool as substitute collateral. In respect to liquidity risk, periodic stress tests are stipulated to make sure that there is a satisfactory liquidity reserve. With respect to liquidity requirements, section 2-32 of the revised Mortgage Act states that cash flows from collateral assets must at all time meet scheduled payments of the covered bondholders and derivatives' counterparts. Secondary legislation only states that an issuer must not take on more liquidity risk than can be considered 'securely'. Thus, it is up to the separate issuers to set the liquidity limits. On top of this, e.g. DNB NOR committed itself to the cash flow of the cover pool and covered bonds (including redemptions) being positive on a 6 month horizon.

V. COVER POOL BANKRUPTCY RISK

Asset segregation and bankruptcy remoteness

The law explicitly defines the mandatory procedures to be followed in case of bankruptcy and procedures to ensure timely payments. The cover assets remain with the estate in case of bankruptcy, but the bondholders have exclusive, equal and proportionate preferential claim over the asset pool, and the administrator is bound to assure timely payment, provided the pool gives full cover to the said claims. In case of bankruptcy of the issuer an administrator shall be appointed by the court. Bankruptcy or insolvency itself does not give the bondholders the right to accelerate their claims. In case of issuer insolvency, a cover pool administrator (bostyret) is appointed. He has broad legal competences to ensure that the covered bonds and derivative contracts are paid. Together with the creditors' committee, the cover pool administrator can decide to sell cover assets in order to be liquid to repay covered bonds becoming due. If case of need, even new covered bonds may be issued against the separated cover pool. Potential fees and administration costs have to be borne by the cover pool and are senior to the covered bondholders. Only payment default will give the holders of preferential claims the right to declare default. If the cover pool is not sufficient to cover all the preferential claims, the administrator shall declare default of the pool and halt of payments. The cover pool administrator must respect and honour the rights of the bondholders and derivative agreements counterparties.

Preferential claim and bankruptcy remoteness

In the revised act, the preferential right to cover assets is explicitly stipulated. Hence, in case of insolvency of the mortgage institution, the bondholders/derivatives counterparts have a statutory preferential right to the cover pool. As long as covered bonds receive payments in due time, the claimants have no right to declare default. Details about this will be reflected in the individual agreements between the issuer and the trustee of the bondholders. This will also apply to any netting agreement between the company and its counterparties.

Legal protection of OC

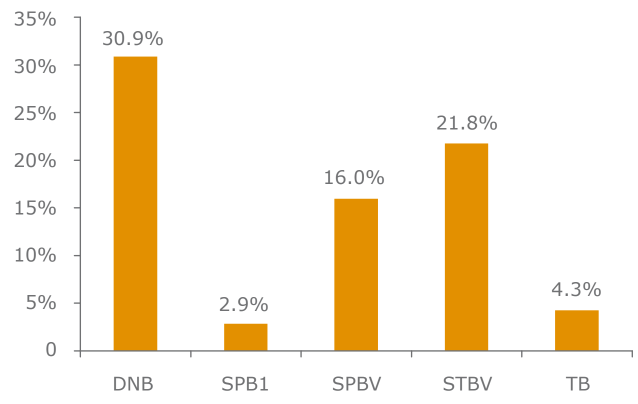
No mandatory overcollateralisation (OC) is stipulated, but any voluntary OC is protected if it is registered in the cover register.

Ratings

Norwegian covered bonds are rated triple A. Most issuers (which are specialised banks) do not have a separate senior bank rating. According to Moody's, all Norwegian covered bonds benefit from a strong legal framework. Moreover, Norwegian covered bonds have extended refinance periods stipulated in their documentation – which should mitigate refinancing risks – and typically benefit from the lowest so called collateral scores in the covered bond market. In case of Fitch, Norwegian covered bonds typically receive a comparably low discontinuity factor showing comparatively high independence from the senior bank rating.

Typically high surplus OC at Moody's (as of Q3 2009) suggests that Norwegian covered bond ratings are comparably well protected.

> Figure 1: Norwegian covered bond ratings at Moody's seem well protected

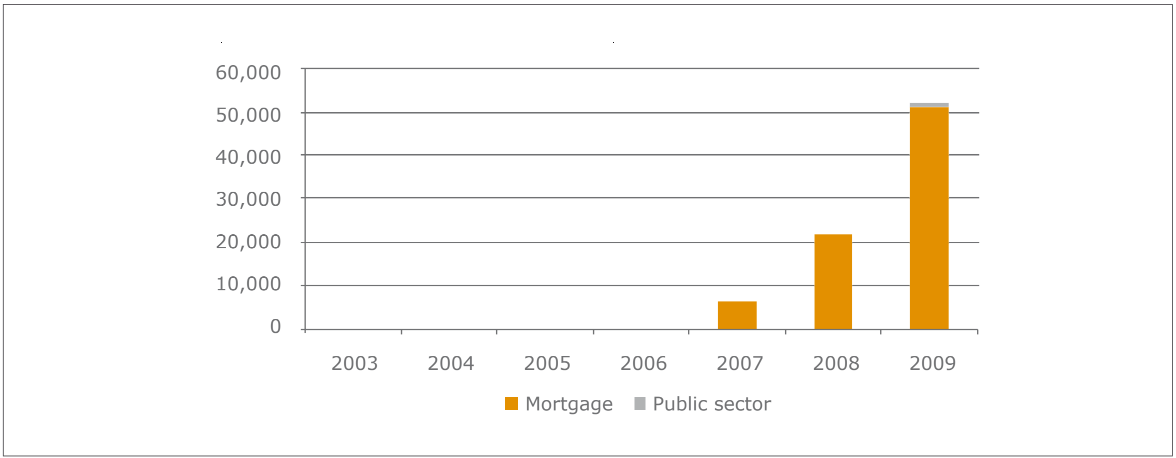


Source: Moody's, as of Q3 2009 performance data; Deutsche Bank

VI. RISK WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

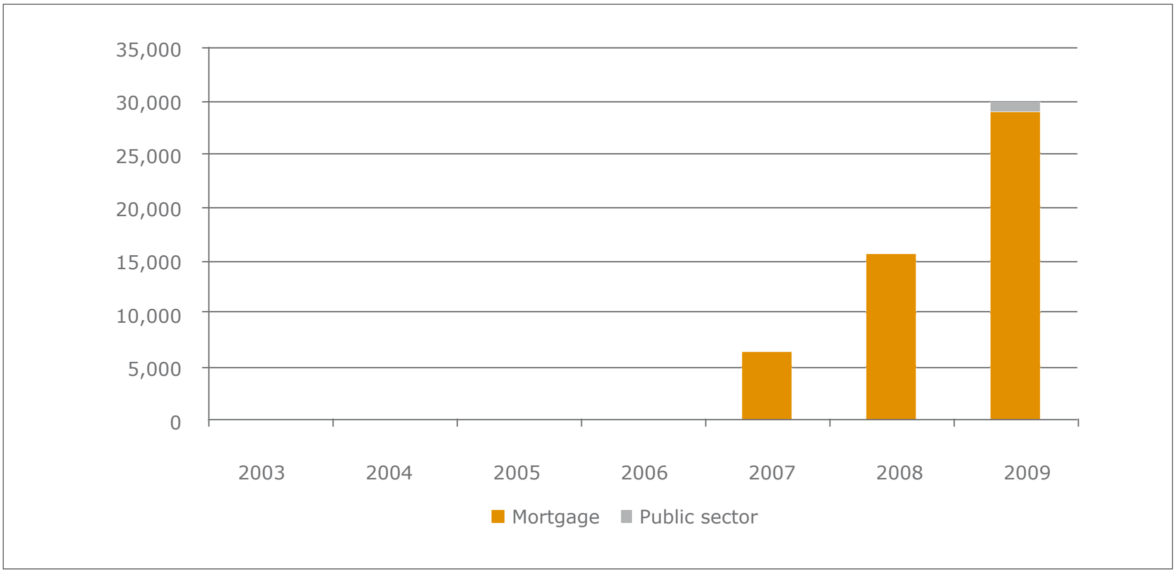
UCITS 22 (4)/CRD is applicable to EEA countries. This is stipulated in article 36 in the contract of the European Economic Area. Besides the UCITS 22 (4), covered bonds have also to fulfil the requirements of CRD to get a privileged risk weighting. In the Norwegian legal framework for covered bonds, lending is geographically restricted according to risk classes. In line with CRD, eligible countries have to be credit quality step 2 (equivalent to a minimum A- rating). In line with the CRD 'credit quality steps' as referred to in the MoF regulation imply the same credit quality steps as referred to in the CRD. Generally, the Norwegian law sticks very closely to CRD. Hence, investors benefit from a privileged risk weighting.

> Figure 2: Covered Bonds Outstanding 2003-2009, €m



Source: EMF/ECBC

> Figure 3: Covered Bonds Issuance, 2003-2009, €m



Source: EMF/ECBC

3.17 POLAND

By Agnieszka Drewicz-Tułodziecka, Mortgage Credit Foundation,
and Piotr Cyburt, BRE Bank Hipoteczny

I. LEGAL FRAMEWORK

The legal basis for covered bond issuance in Poland is "Act on mortgage bonds and mortgage banks" of August 29, 1997; Journal of Laws no. 99, item 919 (List Zastawny Act – hereafter: LZ Act). There is also a special chapter concerning bankruptcy of mortgage banks in the new Bankruptcy Act - *Art. 442 – Art.450* - Bankruptcy and Reorganisation Law of 28th of February 2003.

II. STRUCTURE OF THE ISSUER

The issuer is a specialised mortgage bank, licensed by the National Bank of Poland.

A mortgage bank may only engage in the activities specified in the LZ Act.

According to the Art. 12 LZ Act, **the core operations** of mortgage banks include:

1) granting credits secured with mortgages;
2) granting loans not secured by mortgage, only if the borrower, guarantor or underwriter of a loan repayment to its full amount, including the interest due, is the National Bank of Poland, Central European Bank, governments or central banks of the European Union states, Organisation for Economic Cooperation and Development, excluding those countries, which are or have been for the past 5 years restructuring their foreign debt, or by means of a guarantee or security granted by the State Treasury;
3) acquisition of other banks' receivables on account of loans granted by them, secured by a mortgage and receivables on account of credits not secured by a mortgage, granted to the entities of the local self-government;
4) the issue of mortgage bonds the base of which constitute the Bank's receivables on account of the granted loans secured by a mortgage or purchased receivables of other banks on account of the loans granted by them secured by mortgage;
5) issuing public mortgage bonds on the basis of:
   a) the mortgage bank's receivables arising from its credits not secured by mortgages referred to in point 2);
   b) purchased receivables of other banks arising from their credits not secured by mortgages referred in point 2).

According to the article 15 LZ Act, **apart from core operations** referred to in Article 12, mortgage banks may engage in the following activities:

1) accepting term deposits;

2) taking credits and loans;

3) issuing bonds;

4) safekeeping securities;

5) purchasing and taking up shares and stocks of other entities whose legal form limits the liability of a mortgage bank to the sum invested insofar as it helps the performance of activities of a mortgage bank, where the total value of purchased or taken up shares and stocks may not be higher than 10% of the mortgage bank's equity;

6) keeping bank accounts for servicing investment projects financed through credits granted by a mortgage bank;

7) providing consulting and advice with respect to the property market, including help in establishing the mortgage lending value of the property;

8) managing receivables of a mortgage bank and other banks arising from credits referred to in Article 12 LZ Act, as well as granting these credits on behalf of other banks on the basis of relevant cooperation agreements.

All the listed activities may be executed also in foreign currencies upon obtaining relevant authorizations.

Under the LZ Act, the range of activities that can be performed by mortgage banks is specified in a closed catalogue as mentioned above. Particularly, mortgage banks cannot collect deposits of individual saver. The narrowing of activity of mortgage banks facilitates the development of a simplified and clear activity structure (which facilitates supervision, especially external one), the specialization of the loan division and an improvement in methods of credit risk assessment in the field of real (estate) property financing. Due to the above limitations, funds resulting from the issue of mortgage bonds are mainly used towards the financing of the lending activity.

The issuer holds the cover assets on his balance sheet. The covered bonds are direct, unconditional obligations of the issuer.

III. COVER ASSETS

All covered bonds must be fully secured by cover assets. There are two specific classes of the covered bonds: *hipoteczne listy zastawne* (mortgage covered bonds) and *publiczne listy zastawne* (public covered bonds); registered in two separate cover registers.

a. The cover register for mortgage bonds.

The LZ Act provides for a cover register for the mortgage assets, which will be used in the cover pool for the mortgage covered bonds.

There is also a provision for substitute assets, which is limited to 10% of the cover pool and come from the asset categories below:

(i) in securities issued or guaranteed by the National Bank of Poland, European Central Bank, governments or central banks of European Union Member States, OECD(with the exclusion of states which are or were restructuring their foreign debt in the last 5 years), and the State Treasury;

(ii) in the National Bank of Poland;

(iii) in cash.

In addition, receivables secured by mortgages established on buildings which are in construction phase may not in total exceed 10% of the overall value of mortgage-secured receivables in the cover pool. Within this limit, the receivables secured by mortgages on construction plots in compliance with the land use plan, may not exceed 10% (Art. 23 of LZ Act).

b. The cover register for public covered bonds.

A public bond is a registered or bearer security issued on the basis of receivables of a mortgage bank arising from:

1) credits within the secured part with due interest, a guarantee or surety of the National Bank of Poland, the European Central Bank, governments or central banks of the EU Member States, the Organisation for Economic Cooperation and Development, except for states which are currently in the process of restructuring of restructured their foreign debts during the last 5 years, as well as a guarantee or surety of the State Treasury in accordance with provisions of separate laws; or
2) credits granted to entities listed in point 1); or
3) credits in the secured part with due interest, a guarantee or surety of local government units and credits granted to such local government units.

In regard to collateral location, mortgage collateral is restricted to mortgages against the right of perpetual usufruct or the right of ownership to a property situated in Poland are eligible for the cover. For public covered bonds, there is a wider scope and includes the following countries and institutions as eligible for the cover: National Bank of Poland, the European Central Bank, governments or central banks of the EU Member States, the OECD, except for states which are currently in the process of restructuring of restructured their foreign debts during the last 5 years, as well as a guarantee or surety of the State Treasury.

IV. VALUATION AND LTV CRITERIA

The mortgage lending value of real estate is determined under the LZ Act. The mortgage lending value of real property is determined prudently, with due diligence, on the basis of an expert opinion prepared by the mortgage bank or entities with appropriate real estate appraisal qualifications commissioned by the mortgage bank. The mortgage lending value can not be higher than the market value of the real estate.

There are special banking supervisory regulations, which stipulate in details the assessment of the mortgage lending value and impose on the bank a duty to have a database for real estate prices.

The LTV limits are as follows:

- single Loan to Value of Security limit: not more than 100% of mortgage lending value (Art 13.2 LZ Act)
- portfolio bonds o/s to Value of Security limit: max. 60%, to refinance 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 Art. 18 of the LZ Act:

1. The total nominal value of all outstanding mortgage bonds shall not exceed the sum of nominal amounts of the bank's receivables secured with mortgages, which form the basis for the mortgage bond issue.
2. The bank's income from interest on its mortgage-secured receivables, referred to in paragraph 1, may not be lower than the amount of the bank's payable interest on outstanding mortgage bonds.

The Act also ensures a suitable monitoring, according to the article 25: A mortgage bank shall keep a mortgage cover account to ensure compliance, in the long term perspective, with the requirements referred above.

Additionally, according to the internal policy of each mortgage bank, the internal limits are set using management's experience in a development bank as reference.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

According to the art. 31 LZ Act, the cover pool monitor (*powiernik*) maintains ongoing supervision of the management of the mortgage cover register.

The cover pool monitor should ensure that:

1) commitments pertaining to the outstanding mortgage bonds are at all times covered by the mortgage bank in compliance with the provisions of LZ Act;
2) the mortgage lending value of the property adopted by the mortgage bank has been established in accordance with the regulations referred to in Article 22, paragraph 2; the cover pool monitor shall not be required to investigate whether the mortgage lending value of the property corresponds to its actual value;
3) the mortgage bank observes the limits laid down in Article 18 LZ Act; the cover pool monitor shall promptly inform the Banking Supervisory Commission of any cases of non-compliance by the mortgage bank with these limits.
4) the manner in which the mortgage bank keeps the mortgage cover register is in compliance with this Act;
5) the mortgage bank ensures appropriate cover for planned mortgage bond issues in accordance with the provisions of this Act, and proper control of appropriate entries in the mortgage cover register.

In order to perform tasks referred to in Article 30 LZ Act, the cover pool monitor shall have the right to inspect accounting books, registers and other bank documents at any time.

In matters not regulated by the LZ Act, supervision over mortgage banks shall be exercised in compliance with the Banking Law and the regulations on the National Bank of Poland (NBP). The NBP regularly checks the cover assets.

The Banking Supervisory Commission may commission an independent expert at the expense of the inspected mortgage bank to inspection of the appropriateness of the mortgage bank's entries to the mortgage cover register. This would also including establishing the mortgage lending value of the property was in compliance with the rules referred to in Article 22, paragraph 5 LZ Act.

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

The Act of 28 February 2003 – Bankruptcy and Rehabilitation Law (Journal of Law no. 60 item 535) contains separate chapter: Chapter II - Bankruptcy proceedings for mortgage banks – Articles 442-450.

In case of bankruptcy of the mortgage Bank, the claims, rights and means referred to in Article 18.3 and 18.4 of LZ Act, recorded in the mortgage bonds cover register, shall constitute a separate bankruptcy estate, which shall serve in the first place to satisfy the claims of mortgage bond creditors; after satisfying the mortgage bonds creditors, the surplus of the assets of the separate estate shall be allocated to the bankruptcy estate.

In declaring the bankruptcy, the court appoints a curator (*kurator*) who represents the rights of covered bond holders in the bankruptcy proceedings. Before the appointment of the curator, the court seeks an opinion on the proposed curator of the Banking Supervisory Commission (Art. 443.1. of the Bankruptcy and Rehabilitation Law).

The following order shall apply to the satisfaction from the separate bankruptcy estate:

> the costs of liquidation of this estate, including also the remuneration of the curator,

> the amounts due to the mortgage bonds per their nominal value,

> interest (coupons).

In case that the separate bankruptcy estate does not fully satisfy the mortgage bondholders, the remaining balance shall be satisfied from the whole bankruptcy estate funds; with that sum the curator shall vote when the arrangement is being adopted – according to article 449 of the Bankruptcy and Rehabilitation Law: *If the separate estate is not sufficient for full satisfaction of covered bond holders, the remaining sum is satisfied from the distribution of the funds of the bankrupt estate; with this sum the curator votes in the signing of the arrangement; he has one vote for each sum resulting from dividing the sum of all other claims of those entitled to vote by the number of creditors representing these claims. The sum earmarked for the satisfaction of covered bond holders is moved from the funds of the bankrupt estate fund to the funds of the separate bankrupt 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 art. 446 Bankruptcy Act – The declaration of bankruptcy of a mortgage bank does not infringe maturity dates of its obligations towards covered bond holders. It means that the covered bonds do not accelerate.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Covered bonds are risk weighted 20%.

Polish "list zastawny" meets the criteria of UCITS 22(4) as well as of the CRD Directive, Annex VI, Paragraph 65 a) to f), so hopefully soon the Polish covered bond will be weighted 10%. In July 2008, the Polish Ministry of Finance sent a letter to the EU Commission to report that the "list zastawny" fulfils the criteria of Art. 22 (IV) of the UCITS Directive.

In Poland, the investment regulations pertaining to the limits for covered bonds are as follows:

> Banks – no limits

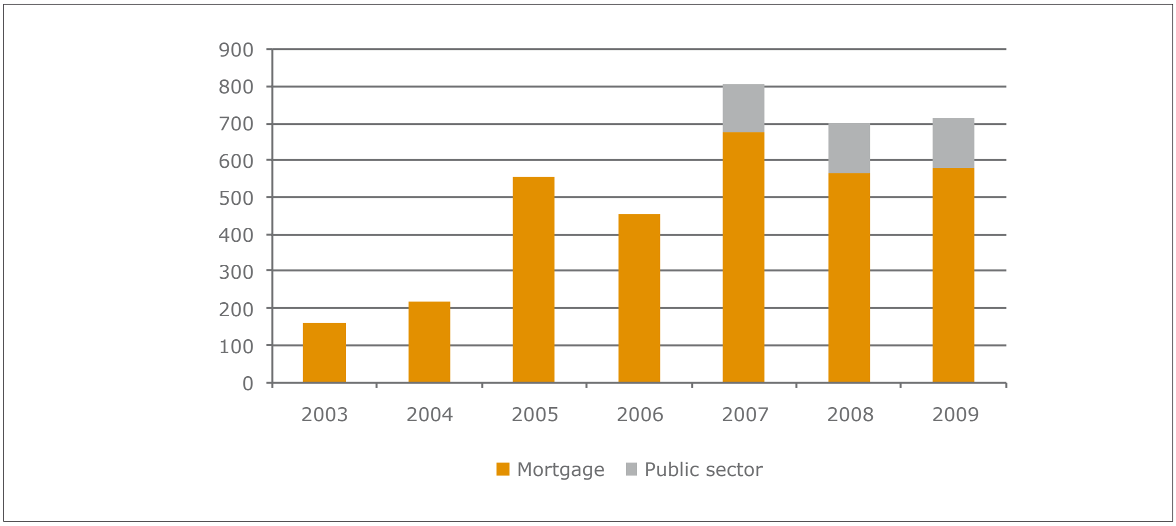
> Insurance companies – up to 40% of technical-insurance reserves – insurance companies (10% in covered bonds which were not allowed to public trading)

> Investment funds – open: 25% of the assets may be invested in covered bonds issued by one mortgage bank; but: total investments in covered bonds may not exceed 80% of the fund's assets and total value of investments in securities or in monetary market instruments, issued by the same mortgage bank, deposits in that entity, as well as the total value of risk connected with the transactions on non-standardised derivatives, which were dealt with that bank, can't exceed 35% of the fund's assets.

> Pension funds up to 40% of the total asset value.

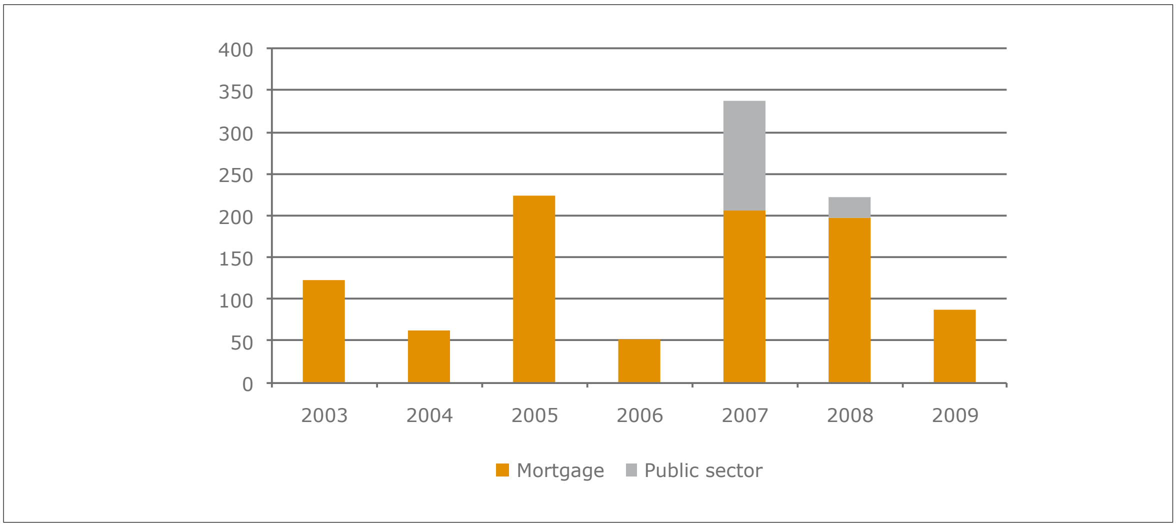
Only the specialised mortgage banks are entitled to the issue of the "list zastawny" (the Polish covered bond). The current "list zastawny" issuers are: BRE Bank Hipoteczny S.A., BPH Bank Hipoteczny S.A. and ING Bank Hipoteczny S.A.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2009, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2009, €M



Source: EMF/ECBC

3.18 PORTUGAL

By Alda Pereira
Caixa Geral de Depósitos

I. FRAMEWORK

In Portugal, the legislation on Covered Bonds (Obrigações Hipotecárias and Obrigações Sobre o Sector Público) is regulated by Decree-law no. 59/2006 of March 20th 2006 and complemented by secondary legislation – Notices and Regulatory Instruments of the Central Bank (Avisos e Instruções), which address issues such as the segregation of assets from the insolvent estate in case of issuer insolvency, the compliance of asset and liability matching and mortgage valuation methodology.

The exemption of withholding tax for non-resident investors for bonds issued by Portuguese entities was passed in November 2005 (Decree Law n. º 193/2005).

II. STRUCTURE OF THE ISSUER

Obrigações Hipotecárias and Obrigações Sector Público may be issued by credit institutions legally authorised to grant credits guaranteed by mortgages on real estate and with own funds amounting to no less than 7 500 000 euros. These credit institutions are either universal banks or special issuance entities – Mortgage Credit Institutions (MCI).

If the issuer is a universal bank, a direct issue will take place with the cover assets remaining on its balance sheet. If the issuer is a MCI, its authorised business activity is restricted to the granting and acquisition of credits guaranteed by a mortgage or loans of the central government, regional or local authorities or credits guaranteed by these entities. They may also undertake the management of assets that have been repossessed from credits in default, and undertake the activities necessary to obtain additional liquidity and adequately manage the pool.

Assuming the MCI is wholly-owned, the asset originator then transfers the cover assets to this institution and the assets and liabilities will consolidate on the originator's balance sheet. However, it is also possible for the MCI to have multiple owners and, in this case, the assets may or may not consolidate back to the originator.

Considering the MCI has a limited business activity which only makes sense within the context of Covered Bond issuance, one could expect the MCI to be a 100% owned subsidiary and, as such, act as a complement to the originator's business and funding activity. In this sense, it seems reasonable to expect that it could draw on the parent company's resources to operate.

However, the Bank of Portugal will always determine, on a case by case basis, the necessary conditions that must be met in order to set up an MCI.

III. COVER ASSETS

Credit mortgage loans are eligible as collateral for mortgage Covered Bonds i.e. credits guaranteed by first ranking mortgage loans. Second mortgage loans can be assigned to the pool if the first mortgage loan was previously assigned as well – therefore both loans are attached to the same property, provided that the total amount of these loans does not exceed the maximum Loan to Value (LTV) permitted.

Public sector assets are eligible as collateral for Public sector bonds i.e. loans granted to the central governments, regional or local authorities or guaranteed by these entities.

The Law specifies that the registration of the assets must assure mortgage credit and public sector segregation. This means that separated pools will have to be set up.

Substitution assets (up to 20%) can be included in the pool:

> Deposits with the Bank of Portugal in cash, government bonds or other eligible bonds (ECB Tier 1 assets)[1];

> Deposits in other credit institutions rated at least "A-";

> Other low risk and high quality assets – if necessary, to be defined by the Bank of Portugal.

Even thought, at first look, it would seem that OH would not meet all the requirements of the CAD since Portuguese law allows for substitution assets up to a limit of 20% of the pool, this cannot be considered per si. In fact, Bank of Portugal's regulation establishes that the pool can only trade with credit institutions qualifying for credit quality assessment step 1 and that the aggregate risk positions cannot exceed 15% of the aggregate nominal value of the outstanding covered bonds or public sector covered bonds.

The geographical scope of eligible assets is restricted to loans guaranteed by first lien mortgages on property located in the European Union (EU) or loans granted to the central governments and regional or local authorities located in an EU member state.

Derivatives contracts are permitted in the cover pool for hedging purposes, namely to mitigate interest rate, exchange rate and liquidity risks. The transactions involving derivatives, must be executed in a regulated market of a Member State of the European Union, in a legally established exchange of a full member of the OECD, or entered into with a counterparty that must be a credit institution rated "A-" or above. The legal documentation (agreement between the parties) should be standard, however this will have to safeguard the preferential claim for the counterparty. If the currency of the issue is not in EUR, the use of exchange rate derivative contracts is mandatory in order to hedge the inherent risk of the issue.

The cover pool is dynamic while the originator is solvent and issuers are required to maintain a record of all the assets in the cover pool, including derivatives contracts.

IV. VALUATION AND LTV CRITERIA

The value of the mortgaged asset[2] is the commercial value of the real estate, considering:

> Sustainable characteristics over the long term;

> Pricing under normal market conditions;

> The peculiarities of the local market;

> The current and alternative uses given to the mortgage asset.

The value of the mortgage asset ascertained by the issuer cannot be superior to its market value, which is the price that the object could be sold at the time the appraisal is made. This assumes that the real estate is placed on sale and that market conditions allow for a regular transmission of the mortgaged asset within an adequate timing.

1 Notice n.º 6/2006

2 Notice n.º 5/2006

The property appraisal should be carried out by an independent appraisal specialist, previous to the respective mortgage credits being assigned to the Covered Bond pool.

Appraisals already carried out by a property appraisal expert are also accepted as long as the following conditions have been met:

> Appraisals have been carried out by an expert independently of the credit analysis and decision process of the bank;

> Appraisals have been documented in a written report that includes, in a clear and rigorous form, the elements that allow for an understanding of the analysis conducted and the conclusions arrived at by the expert;

> The property was appraised from a market value perspective or a property value perspective as defined in the law;

> There is no evidence that the property appraisal, arrived at from the perspective above mentioned, was overvalued at the time the loan was assigned to the Covered Bond pool.

The value of the mortgaged property must be checked by the institution on a periodic basis, at least every three years for residential mortgages and at least once a year for commercial properties. More frequent checks must be carried out if market conditions are prone to significant changes.

In order to check the value of the mortgaged property or to identify those properties that require periodic appraisal by an expert, the institution may use indices or accepted statistical methods that it considers appropriate. When indices or statistical methods are employed, the credit institution must submit to the Bank of Portugal a report detailing the foundations for the use of those indices or statistical methods along with an opinion on their adequacy by an external independent appraisal specialist.

Property appraisal must be revised by an expert whenever there is relevant information that indicates that a substantial reduction of the asset value has occurred or that the asset value relative to the general trend of the market has declined significantly.

For loans that exceed 5% of the institutions' own funds or exceed €500.000 for residential mortgages and €1 million for commercial mortgages, the appraisal must be carried out at least every three years.

Revision of the value of an asset must be documented by the credit institution, in a clear and rigorous way, namely a description of the criteria and frequency of such a revision.

The property appraisal should be carried out by an independent appraisal specialist, with qualifications, competency and professional experience to perform this function.

The appraisal specialist is deemed not to be independent if he is in a situation susceptible of affecting his unbiased opinion, namely if he has any specific interest in the real estate being appraised or any relationship - commercial or personal - with the debtor, or if his compensation is dependent on the appraisal value of the property. The appraisal specialist may belong to the institution; however, he must have independence from the credit analysis and decision process.

The selection of the appraisal specialist by the institution must assure both diversification and rotation, and the credit institution has to maintain an updated list of the selected appraisal specialists, identifying the criteria justifying their selection and the real estate appraised by each specialist.

This list should be sent to the Bank of Portugal until the end of January of each year, reporting up to the 31st of December of the previous year, and indicate any changes from the last report. If there are any doubts on the performance of the appraisal specialist, the Bank of Portugal can refuse to accept the valuations, demanding the appointment of another appraisal specialist by the credit institution.

When choosing the appropriate method, the appraisal specialists should consider the specific characteristics of the real estate and its local market. The appraisal of the real estate performed by the specialist should take the form of a written report and include all the elements that allow for an understanding of the analysis carried out and conclusions arrived at.

The maximum loan to value accepted for assets to be eligible into the pool is 80% for residential mortgages and 60% for commercial mortgages loans.

V. ASSET - LIABILITY MANAGEMENT

There are various asset and liability matching requirements established in the decree-law:

> The global nominal value of the outstanding mortgage bonds cannot exceed 95% of the global value of mortgage credits and other assets at any point in time assigned to the bonds (i.e., mandatory overcollateralisation of 5.2632%);

> The average maturity of outstanding mortgage bonds can never exceed the average life of the mortgage credits and substitution assets assigned to the issues;

> The total amount of interest to be paid by the mortgage bonds shall not exceed, at any point in time, the amount of interest to be collected from mortgage credits and other assets assigned to the bonds – cash flows from the cover pool must all be sufficient to meet all scheduled payments due to Covered Bond holders.

The law also promotes a sound cover pool management by allowing the issuer to apply the funds (for example, funds received from early repayment) to other assets and assign new mortgages to the pool. This option allows issuers to avoid potential cash-flow mismatches. It is also possible for issuers to establish a credit facility to provide for liquidity. This credit facility counterparty is required to have a minimum credit rating of "A-".

Issuers may use derivatives contracts to hedge the interest and exchange rate and liquidity risks. The derivatives are included in the cover pool and derivative counterparties – who also benefit from preferential claim - have to be rated "A-"or above.

If the limits defined in the Decree Law are exceeded, the issuer shall immediately resolve this situation by assigning new mortgage credits, purchasing outstanding bonds in the secondary market and/or assigning other eligible assets. These will, in turn, be exclusively assigned to the debt service of the bond.

Regarding these matters, the secondary legislation[3] determines the application of the following criteria:

> Loans must be accounted according to their outstanding principal, including matured interest;

> Deposits shall be accounted according to their amount including accrued interest;

3 Notice n.º 6/2006

> Interests eligible for Eurosystem credit transactions shall be accounted according to the value resulting from the rules regarding valuation margins defined by the Eurosystem or, if lower, according to its nominal value, including accrued interest;

> Covered Bonds and public sector Covered Bonds shall be accounted according to the corresponding outstanding principal, including accrued interest.

Interest rate or FX derivatives must be accounted in accordance with their market value and in the event that the corresponding loans and other substitute assets are denominated in different currencies, the issuer must ensure hedging of the relevant currency risk, and the reference exchange rates published by the European Central Bank shall be used for this purpose.

Single name risk is also addressed. The aggregate in risk positions with credit institutions – excluding those with a residual maturity date of 100 days or less – cannot exceed 15% of the aggregate nominal value of the Covered Bonds or public sector Covered Bonds outstanding.

The actual amount of the liabilities arising from the issuance of mortgages Covered Bonds or public sector Covered Bonds cannot be higher than the actual amount of the portfolio allocated to such bonds, taking into account any derivative instruments put in place. The ratio established shall be able to comply even when 200 basis points parallel movements of the curve are considered.

Each issuer must deliver in writing the specific and individual policies in written form for risk management, namely exchange risk, liquidity risk, interest rate risk, counterparty risk and operational risk and any other procedures aimed at ensuring compliance with the applicable regulatory regime and with any devised risk limitation policies set by the Issuer.

The Bank of Portugal may also make use of its regulatory role to require additional steps by the issuers to meet with all the asset-liability criteria that it sets out.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The Board of the issuer will appoint an independent auditor who must be registered with the Portuguese Securities Commission, with the task of defending the interests of the bondholders and verifying the compliance to applicable legal and regulatory guidelines. An annual report must be published. The Bank of Portugal will review its content and may make use of its regulatory role to request additional information[4].

In the law, there are no specific rules on the cover pool monitor's responsibility. General rules on civil and contractual responsibility apply. The cover pool monitor will only be liable in case it does not comply with rules applicable to its activity or with its contractual obligations. If the cover pool monitor has complied with all its obligations it will not be liable in case the issuer has not respected the applicable regulation.

Also, a bondholders' joint representative – common to all mortgages or public bond issues – is to be appointed by the Board of Directors of the issuer in order to represent the interest of the bondholders and supervise the cover pool.

The Bank of Portugal and the Portuguese Securities Commission (CMVM) are responsible for banking and capital markets supervision. The law grants powers to the Bank of Portugal to regulate and supervise the issuers of Covered Bonds, so they must comply with the requirements of the law and all applicable

4 Regulatory Instrument n.º 13/2006

regulations. Non-compliance by the issuer could imply the application of fines and other sanctions and, ultimately (in a worst case scenario) could determine the revocation of the issuer's licence.

Additionally, the Bank of Portugal has been granted powers to control compliance of the applicable rules for as long as the bonds remain outstanding, namely it may:

> Refuse asset valuations made by a valuation's expert if it has doubts concerning its performance, and demand to the issuer its replacement;

> Require new asset valuations by different experts; and

> Ask for clarifications or additional documents concerning all reports required and received.

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

Preferential status for Portuguese Covered Bonds holders and bankruptcy remoteness

Holders of Covered Bonds benefit from special preferential claim over the assets assigned to the issue, with precedence over any other creditors - the Covered Bond law supersedes the general bankruptcy regulation – for the redemption of principal and payment of interest.

The mortgages that guarantee these credits prevail over any real estate preferential claims. The derivatives contracts are part of the pool and derivatives counterparties rank pari passu with bondholders in terms of preferential claim over the assets in the pool, and consequently, their contracts are not expected to be called in case of insolvency of the originator.

Despite the absence of a direct link between the cover assets and the outstanding Covered Bond issuance, there is a legal provision that links the cover pool to the payment of capital and interest on the Covered Bonds thus rendering Covered Bonds direct, unconditional obligations of the issuer. The issuer of Covered Bonds holds the claims on the cover assets and these, in turn, will guarantee the Covered Bonds until all payments due to bondholders have been met.

If the issuer becomes insolvent, cover assets form a separate legal estate – a pool that is to be administered in favour of the Covered Bondholders, and consequently there is no automatic acceleration of the mortgage bonds.

However, bondholders may convene a bondholders' assembly and may decide by a majority of 2/3 with regard to the outstanding bond volume to call the mortgage bonds, in which case, the administrator shall provide for the liquidation of the estate assigned to the issues and thereafter the payment of creditors in accordance with the provisions defined in the decree-law.

If the cover assets are not sufficient for the Covered Bonds, bondholders and derivative counterparties will rank pari passu with any common creditors of the issuer in relation to all other assets of the issuer (not included in the cover pool), after all guaranteed and privileged creditors have been duly paid up, for the payment of the remaining debt due to them.

Asset segregation

The assets – mortgages loans or public sector loans and substitute assets – and derivative contracts assigned to the issues are held by the issuer in separated accounts – cover register – and can be identified under a codified form. This information is deposited in the Bank of Portugal in the form of a code key.

The Bank of Portugal regulates the terms and conditions by which the bondholders will have access to such key in case of default[5].

The legal effect of registration is to segregate those assets from the insolvent estate over which bondholders will have a special claim in case of insolvency/bankruptcy. In this situation the assets pledged to one or more issues of mortgage bonds will be separated from the insolvent estate for the purpose of its autonomous management until full payments due to the bondholders have been met. Despite this, the law stipulates that timely payments of interest and reimbursements should continue. In that way, cover assets form a separate legal estate, a pool administered in favour of the Covered Bondholders.

In an insolvency situation of the issuer two situations may occur:

> The issuer voluntarily assumes that it is insolvent and will present a project to the Bank of Portugal pursuant to article 35.-A of the Credit Institutions General Regime, containing the identification of the credit institution that will be appointed to manage the cover pool, together with the terms under which those services will be rendered;

> The revocation of the authorisation of the issuer with outstanding Covered Bonds or public sector Covered Bonds takes place, and the Bank of Portugal shall appoint a credit institution[6] to undertake the management of the cover pool.

The cover pool will be managed autonomously by this credit institution, which should prepare, immediately upon initiating its management, an opening balance sheet in relation to each autonomous portfolio and relevant bonds, supplemented by the necessary explanatory notes and should perform all acts and deals necessary for a sound management of the loan portfolio and its guarantees with the aim of ensuring a timely payment on the Covered Bonds, including selling credits, assuring their servicing all administrative procedures pertaining to these credits, the relationship with the debtors, and all modifying and extinguishing acts relating to their guarantees and must carry out and keep updated a registry, in off-balance sheet accounts, the details of the cover pool, in the terms set forth in the Decree-law no. 59/2006.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

According to secondary legislation, stated in the notice of Bank of Portugal[7], and in compliance with Basel I, Article 22(4) of UCITS, a 10% risk-weighting can be applied for Covered Bonds issued within the scope of the Portuguese jurisdiction, as well as to Covered Bonds that already benefit from a 10% risk-weighting in their home country. The risk-weighting of derivatives that are included in the cover pool will be 20%. Investment funds can invest a maximum of 25% of their own funds in a single issuer's Covered Bonds.

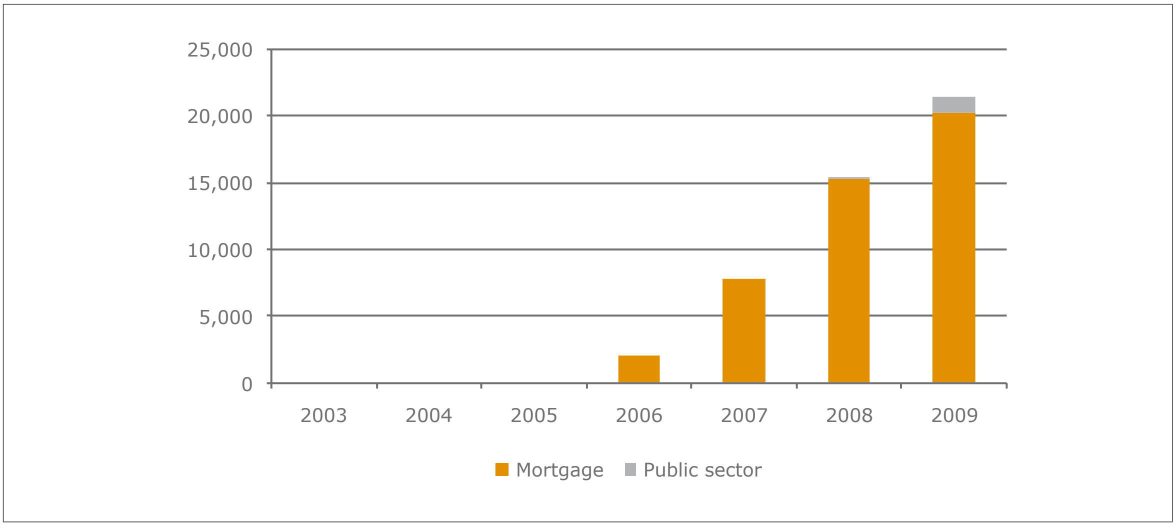
Portuguese Covered Bonds also meet the requirements of the Annex 6 of CRD of June 2006.

5 Notice n.º8/2006

6 Designated Credit Institution

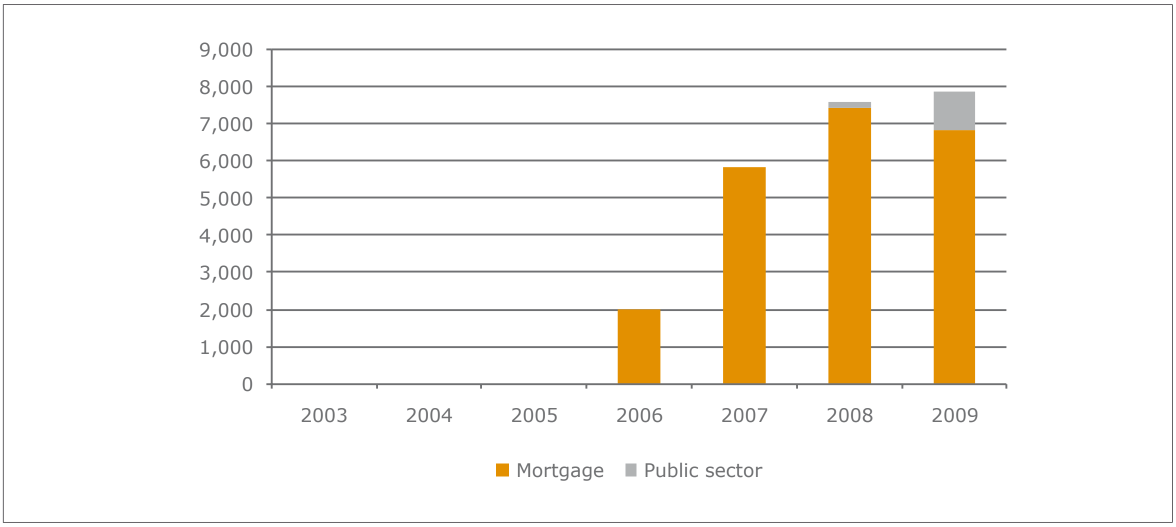
7 Notice n.º7/2006

> Figure 1: Covered Bonds Outstanding 2003-2009, €m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2009, €m



Source: EMF/ECBC

Issuers: There are 6 active issuers in Portugal: Milleniumbcp Banco Comercial Portugues, Banco Espirito Santo, Banco Portugues de Investimento, Caixa Económica Montepio Geral, Caixa Geral de Depositos and Santander Totta.

DEVELOPMENTS IN THE PORTUGUESE COVERED BOND MARKET

2009 was a strong year for jumbo covered bonds when compared to the previous year, mainly boosted by the Covered Bond purchased programme launched in May by the ECB which opened the primary market to nearly all countries and issuers and supported the stabilization of levels in the secondary market. Despite the turmoil that continued to be felt in the market, the ECB showed its confidence in the overall covered bond market by valuing its intrinsic characteristics and safety.

Consequently, between May and September, the regular working of the covered bond markets improved permitting financial institutions to fund themselves in it to a greater extent than during the crisis that characterized the year 2008 and the first 4 months of 2009.

During 2009 and the beginning of 2010, issuance in the Portuguese covered bonds primary market took the form of longer dated bonds in comparison with the previous years. This indicates that Portuguese covered bonds remained a good option for those investors who opted to put their money into safe assets since risk aversion remained very high. Also, the performance of the Portuguese real estate market which showed stable evolution, provided evidence that it was not as overvalued as other markets.

Throughout 2009, all six major Portuguese banks went to the market, issuing a total of 6 new jumbo covered bonds in the amount of Eur 6 billions, of which Eur 5 billions were Obrigações Hipotecárias (mortgages covered bonds issues) with a weighted average maturity of 4.75 years. Caixa Geral de Depósitos was the exception as it issued its inaugural Public Sector covered bond jumbo (Obrigações sobre o Sector Público) with a maturity of 5 years.

In the 1st trimester of 2010, Banco BPI, CGD e Banco Santander Totta tapped the Jumbo market again with public issues in the amount of Eur 1 billion each: On the 7th of January 2010, Banco BPI launched a 5 years jumbo mortgage covered bond issue, on the 10th of January 2010, Caixa Geral de Depósitos offered its 3rd mortgage bonds under its Programme with a maturity of 10 years and on the 29th of March Banco Santander Totta also launched a 3 years mortgage issue.

In April 2010, Obrigações Hipotecárias and Obrigações sobre o Sector Público combined achieved an outstanding of €20.15 billion of Jumbo issues (fixed rate issues) with a residual weighted average tenor of 3.72 years.

In the very near future, despite the secondary market being relatively illiquid and driven by concerns about the potential spill over effect from the Euro zone's debt problems which has led investors to be in a risk-reduction mode, we hope to see some improvement in sentiment and to witness a reopening of the market, specially the Portuguese Covered Bond market. We must keep in mind that Portuguese covered bonds are supported by a strong legislation, monitored closely by the supervision authorities and, as such, it constitutes a secured option for Investor's portfolio diversification.

3.19 ROMANIA

By Martin Schweitzer, Erste Group and
Adrian Sacalschi, FHB Bank

I. FRAMEWORK

In Romania, the legal basis for Covered Bond issuance is the Mortgage Bonds Law from March 2006. This law supersedes the general bankruptcy regulation.

The legal framework for covered bonds is currently under revision in Romania. Below we will refer also to some important issues which will be amended.

II. STRUCTURE OF THE ISSUER

The issuer can be only a credit institution (as defined by Romanian Banking Law which is in line with the EU Directive). Therefore, all commercial or mortgage banks may be an issuer and no other special covered bond license is required.

Mortgage banks are credit institutions, but their licensing is limited since these types of credit institutions are not allowed to receive deposits. The National Bank has not yet issued the set of applicable regulations for mortgage banks. Up to date no mortgage bank as such is incorporated under Romanian Law.

Pursuant to the Mortgage Bonds Law, the issuer holds the assets on its balance sheet. The covered bond issuer holds the ownership title over the portfolio. A direct legal link between single cover assets and covered bonds does not exist. All obligations from bonds are obligations of the issuing bank as a whole. However, under the current law there is a legal link between each bond issue and its pool of cover assets. In the event of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved for the claims of holders of the specific bond issue.

Assets servicing may be outsourced, but for covered bonds it is expressly regulated only in case of issuer's bankruptcy.

The covered bonds are direct and unconditional obligations of the issuer. The claims of the holders of covered bonds are secured by a first rank security interest over the cover assets, which are segregated in bankruptcy. Each bond issue is guaranteed by a distinct pool of assets. In the event of bankruptcy, the bonds holders in a specific issue will have first priority over the pool of assets dedicated to the specific issue. *This legislative provision regarding separate cover pools for each covered bond issue will be set aside in the projected new Romanian covered bond legal framework, which is currently under preparation in Romania.*

III. COVER ASSETS

In the case of covered bonds structured under the Mortgage Bonds Law, only mortgage loans (i.e. residential or commercial mortgage loans) can be included in the cover pool. The cover pool could be replenished with other mortgage loans if some of the pledged loans don't fulfil the eligibility criteria anymore. Other eligible assets (besides mortgage loans) will only be used for supplementing the cover pool if the issuer has no other mortgage loans that could be used for such a purpose. The list of these other eligible assets which can be included in a cover pool is to be established by the National Bank.

In terms of derivatives allowed to be included in the cover pool, no special provisions are contained in this respect in the Mortgage Bonds Law. However, the National Bank is entitled to regulate the categories of eligible assets that can be used for supplementing the cover pool in case the issuer has no other mortgage loans. The only restriction in this respect imposed by the Mortgage Bonds Law stipulates that the general maximum ratio allowed for supplementing the portfolio and the substitution of the mortgage loans in a cover pool with eligible assets may not exceed 20% of the portfolio value.

The mortgage loans must fulfil several eligibility or performance criteria imposed by the Mortgage Bonds Law in order to be included in the cover pool:

a. the pool is homogenous comprising of only one type of mortgage loan according to its investment destination;

b. the weighted average of the maturities of the mortgage loans included in the cover pool securing an issue is higher than the maturity of the mortgage bonds secured by such a cover pool; the weighted average of maturities shall be calculated by weighting the outstanding life time of the loans included in the cover pool with the nominal value of the loan as at the date of issue;

c. the updated value of mortgage loans securing an issue of mortgage bonds is to be at least equal with the updated value of the payment obligations of the issuer towards the bondholders;

d. the aggregated value of the mortgage loans secured with mortgages on properties with no constructions built on them and of those secured with mortgages on immovable assets in the process of being built must not exceed 20% of the value of the portfolio;

e. each mortgage loan in the cover pool meets the general eligibility criteria provided by this law and the performing criteria established through the prospectus;

f. the nominal value of a mortgage loan must not exceed, in case of a residential mortgage loan, 80% of the reference value of the immovable asset over which the security interest was created and, in case of a commercial mortgage loan, 70% of the reference value of the immovable asset over which the security interest was created;

g. the amount representing the principal granted through a mortgage loan agreement has been fully disbursed to the beneficiary;

h. the amount granted to a single beneficiary or to a single beneficiary and all affiliated persons of the beneficiary does not exceed 10% of the value of the cover pool;

i. the receivables deriving from the mortgage loans are not subject to a security interest in favor of any other person;

j. the mortgage loan must not register delayed payments exceeding 61 days;

k. the real estate over which a security has been created for the reimbursement of the mortgage loan is insured against all risks for an amount equal with the reference value of the immovable established on the date of the mortgage agreement;

In terms of geographical coverage, the sole restriction imposed under the Mortgage Bonds Law, provides that, in order to be included in the cover pool, the mortgage loans were granted for real estate investments on the territory of Romania or on the territory of member states of the European Union or the European Economic Area.

The Mortgage Bonds Law generally stipulates that the cover pool is static. The replacement of the mortgage loans included in the cover pool is prescribed as an obligation only when certain mortgage loans no longer comply with the eligibility criteria, have become non-performing in the meaning of this law or determine the reduction of the weighted average of the maturities of the mortgage loans included in the cover pool, of the value of the mortgage loans included in the pool or of the interest amount, according to the limits provided by law.

In the projected new Romanian covered bond legal framework it will be possible to have only two cover pools (a mortgage cover pool and a public cover pool), which will be dynamic.

Regarding the **disclosure requirements**, detailed information concerning the assets included in the cover 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 Bond Law stipulates limits for maximum LTVs on both commercial and residential loans at 70% and 80%, respectively. *These are absolute LTVs referring to the loans granted. No provision is made regarding a relative limit. The new Romanian covered bond legal framework will introduce a lending limit of 60%, so that mortgages may be used as cover only up to the first 60% of the value of the mortgaged property.*

V. ASSET - LIABILITY MANAGEMENT

The Mortgage Bonds Law stipulates that the net present value of the outstanding bonds must be covered at all times by the net present value of the assets and that the weighted average term to maturity of the assets should be higher than the bonds' maturity. The issuer can provide overcollateralization up to a maximum ratio of 20% of the cover pool value.

If any of these limits is breached, the bondholders may request that the bonds are immediately repaid, unless the breach is redressed within 30 days.

The new Romanian covered bond legal framework will introduce details about the calculation of a stress-tested NPV, the liquidity needed and hedging with derivatives.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

Under the Mortgage Bond Law, the activity of a mortgage bond issuer is monitored by the National Securities Commission (CNVM) and the National Bank (BNR). For covered bonds, the law provides for the mandatory appointment of an agent. The agents have to be authorised jointly by the National Securities Commission and by the National Bank. Initially, the agent shall be appointed by the issuer from a list of agents, approved by the National Bank (mandatory pre-requisite for the issuance of mortgage bonds). Upon subscription of the mortgage bonds by the investors, the revocation/appointment of the agent shall be made exclusively by the general meeting of bondholders.

The agent's main role is to monitor the cover pool on behalf of the bondholders. Its monitoring obligations shall be performed on a monthly basis, based on the synthetic documentation provided by the issuer. The agent has to observe issuer's compliance with the law and prospectus requirements. Based on the documentation provided by the issuer, the agent shall issue a certificate attesting the issuer's compliance with the provisions of the law and with the offering curricular regarding the cover pool structure. The agent shall be jointly and severally liable towards the bondholders with the issuer, with the financial investment services company handling the sale and with the issuer's financial auditor for the damages caused by non-fulfilment of several duties provided for under the law (including the obligation to monitor the issuer's compliance with the requirements related to the cover pool).

The qualification, role and duties of the agent will be clarified in the new Romanian covered bond legal framework.

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

A cover register allows for the identification of the cover assets for each issue. The issuer has the obligation to keep a cover register for each covered bonds 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

Covered bonds do not automatically accelerate when the issuing institution becomes insolvent, but the bondholders could be obliged to accept payments in advance, with the corresponding recalculation of their rights if the cash-flows in the cover pool allows that.

The new Romanian covered bond legal framework will clarify the asset segregation provisions, set aside the de facto acceleration provision and will also clarify the regime of derivatives registered in the cover register.

Preferential treatment of covered bond holders

Covered 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 Bond 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 issuer's bankrupt estate for the difference.

A moratorium on the insolvent issuer's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of covered bond holders.

A special insolvency procedure could be commenced against the cover pool only by the bondholders.

Access to liquidity in case of insolvency

After bankruptcy proceedings are opened, with the appointment of an asset management company as the cover pool administrator, the right to manage and dispose of the recorded assets is transferred to this company by law. Thus, the cover pool manager first has access to the cover assets and collects the cash flows according to their contractual maturity and pays the amounts due by the issuer to the bondholders.

There are no specific regulations expressly addressing the issue of voluntary overcollateralisation in insolvency. It may be argued that voluntary overcollateralisation is part of the cover pool with all legal consequences regarding segregation in the event of bankruptcy applicable to the respective pool.

Sale and transfer of mortgage assets to other issuers

A bankrupt issuer cannot be liquidated until it has assigned the cover pool to another issuer. The portfolio of assets may be sold to other issuers in a transaction concluded after the launching of the bankruptcy proceedings if the liquidator's report provides the sources from which the insolvent issuer may pay in full the amounts due to the bondholders and if the bondholders in each issue (if more than one) have decided in the general meeting of bondholders to accept payment in advance under the terms provided in the liquidator's report.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The cover bonds issued under the Mortgage Bond Law fulfil the UCITS 22(4) criteria. The law requires such bonds to be issued by a credit institution, which is subject by law to special public supervision designed to protect bondholders (i.e. supervision by the National Bank of Romania and respectively by the National Securities Commission) and provides coverage by law of the claims attaching to the bonds in the event of failure of the issuer, on a first priority basis for the reimbursement of the principal and payment of the accrued interest.

Covered bonds under the Mortgage Bonds Law also comply with the CRD Directive Annex VI, Part 1, Paragraph 68 a) to f). Therefore they should enjoy a 10% risk weighting.

3.20 RUSSIA

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I. FRAMEWORK

In Russia, the legal basis for covered bonds is the Covered bond law[2]. This law is supported by rules in the Mortgage law[3], the Bankruptcy law, the Credit organisations bankruptcy law and Securities market law[4].

In addition the Central Bank of the Russian Federation (CBRF)[5] issued the Mortgage cover mandatory requirements instruction[6]. The Federal Financial Markets Service (FSFR)[7] released the Mortgage cover determination order, the Special depositor decree and Register maintenance rules[8] and the Mortgage cover special depositor data reporting decree. Further rules are in general regulations of the CBRF and the FSFR.

II. STRUCTURE OF THE ISSUER

The Russian Covered bond law foresees three types of securities:

> Two types of "mortgage obligations"[9] (obligation issues (i) by a credit organisation or (ii) by a SPV ("mortgage agent"), art. 7 sec 1[10]), here in the following: "Covered bonds"[11]. Covered bonds have to bear interest[12] (art 10),

> Mortgage participation certificates (art 17 – 31). These certificates a similar to investment fund certificates, giving a direct share in the mortgage secured loans. Due to their different structure in this article we will not look after them.

Obviously the covered bonds issued by credit organisations, are oriented on the European covered bond model, those 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.[13]

As a general rule mortgage obligations are secured by static cover pools (other as dynamic cover pools in most other European countries[14]). Even if the Russian Covered bond law allows several issues from one cover pool, the cover for every issue is static and can be modified only in some cases, stipulated by the law.

1 Special thanks goes to colleagues from Bank VTB24 and DeltaCredit for proofreading and commenting on this article.
2 A list of the legal framework is attached hereto in chapter XII. The new regulations on covered bonds ("zakladnoy list"), described by the author in the ECBC Fact Book 2009 (p. 253 – 259), have still not been adopted. On this regulation see as well: "Russian law to put framework to rights in spring" (by Susanna Rust) in: The Cover, December 19, 2008; www.coveredbondnews.com.
3 In art 20 sec 4.1; 22 sec 1.1 the Mortgage law includes regulations only for mortgage participation certificates.
4 Art 8 sec 4 contains rules for mortgage share certificates, art 27.3 general rules for securities, secured by a pledge.
5 www.cbr.ru. In Russian "Central'nyy Bank Rossiyskoy Federatsii".
6 Instruction of the CBRF dated 31 March 2004 No 112-I "On mandatory requirements for credit organisations, issuing securities with mortgage cover".
7 www.fcsm.ru. In Russian "Federal'naya sluzhba po finansovym rynkam".
8 Enacted in one order
9 Language of the law: "Obligations with mortgage cover".
10 Law citations without link are citations of the Covered bond law.
11 A special type of mortgage obligations are "Housing mortgage obligations" (in Russian "zhilishchnaya obligatsiya s ipotechnym pokrytien"): Their cover pool consists only of claims, secured by mortgages over housing premises (art 3 pt 5).
12 To be paid at least once a year, art 10 para 2.
13 Knowing, that in fact MBS are no covered bonds!
14 European Central Bank: Covered Bonds in the EU Financial System, December 2008, p. 7.

1. Credit institution (art 7 sec 2)

A credit organisation has to comply with the Banking law and the rules, set up by the Central Bank for covered bond issuing credit organisations. If the credit organisation does not fulfil the statutory requirements, the licence can be revoked (art 20 sent 1 no 10 Banking law).

By pt 2 and 3 Mortgage cover mandatory requirements instruction[15] the CBRF has set up special regulations for:[16]

> Minimal ratio between the cover pool and the equity of the credit organisation: 10% (pt 2.3 Mortgage cover mandatory requirements instruction),

> Minimal ratio between the volume of the cover pool and the volume of the issued covered bonds: 100 % (pt 2.4 Mortgage cover mandatory requirements instruction),

> Maximum ratio of all claims against the credit organisation, privileged before the covered bond holders[17] and the equity: 50% (pt 2.5 Mortgage cover mandatory requirements instruction).

For the following ratios mortgage securities' issuers have to apply the general rules for credit organizations:

> Ratio of sufficient equity (capital) (pt. 2.2 General mandatory requirements):

- 10% for banks with equity (capital) of minimum 180 mil RUB or

- 11% for banks with equity (capital) of less than 180 mil RUB.[18]

> Ratio of general liquidity (pt 3.2, 3.3 and 3.4 General mandatory requirements instruction)[19]:

- Momentary liquidity: 15%.

- Floating liquidity: 50%.

- Long term liquidity: 120%.

The Central Bank has not used its right to set a limit special limit for covered bond issuers of the interest rate and foreign exchange risk.[20]

2. SPVs (mortgage agents, art 8)

The mortgage agent has to be a joint stock company, its only task is the purchase of mortgage secured credits (loans) and issuance of covered bonds (art 8 sec 1 para 1). This has to be foreseen in its charter, theses parts of the charter can not be changed or amended later (art 8 sec 1 para 4).

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15 Instruction of the CBRF dated 31 March 2004 No 112-I "On mandatory requirements for credit organisations, issuing securities with mortgage cover".

16 Legal bases is art 7 sec 2 para 1 and 2 Covered bond law.

17 Due to art 50.36 sec 3 and 4 Credit organizations bankruptcy law physical persons as holders of deposits have to be served before creditors secured by a pledge. Despite the regulations, that the cover pool is separated from the bankruptcy estate, the ranking between physical deposit holders and mortgage securities' holders is not clear.

18 Pt 2.2 General mandatory requirements instruction. This current pt 2.2 was introduced by the last amendment. The former regulation in pt 2.1 Mortgagec over mandatory requirements instruction was abolished by pt 1.4 of the CBRF-Instruction dated 1 June 2007 No 1831-U.

19 The former rule of a general liquditiy of 20% for mortgage securities' issuers (former pt. 2.2 Mortgage cover mandatory requirements instruction) was abolished by CBRF-Direction dated 18 February 2005 No 1550-u.

20 Even not by general rules, although it is foreseen in art 62 Central bank law. But issuing credit organisations have to describe the f/x and the interest rate risk in the prospectus (annex 5 pt 3.5.3.2 and 3.5.3.3 Instruction 128-I/2006). For f/x risk see: Efimova, L. G.: Bankovskoe pravo (Banking law) – Tom (volume) 1, Moscow 2010, p 88 et seq.

In the founding documents of the mortgage agent has to be stipulated the number of covered bond issues, this agent is founded for. After this issuance(es) the mortgage agent has to be liquidated (art 8 sec 1 para 6).

A mortgage agent is not allowed to have employees. As executive organ a commercial organisation has to act, the bookkeeping has to be done by a specialized organisation (different from the executive organ organisation). If the commercial organisation, acting as executive organ, exercises transactions in contrary to the list of allowed transactions, these transactions will be on account of the commercial organisation, not of the mortgage agent (art 8 sec 2).

The mortgage agent is not allowed to sign contracts against payment with physical persons or to perform commercial activities other than stipulated in the Covered bond law. In case of breach of this rule, the FSFR may apply for liquidation of the mortgage agent (art 8 sec 3).

The FSFR has the right to set up rules on capital requirements, field of activities, bookkeeping and accounting of mortgage agents (art 43 sec 1).

Protection of terms:

Due to art 6 the words "obligation with mortgage cover" (in Russian "obligatsiya s ipotechnym pokrytiem"), mortgage participation certificate ("ipotechnyj sertifikat uchastiya"), mortgage cover ("ipotechnye pokrytie"), mortgage agent ("ipotechnyj agent") and "mortgage specialized organisation" ("ipotechnaya spezializirovannaya organisatsiya")[21] may be used only for the purposes of the Covered bond law.[22]

III. COVER ASSETS

Eligible assets under the Russian Covered bond law are mortgage secured claims under a loan or credit agreement, including interest (art 3 sec 1). These secured claims may be certified by mortgage certificates ("zakladnaya", art 13 – 18 Mortgage law)[23] or mortgage participation certificates under the Covered bond law.

Eligible are also money in Russian and foreign currency, state bonds and real estate (art 3 sec 1). Real estate can only be used as cover, if it is purchased in foreclosure of a cover mortgage (art 3 sec 1; 13 sec 1 para 3).

Requirements for eligible mortgage secured claims are:

> The mortgage shall content a prohibition on sale of the mortgaged property by the mortgagor without consent of the mortgagee (art 3 sec 2 pt 2).

> The property has to be insured to the benefit of the mortgagee for the whole term of the loan to an amount not less than the mortgage secured claim (art 3 sec 2 pt 3).

> The share of mortgage secured construction claims is limited to 10% of the cover pool (art 3 sec 3 para 3). For Housing mortgage obligations mortgage secured construction claims are not eligible (art 3 sec 3 para 1 sent 2).

> Claims, secured by a second ranking mortgage are eligible, as far as they do not exceed the LTV limit of 80% (art 3 sec 2 para 2).

21 "Mortgage specialized organization" is another allowed name for "mortgage agent" (art 8 sec 1 para 5).

22 The word "Obligation with mortgage cover" have to be shown on the title page of a prospectus, the words "Housing obligations with mortgage cover" can be shown (pt 3.14 sec 1 and 2 Order No 06-117/pz-n/2006); annex 5 Instruction 128-I/2006.

23 A mortgage certificate is only eligible, if it is not pledged of another purpose (art 3 sec 3 para 1).

One asset may only be used for one cover pool. A mortgage participation certificate can not be part of the cover pool, where it represents a share in the mortgage secured claims. (Art 3 sec 5)

Publishing of information

The Covered bond law stipulates a wide range of publishing information on the covered bonds by the issuer (art 37 – 41). In addition to the main rules according to the Securities market law (art 37 para 1; 40 sec 1) an important information is an account report on performance of the cover assets (art 40 para 4 sec 2).

If the covered bonds are rated by a rating agency, this rating has to be published (art 37 para 2). The issuer bears responsibility for observing the duties on publishing information (art 38 sec 2). The FSFR may apply to a court, if the rights of the covered bond holders are violated due to insufficient or incorrect publishing of information (art 38 para 7).

Interested persons have the right to get knowledge of the cover register (art 39 para 1). The issuer is obliged to allow all interested persons to get knowledge of the information, contained in the cover register.[24] This can be done under the general rules of the Order No 06-117/pz-n/2006, by giving access to the register or with copies of it. The information has to be as of the latest working day of each month. (pt 10.3.1 Order No 06-117/pz-n/2006) When giving access to copies of the cover register, the issuer has to make sure, that the interested person can get copies and excerpts from the register as well as a note on the volume of the securities' cover pool[25] (pt 10.3.3). After obtaining the state registration of the issue, the issuer is obliged to publish the cover register as of the registration for a term of three months on his internet site (pt 10.3.4 sec 1 and 2). Distribution of the mortgage securities before publishing the cover register in the internet is not allowed.[26]

Credit organisations issuing covered bonds have special reporting duties to the Central bank (art 7 sec 1 para 3; pt 3.1 – 3.5 Mortgage cover mandatory requirements instruction[27]).

The regulators set up further special rules for covered bond issuers in the general acts on disclosure of information.[28] Credit institutions, issuing mortgage securities have to report quarterly to the regulators.[29]

Issuers of mortgage securities have – in addition to the general requirements – to disclose (i) information, that might have significant influence on the value of the mortgage securities and (ii) information contained in the cover register and the note on the volume of the securities' cover pool (pt 10.1.1 Order No 06-117/pz-n/2006).

Information that might have significant influence on the value of the mortgage securities can be the occurrence of the investors' right to claim for prepayment or curing of this occurrence (pt 10.2.1 lit a and b Order No 06-117/pz-n/2006), replacement of cover assets, if the value is min 10% of the cover pool (pt 10.1.1 lit v), incorporation of mortgage secured construction claims into the cover pool (10.1.1 lit g), first obtaining or change of credit rating of the mortgage securities or the issuer (10.1.1. lit d),

24 For credit organisations as issuers explicitly stipulated in pt 14.5 Instruction 128-I/2006.

25 In Russian "Spravka o razmere ipotechnogo pokrytiya obligaciy".

26 Pt 10.3.4 sec 3 Order No 06-117/pz-n/2006; pt 15.2 sec 2 Instruction 128-I/2006.

27 Instruction of the CBRF dated 31 March 2004 No 112-I "On mandatory requirements for credit organisations, issuing securities with mortgage cover".

28 FSFR: Order No 06-117/pz-n/2006 and Order No 07-4/pz-n/2007.
Central Bank: Instruction No 128-I/2006.

29 Pt 5.6 Order No 06-117/pz-n/2006.

positive or negative decision of a court on foreclosure in the cover pool (10.1.1 lit zh). This information has to be published in the broad tape within one day, on the internet site within two days (10.2.3).[30] The regulators have to be informed as well (10.2.5).[31]

If the issuer is a credit organisation, it has to give in the prospectus information on fulfilment of the special ratios for mortgage securities' issuers, set up by the Central Bank.[32]

Mortgage securities qualify as secured bonds.[33] The pledge over the cover pool has to be named as security for the bonds.[34]

The prospectus has as well to show information on the specialized depositar, on the planned issues and fulfilment of the cover mortgage assets, on insurance of the issue and a servicing agent (both if applicable) and composition, structure and volume of the cover pool[35], also information on the structure of the mortgage secured claims[36]. Similar information have to be shown in the quarterly data report.[37]

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.[38] The valuation has to be made by an independent valuer.[39]

The law does not contain special regulations on the valuation.

V. ASSET-LIABILITY MANAGEMENT

Art 3 sec 4 stipulates, that the amount of the cover is defined by summing up the mortgage secured claims, amount of money in the cover and value of other assets.

Details are set up by the FSFR in the Mortgage cover determination order. The mortgage secured claims are defined as the outstanding capital and/or interest, as defined in the credit or loan agreement (pt 2.1 Mortgage cover determination order). The volume of the cover has to be accounted in RUB, as far as the mortgage securities are not nominated in foreign currency. If this is the case, the cover has to be accounted in the foreign currency. In both cases, for including cover assets, nominated in another currency than the accounting currency, in the calculation, the exchange rate of the CBRF of the calculation date has to be used. (Pt 2.5 Mortgage cover determination order)

The following claims shall not be encounted by summing up the mortgage cover:

> No payment made on the claim for more than six month,

> Loss of the mortgage object, including if the mortgage was declared void by a court,

30 Information according to pt 10.1.1 lit a, b and zh has also to be published in print media.
31 The form of publishing this information is fixed in annex 10 Order No 06-117/pz-n/2006 (pt 10.2.2).
32 Annex 5 pt 5.2 sec 4 Instruction 128-I/2006.
33 In Russian "Obligaciya s obespecheniem". Pt 6.4 Instruction 128-I/2006.
34 Annex 8 pt 10.3.2 sec 2 subsec 14; annex 8 pt 10.5 Order No 06-117/pz-n/2006; pt 6.4.2 Instruction 128-I/2006. As well in the prospectus: Annex 5 pt 10.3.2 sec 13 Instruction 128-I/2006.
35 Annex 8 pt 9.1.5.1 – 9.1.5.5; annex 8 pt 10.5.1 Order No 06-117/pz-n/2006; annex 5 9.1.5.1 – 9.1.5.5 (publishing information on the issued securities) and – regarding depositar, insurance, service agents and cover pool - pt 10.5.1 lit a – g (publishing information on the issuing credit organisation) Instruction 128-I/2006.
36 Annex 8 pt 10.5.1 sec 2 no 2.2; pt 3 -5 Order No 06-117/pz-n/2006; annex 5 pt 9.1.5.5 lit g – zh (publishing information on the issued securities) and pt 10.5.1 lit g no no 2.2 – 5 (publishing information on the issuing credit organisation) Instruction 128-I/2006.
37 Annex 10 pt 8.5; 8.5.1 Order No 06-117/pz-n/2006.
38 The former LTV limit of 70% was uplifted to 80% by the Federal law dated 9 March 2010 No 22-FZ.
39 The valuers profession is regulated in the Valuation law.

> Secured obligation declared void by a court,

> Bankruptcy of the debtor,

> No insurance of the mortgage object for more than 6 month.

Only in these cases and in case, that the cover asset does not fit to the general rules for eligible claims, cover assets can be replaced by other assets (art 14 para 1; art 3 sec 4). Cover assets may be deleted from the cover pool in case of their exchange or sale or if the secured obligation is terminated (art 4 sec 1).

At the moment of state registration of the issue, the volume of the cover pool has to be not less than the nominal value of the covered bonds (art 13 para 3 sec 1). For proper performance of the obligations under the covered bonds the amount of the cover pool for the whole maturity of the bonds shall not be lower than the aggregate outstanding nominal value of the bonds (art 13 sec 2 para 2 sent 1).

The decision of the terms of issue of the covered bonds may stipulate an excess cover. In this case the excess cover has to be kept during the whole maturity of the mortgage obligations. (Art 13 sec 2 para 2 sent 2 and 3) For credit organisation the excess amount of the cover pool shall not be more than 20% (art 13 para 3 sec 2).[40]

One cover pool can secure two or more issues of covered bonds (art 11 sec 2 para 1; 12 sec 2). In this case the rules on calculation of the necessary cover for one issue apply similarly (art 11 sec 2 para 1). Among the two or more issues the issuer may define an order of priorities: The performance of claims of one issue is only allowed after proper performance of the claims of the higher ranking issue(s) (art 11 sec 2 para 2 and 3). If mortgage securities are issued in several issues on the bases of one cover pool, the volume of the cover pool has to be not less than the nominal value of last priority rank and the foregoing ranks (art 13 sec 2 para 3).

The decision on the issue shall define the maturity and denomination on the day of maturity (art 13 sec 3).

At least 80% of the cover pool have to be mortgage secured claims. If this ratio is lower than 80% within three months the issuer has to increase the share of mortgage secured claims. This can be done by obtaining new mortgage secured claims and/or by prepayment of outstanding covered bonds (art 13 sec 1 para 2).

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40 The excess cover rule was introduced in the law in 2006. The original regulation of art 13 sec 3 para 3 until 2006 was, that to insure timely payment – what was expressly mentioned in the law („obespecheniye svoevremmenosti ispolneniya obyazatel'stv") – the amount
- of cash money in the cover pool and
- of payments, which are to be obtained from the cover assets not later than the payment day under the covered bonds on every day before maturity of the bonds

shall not be lower than the amount of „upcoming payments" („predstoyashchie platezhi") under the covered bonds.
Notwithstanding the changes to the Covered bond law in 2006, the Instruction 128-I/2006 of the CBRF still foresees that the cover pool has to secure completeness ("polnota") of payment and timely payment (pt 6.4.2 sent 8 Instruction 128-I/2006):
Completeness of payment is secured, when the amount of the cover pool on every day until repayment covers the amount (sum) of unfulfilled obligations under the mortgage securities (pt 6.4.2 sent 9).
Timely payment is secured, when
at the starting date of the next period (coupon period), at the end of which the investors have to be paid the respective return (interest (coupon) return) the
- amount of mortgage secured claims which have to be performed until this payment date,
- together with the cash money and the value of the state securities in the cover pool,

cover the amount (sum) of the return to be paid to the investors at the end of the next period (coupon period) (pt 6.4.2 sent 10).
The issuing credit organization has to provide notes with the prospectus (annex 5 pt 3.5.9 Instruction 128-I/2006) and for state registration of the results of the issue, containing the respective information (annex 8 I B pt 8 sec 2 Instruction 128-I/2006).

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).

If the issuer does not or not properly fulfil his obligations in front of the holders of the covered bonds, the holders have the right for enforcement into the cover pool. As the cover pool is pledged to the covered bond holders, the rules on the Mortgage law apply to this foreclosure, as far as special regulations in the Covered bond law do not exist. (Art 15)

The mortgage securities' holders have the right to claim for prepayment of the covered bonds in the following cases (art 16): Breach of the rules regarding

> volume of the cover pool,

> replacement of cover assets,

> proper fulfilment of obligations under the covered bonds,

> the issuer is active in fields not allowed for it,

> other reasons stipulated by the decision on issuing covered bonds.

VI. COVER POOL MONITOR, COVER REGISTER AND BANKING SUPERVISION

Cover Pool Monitor

The cover pool is controlled by a cover monitor (the "specialized depositar of the mortgage cover"[41]), art 33 sec 1. The cover monitor has to be a commercial organisation[42], licenced for depositary activities for investment funds, non-state pension funds and on the securities market (art 32 para 2). The FSFR has published the Special depositar decree.

The specialized depositar is acting on the bases of a contract with the issuer (pt 1.2 Special depositar decree).

Task of the cover monitor is to control the fulfilment of the Covered bond law and other corresponding legal acts (art 34 sec 1 para 1). He has to determine the volume of the cover pool (4.5 sec 1 Special depositar decree) and – when the issuer is a credit organisation – sign the prospectus (pt 12.4 sec 6 Instruction 128-I/2006).

One cover pool may be only administrated by one monitor (art 33 sec 3 para 1). The monitor is acting solely in the interests of the holders of mortgage securities (art 35 para 1). He is obliged to inform the FSFR on breaches of the Covered bond law (art 35 para 3; pt 4.14 Special depositar decree)[43] and on the elimination of breaches (pt 4.15; 4.16 Special depositar decree).

Every cover monitor has to implement a reglament[44], to be registered by the FSFR, describing the procedure of control, of schedule and time frames for registration in the cover register, disposal of cover assets and the overall course of working (pt 2 Order No 05-60pz-n/2005). The reglament also stipulates the rules for the exchange of documents between the issuer, the specialized depositar and mortgage securities' holders (pt 1.4 Register maintenance rules).

41 In Russian "spetsializirovannyj depozitariy ipotechnogo pokrytiya".
42 Not affiliated with the issuer (art 33 sec 3 para 2).
43 For this purpose the depositar has to keep a journal on detected breaches (in Russian "zhurnal vyyavlennykh narushenii"), pt 2.5 Special depositar decree.
44 In Russian "reglament spetsializirovannogo depozitarya".

For the cover monitor it is forbidden to give his consent to disposal of cover assets, if this disposal is in contradiction to the Covered bond law or other legal acts (art 34 sec 1 para 3).[45]

The cover monitor is obliged to (art 35 sec 2):

> Safekeeping of the documents confirming the mortgage secured claim (pt 2.1 – 2.3; 3.1 – 3.5 Special depositar decree),

> deciding on consents for the disposal of cover assets (pt 2.4 Special depositar decree),[46]

> submission of data information to the FSFR,[47]

> information of the covered bond holders of their right to claim for prepayment of the covered bonds according to art 16 (pt 4.7 Special depositar decree).

For safekeeping the depositar has e. g. to be registered as nominal holder of securities, which are part of the cover. Also mortgage certificates, evidencing a mortgage secured claim, have to be kept by the depositar (art 16 sec 2 subsec 6 Covered bond law; pt 3.3 sec 2; 3.4 sec 2 Special depositar decree).

For including assets in the cover the cover pool monitor has to control, e. g. if the assets are eligible under the Covered bond law, if the issuer is the holder of the claim and if the mortgage is registered (pt 4.2 Special depositar decree). The accordance of the cover pool structure with the Covered bond law has to be verified by the monitor daily (pt 4.3; 4.4 Special depositar decree).

The payment of the monitor can be done on the account of the cover pool. Nevertheless the rules on necessary volume of the cover pool have to be observed. (art 13 sec 5)

The monitor has also to control the payment of other costs, which have to be borne by the cover pool (e. g. for the specialized depositar, for the registrar of bearers securities etc.). This includes also controlling the amount of the costs. (Pt 4.11; 4.12 Special depositar decree)

The cover pool monitor is controlled by the FSFR (art 43 sec 1 pt 7, sec 2 para 1). He has to keep four journals: (i) Journal on detected breaches, (ii) recording journal on disposal consents, (iii) registration journal[48] and (iv) journal for recording incoming documents[49].

The monitor may insure his responsibility in front of the covered bond holder on his own account (art 36).

Cover register

Cover assets have to be registered in a "register of mortgage cover"[50] (art 5). The FSFR has adopted Register maintenance rules.

The register of mortgage cover is maintained by the cover monitor (art 33 sec 1). Maintenance means, among others, bringing in entries in the register, granting of information from the register and safe-keeping of documents (pt 1.2 Register maintenance rules). When closing the contract with the special-

45 In case of non-fulfillment of these tasks the cover monitor has a shared responsibility with the issuer in front of the covered bond holders (art 34 sec 2).

46 Consents to disposals have to be registered in the recording journal for disposal consents (in Russian "uchëtnyy zhurnal o vydache soglasiya na sovershenie sdelki"), pt 2.4 Special depositar decree.

47 The FSFR adopted for this purpose the Mortgage cover special depositor data reporting decree. The data has to be provided to the FSFR quarterly (pt 3 Mortgage cover special depositor data reporting decree).

48 In Russian "zhurnal registracii".

49 Pt 2.3 Special depositar decree (in Russian: "zurnal uchëta vkhodyashchikh dokumentov").

50 In Russian "reestr ipotechnogo pokrytiya".

ized depositar, the issuer has to hand over a depositary card[51], showing his co-ordinates and specimen signatures (pt 2.1 Register maintenance rules).

Cover assets are enclosed in the cover pool by bringing in a respective entry[52] in the cover register (pt 4.1 Register maintenance rules). Basis for the entry is a disposition[53] of the issuer (pt 4.2 Register maintenance rules). Every entry has to be registered by the depositar in the registration journal (pt 1.8 Register maintenance rules). Simultaneously with a new entry, the cover pool monitor has to register the value of the mortgage cover[54] (pt 3.8 Register maintenance rules).[55]

Within three working days the entry in the cover register has to be done or the issuer has to be informed about a refusal of entry by the monitor (pt 4.20 – 4.22 Register maintenance rules).

The cover register itself has to contain information on the issuer (pt 3.1 Register maintenance rules) and on the different types of cover assets (pt 3.2 Register maintenance rules)[56] This information is brought in the register at the same time as the incorporation of assets into the cover (pt 3.6 sec 1 Register maintenance rules). Pt 4.3; 4.4 Register maintenance rules set up the documents, to be presented by the issuer for the entry, evidencing the mortgage secured obligation, including valuation and insurance.[57]

Within one day the specialized depositar has to inform the issuer about a new entry (pt 7.1 sec 1 Register maintenance rules). A copy of the register has to be given to the issuer montly (pt 7.2), to state authorities on request (pt 7.3).

Register maintenance ends – based on a dispositon of the issuer – in cases, when the issue will not take place or when all mortgage securities have been repaid (pt 1.9 Register maintenance rules).

Supervision

State regulation of issuing covered bonds is done by the FSFR in co-ordination with the Central Bank of the Russian Federation (art 42).

Banks, issuing covered bonds, are supervised by the Central Bank (art 7 sec 2), mortgage agents are by the FSFR (art 43 sec 2).

51 In Russian "anketa".

52 In Russian "zapis'".

53 In Russian "rasporyazhenie". Documents to be added to the disposition are named in pt 4.9 Register maintenance rules.

54 This has to be done also when changes to the cover assets are entered into the cover register. For these entries regarding the mortgage cover value a disposition of the issuer is not necessary (pt 6.3 Register maintenance rules). Details are foreseen in the Mortgage cover determination order.

55 Similar rules are existing for deletion (pt 5.1 – 5-11 Register maintenance rules) and replacement (pt 6.1 – 6.9) of cover assets.

56 On mortgage secured claims the cover register contains the following data (pt 3.2.1 no 1 – 10 Register maintenance rules): (i) Type of claim (credit, loan), amount of capital and interest rate, signing date, (ii) date and number of mortgage registration, registering authority, (iii) date of issuance of the mortgage certificate, if applicable, (iv) information of the pledged real estate (type of real estate, finished or unfinished, location, name (if applicable), use and space (pt 3.2.1 no 4 and pt 3.2.4 no 1 – 5) including amount and date of valuation.
An excerpt from the land registry regarding the pleged real estate is not mentioned here, but it is one of the documents to be presented for bringing in the entry (pt 4.3 no 4 Register maintenance rules). To the disposition of the issuer for an entry in the cover register the mortgage agreement, bearing the registration stamp, and an excerpt from the land register, showing the issuer as mortgagee or a mortgage certificate showing the issuer as holder, has to be added (pt 4.13 sec 1 and 3; pt 4.16 - 4.19). If these evidences are not brought to the cover pool monitor before the issuing date, he has to delete these assets automatically from the cover register (pt 5.11).

57 Pt 4.5 – 4.8 Register maintenance rules contain respective rules for the other cover assets (state bonds, mortgage participation certificates, real estate, cash). Rules for exchanging cover assets by new ones are stipulated in pt 4.10.

Issuing of covered bonds

Normally the volume of possible issues of securities is limited to the amount of the charter capital and/or the amount of security provided by third parties. Obligations (bonds) with mortgage cover are exempt from this rule.[58]

For issuing securities, Russian law foresees a four step process:[59] (i) Decision on issue[60], (ii) state registration of issue, (iii) distribution of securities and (iv) state registration of the report on results of the issue.[61] For these general steps the FSFR and the CBRF set up special requirements for the issue of mortgage securities.

The decision on the issue[62], taken by the issuer, has to show, that the issuer is a credit organisation,[63] contain information of the security for the bonds,[64] of composition, structure and volume of the cover pool[65], procedure for exclusion and replacement of cover assets[66], on the special depositar[67], on the bonds[68], insurance of the issue and service agents (if applicable)[69] and procedure of prepayment[70]. The decision has to foresee interest payments to the investors, not less than once a year[71] and can foresee costs to be paid from the cover pool[72]. On the first page of the decision has to be written "Obligations with mortgage cover", it has to be signed by the special depositar.[73]

For state registration of the issue the contract with the special depositar and the notes of the special depositar on overall volume (sum) of mortgage secured loans and on the volume of the mortgage cover[74] (on the date of presentation) have to be presented.[75] Credit organisations also have to present the fulfilment of the mandatory requirements of the CBRF and the coverage regulation according to art 13 Covered bond law.[76]

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58 Restictions by art 102 sec 2 subsec 2 sent 3 Civil code; art 27.5-4 sec 3 subsec 1 Securities market law; art 33 sec 3 sent 3 JSC law and art 31 sec 2 sent 3 LLC law do not apply for the issuance of covered bonds.

59 Pt 2.1.1 Order No 07-4/pz-n/2007.

60 The decision sustains of two parts: Taking the decision and confirmation of the decision.

61 In Russian: (i) "Reshenie o vypuske" (sustaining of: "prinyatie resheniya" and "utverzhdenie reshenia", (ii) "gosudarstvennaya registraciya vypuska", (iii) "razmeshchenie obligaciy", (iv) "gosudarstvennaya registraciya otchëta ob itogakh vypuska".

62 The form of the decision is stipulated in annex 4 (7) Order No 07-4/pz-n/2007; for credit institutions: Annex 4, esp. pt 10.6.2.3 Instruction 128-I/2006.

63 Pt annex 4 Pt 10.6.1 sec 5 Instruction 128-I/2006.

64 The pledge over the cover pool (pt 6.7.2.2 lit a – n Order No 07-4/pz-n/2007; annex 4 pt 10.6.2.3 no 1 Instruction 128-I/2006), including description of the procedure, how investors can foreclose into the cover pool (pt 6.7.2.2 lit m Order No 07-4/pz-n/2007; annex 4 pt 10.6.2.3 no 8 Instruction 128-I/2006 [pt 6.4.3 Instruction 128-I/2006 contains a description of the foreclosure]).

65 The cover register as of the date of the decision's confirmation has to be added (pt 6.7.2.3 lit a Order No 07-4/pz-n/2007; annex 4 pt 10.6.4.2 Instruction 128-I/2006).

66 Pt 6.7.2.4 Order No 07-4/pz-n/2007. The replacment procedure shall contain a regulation, that purchase of a mortgage security by an investor means also giving the consent to this procedure (pt 6.7.2.4 sec 7). Similar regulations in annex 4 pt 10.6.2.3.2 Instruction 128-I/2006.

67 Pt 6.7.2.5 Order No 07-4/pz-n/2007; annex 4 pt 10.6.2.3.3 Instruction 128-I/2006.

68 E. g. number of issues, number of bonds, volume of interest and maturity, pt 6.7.2.6 Order No 07-4/pz-n/2007; annex 4 pt 10.6.2.3.4 Instruction 128-I/2006.

69 Pt 6.7.2.7; 6.7.2.11 Order No 07-4/pz-n/2007; annex 4 pt 10.6.2.3.5 and 10.6.2.3.6 Instruction 128-I/2006.

70 6.7.2.8 Order No 07-4/pz-n/2007.

71 6.7.2.9 Order No 07-4/pz-n/2007; annex 4 pt 13.2.5 Instruction 128-I/2006.

72 E. g. for the special depositar, administration costs for the cover pool. The costs have to be set in a fix number or in a procedure, how to assess it later. Pt 6.7.2.12 Order No 07-4/pz-n/2007.

73 Pt 6.7.2.12; 6.7.2.14 Order No 07-4/pz-n/2007; annex 4 part A Instruction 128-I/2006.

74 In Russian: "Spravka o sovokupnom razmere (summe) obespechenykh ipotekoy trebovaniy" and "spravka o razmere ipotechnogo pokrytiya".

75 Pt 6.7.3.1 Order No 07-4/pz-n/2007; pt 13.3 sent 2 sec 1 and 2 Instruction 128-I/2006.

76 Pt 13.3 sent 2 sec 3 and 4 Instruction 128-I/2006.

The state registration has to be refused, when the cover pool is not in line with the Covered bond law, especially not able to secure the fulfilment of the claims of the bond holders and when no right to interest payments at least once a year is foreseen.[77] For credit organisations additional reasons to refuse the registration are the non fulfilment of the CBRF mandatory requirements for credit organisations, issuing mortgage securities and the coverage rules according to art 13 Covered bond law an the day of confirmation of the issue.[78]

The mortgage securities can only be distributed, after the issuer made the access to the information in the cover register possible, in line with the Covered bond law.[79]

For state registration of the results of the issue a copy of the cover register and a note of the specialized depositar on the volume of the cover pool, a note from the issuer on obeying the rules to secure the due performance of the obligations under the mortgage securities[80], all as of seven days before applying, but later than the factual end of the distribution, and evidence on publication of information have to be presented.[81] Credit organisation have to show as well fulfilment of the CBRF mandatory rules for credit organisations, issuing mortgage securities and the coverage regulations according to art 13 Covered bond law.[82]

The state registration has to be refused, if based on changes in the cover register the cover assets are not securing the due performance of the mortgage securities.[83] For credit organisations the state registration has to be refused as well in case of non fulfilment of the mandatory requirements of the CBRF for credit organisation, issuing mortgage securities and the coverage regulations according to art 13 Covered bond law.[84]

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

The claims of the mortgage securities' holders are secured by a pledge over the cover pool (art 11 sec 1).

Asset segregation

In case of bankruptcy the cover pool is excluded from the bankruptcy estate of the issuer (art 16.1 para 1 Covered bond law; 131 sec 2 Bankruptcy law; art 50.35 sec 2 and 4 Credit organizations bankruptcy law).

The insolvency administrator is obliged to open special bank accounts for the cover pool to collect the money paid on the mortgage secured claims or from realization of this claims and to make payments to the covered bond holders (art 133 sec 4 Bankruptcy law). A special administrator of the cover pool, different from the insolvency administrator of the general bankruptcy estate is not foreseen.

77 Pt 6.7.3.3 Order No 07-4/pz-n/2007; pt 13.10 sent 2 sec 3 and 4 Instruction 128-I/2006.
78 Pt 13.10 sent 2 sec 1 and 2 Instruction 128-I/2006.
79 Pt 6.7.4.1 Order No 07-4/pz-n/2007.
80 This note has to contain information on the volume of non performed obligations under the mortgage securities and the respective amount of cover, pt 6.7.5.1 sec 4 Order No 07-4/pz-n/2007.
81 Pt 6.7.5.1 Order No 07-4/pz-n/2007.
82 This has to include notes on completeness of payments and timely payment, annex 8 I B pt 8 sec 2 Instruction 128-I/2006.
83 Pt 6.7.5.2 Order No 07-4/pz-n/2007.
84 Pt 16.18 sent 2 sec 11 Instruction 128-I/2006.

Impact of insolvency proceedings on Covered Bonds

The Covered bond law stipulates two possibilities of realization of the cover pool in case of bankruptcy of the issuer (art 16.1 para 2):

- Change of the issuer ("zamena ėmitenta obligaciy s ipotechnym pokrytiem"): The cover pool will be sold with the obligation for the buyer to fulfill all conditions of the decision on issuing the covered bonds. Details have to be stipulated by a federal law. This federal law has not been enacted yet.
- Selling of the cover pool ("prodazha ipotechnogo pokrytiya"): The cover pool assets will be sold and the money received will be distributed among the covered bond holders.

The decision which type of realization will be used is made by the bankruptcy administrator (art 16.1 para 3). After adjudication in bankruptcy the exchange of cover assets in the cover pool is forbidden (art 16.1 sec 4).

Costs in connection with the realization, including payment of the bankruptcy administrator, will be covered out of the cover pool in accordance with the Bankruptcy law (art 16.1 para 8).

Preferential treatment of Covered Bond holders

Covered bond holders enjoy preferential treatment as the Russian law stipulates the separation of the cover pool from the general insolvency estate of the issuer (art 16.1 para 1 Covered bond law; 131 sec 2 Bankruptcy law; art 50.35 sec 2 and 4 Credit organizations bankruptcy law).

In case they are not satisfied in the realization of the cover pool, the covered bond holders may ask for satisfaction from the general bankruptcy estate of the issuer (art 16.1 sec 1 para 3).

Access to liquidity in case of insolvency

Change of issuer

Details have to be stipulated in a federal law (art 16.1 sec 2 para 2).

Selling the cover pool

In this case further liquidity is not needed, as the claims of the covered bond holders are becoming due, the cover assets are sold and the return is used to satisfy the bond holders' claims.

Sale and transfer of mortgage assets to other issuers

Change of issuer

Details have to be stipulated in a federal law (art 16.1 sec 2 para 2).

Selling the cover pool

The process of "selling the cover pool" is described in detail in art 16.2.

The bankruptcy administrator has to sell the cover assets not later than nine month after the adjudication in bankruptcy (art 16.2 sec 1). The assets have to be sold under the rules of the Law on Bankruptcy law (art 16.2 sec 2). If the covered bonds have been issued with different priorities, the claims will be satisfied in these priorities (art 16.2 sec 3 para 2).

Cover assets or proceeds from their sale, remaining after the satisfaction of the claims of all covered bond holders and of the costs of realization will be included in the general bankruptcy estate of the issuer (art 16.2 sec 4).

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

No special treatment for covered bonds is foreseen.

Russian covered bonds, issued by credit organisations, comply with the requirements of art 22 sec 4 UCITS as well as those of the Directive of the business of credit institutions[85], Annex VI, Part 1, Paragraph 68 a) to f).

IX. INVESTMENT REGULATIONS

The EU investment regulations for covered bonds are not transferred into Russian law. Nevertheless different investment rules and privileges for mortgage securities are existing. In any case the investment rules are always include further requirements for mortgage securities to be eligible for investment.

Mortgage securities are not per se eligible for Central Bank collateral: Former issues have been included in the Central Bank's Lombard list by special decisions.

Pension Funds

The Russian pension system allows to change for the so-called "savings part of the labour pension" from the state Pension Fund of the Russian Federation[86] to a privately managed pension fund.[87] For theses savings parts the law and the government set up detailed investment rules[88], giving privileges to mortgage securities[89]:

Mortgage securities are except from the limitations for securities from one issuer.[90] For the state pension fund and non-state pension funds the maximum share of mortgage securities in the investment portfolio for pension savings is **40%**.[91]

The Pensions investment law and the Government decree No 379/2003 are setting up further requirements for mortgage securities as investment tool for the savings part of labour pension:

> Mortgage securities need to be traded on an organised market or being first issued. The more requirements set up by the regulator have to be obeyed. (Art 26 sec 4 pt 2 Pensions investment law)

> Mortgage securities have to fulfil at least one of the following criterias (pt 1 lit e subsec 1 – 4 Government decree No 379/2003):

85 Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, Official Journal L 177 as of 30 June 2006.

86 www.pfrf.ru.

87 Manager for the state pension fund is the State Corporation "The Bank for Development and Foreign Economic Affairs" (Vnesheconombank), www.veb.ru.

88 Bases are the Pensions investment law and the Non-state pension funds law.

89 Mortgage securities as investment instrument, see art 26 sec 1 pt 6 Pensions investment law; art 24 sec 2 Non-state pension funds law; pt 4 Government decree No 652/2002; pt 5 lit z Government decree No 63/2007 (if allowed for trading by Russian organizers of trade on the securities market. Further rules in pt 21 and 28).

90 These limitations are: (1) Maximum share of securities of one issuer or one group of connected issuers in the fund's portfolio: 10%, (2) maximum share of bonds of one issuer in the fund's portfolio: 20% of the overall volume of traded bonds of this issuer, (3) maximum share of securities of one issuer in the overall volume of funds of the managing company: 50% of the overall volume of traded bonds of this issuer (art 28 sec 1 no 1, no 6, no 7 Pensions investment law; art 36.15 sec 1 subsec 1, subsec 6 and 7 Non-state pensions funds law).

91 Pt 2 lit g Government decree No 379/2003.
Bases for this Decree are art 28 sec 2 Pensions investment law and art 36.15 sec 4 Non-state pension funds law. The share has to be controlled every day (Pt 2 lit a Government decree No 411/2004).

- The mortgage securities have to be included in at least one high level quotation list[92].
- Minimum rating by at least one agency of long term creditworthiness of the issuer in Russian roubles or foreign currency of BB- (Fitch Ratings, Standard & Poor's) or Ba3 (Moody's Investors Service).[93]
- The obligations for payment of the (i) nominal value or (ii) the nominal value and partly or fully for the coupon are guaranteed
  - by the Russian Federation or Vnesheconombank, or
  - joint surety of a legal entity, enjoying the same rating of the long term creditworthiness as the Russian Federation by at least one rating agency.

> If the issue of mortgage securities is one of several issues from one cover pool (pt 1 lit k subsec 1 – 3 Government decree No 379/2003):

- This issue has to have preferential treatment before the other issues, secured by a pledge over this cover pool.
- On the purchase day the share of this issue shall not be more than 90% of the nominal value of the mortgage securities, secured by this cover pool.
- The cover pool shall not contain mortgage secured construction loans.
- If the issuer is not a credit organisation, the volume of the cover pool shall exceed the nominal value of the issue 1.5 times.

For parts of savings pensions, not going to the "savings part of labour pensions" – so called "wider investment portfolio" - art 27 Pension investment law sets up, that the managing company has to stipulate investment criterias in an investment declaration.[94]

Investment Funds

Mortgage securities are also eligible for investment funds (art 33 sec 1 no 7 Investment fund law). Additional rules are set up by FSFR in Order No 08-19/pz-n/2008.

Due to these rules special mortgage funds can be established.[95] Mortgage funds sustain of mortgage secured credits and loans, mortgage certificates, mortgage securities, real estate objects and some other instruments.

92 These are lists for which the FSFR has set up hightest requirements.
93 Under certain conditions a rating of a Russian rating agency is possible as well.
94 For the state pension fund this has been done by the Government decree No 540/2003: Up to 20% of the wider investment portfolio can be invested in mortgage securities (pt 9 lit g).
Pt 3 lit g; pt 5 lit a – v; pt 6 are setting up special requirements for investments in mortgage securities, mostly similar to the rules for investments "savings part of the labour pension". Interesting is a stricter approach to security: (i) The mortgage securities (a) have a long term creditworthiness rating in RUB or foreign currency not less than BB+ (Fitch, S&P) or Ba1 (Moody's) or (b) are secured by a joint surety of a legal entity with a long term creditworthiness rating in RUB or foreign currency not less than the sovereign rating of the Russian Federation (under certain conditions a rating of a Russian rating agency is possible as well). (ii) From 01 January 2012 on the purchase day share of the issue shall not be more than 70% of the nominal value of the mortgage securities, secured by this cover pool.
95 Pt 1.2 lit 10; chapter XI Order No 08-19/pz-n/2008.

During 2/3 of the working days during one calendar year the amount of mortgage credits and loans, as well as the assessed value of mortgage certificates and mortgage securities shall not be less than **65%** of the value of the assets.[96]

Insurance companies

Due to the Insurance law insurance companies have to fulfil conditions to secure financial soundness[97] and for forming insurance reserves[98].

For financial soundness the Ministry of Finance as insurance companies' regulator stipulated,[99] how equity has to be invested.[100] For mortgage securities a share up to **20%** is possible. This rule is in force until 30 December 2010.[101]

For insurance reserves[102] similar rules have been set up.[103] The possible share for mortgage securities is as well **20%**. This rule is also in force until 30 December 2010.[104]

Other institutional investors

> Free funds of the compulsory deposit insurance,[105] managed by the Deposit Insurance Agency[106],

> the endowments capital of non-commercial organisations,[107]

> housing savings from "savings-mortgage systems for ensuring housing for military personnel"[108] and

> monies from the compensation funds of insolvency receivers' self-regulation organisations[109] can be invested in mortgage securities.

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96 Pt. 11.7 no 1 Order No 08-19/pz-n/2008. As far as apparent, no rules have been set on the share of investment in mortgage securities of one issuer.

97 Among other financial soundness includes the rules for forming insurance reserves and investing insurer's equity.

98 Art 24 and 26 Insurance law.

99 MinFin order No 149n/2005; MinFin order No 71n/2009.

100 "Equity" in the meaning of MinFin orders No 149n/2005 and 71n/2009 is the larger of (i) the minimum size of charter capital for insurance companies by law and (ii) normative size of solvency margin, according to respective regulations.

101 Pt 7 no 15 MinFin order 149n/2005; pt 4 no 4 MinFin order 71n/2009. The regular mortgage securities' share is 5% (Pt 17 Annex to MinFin order 149n/2005).

102 Insurance reserves are designated to ensure the fulfilment of obligations of the insurer by insurances, reinsurance and bilataeral insurance (art 26 sec 1 Insurance law).

103 MinFin order No 100n/2005; MinFin order No 72n/2009.

104 Pt 6 no 19 MinFin order No 100n/2005; pt 4 no 9 MinFin order No 72n/2009. The regular mortgage securities' share is 5% (pt 27 Annex to MinFin order No 100n/2005).

105 Art 38 sec 3 pt 6 Deposit insurance law. These mortgage securities have to circulate on an organized securities' market, to be traded by organizers of trade on the securities market and minimum size of the issue has to be 1 bln RUB (pt 2.1 MinFin order No 113n/2005).

106 www.asv.org.ru.

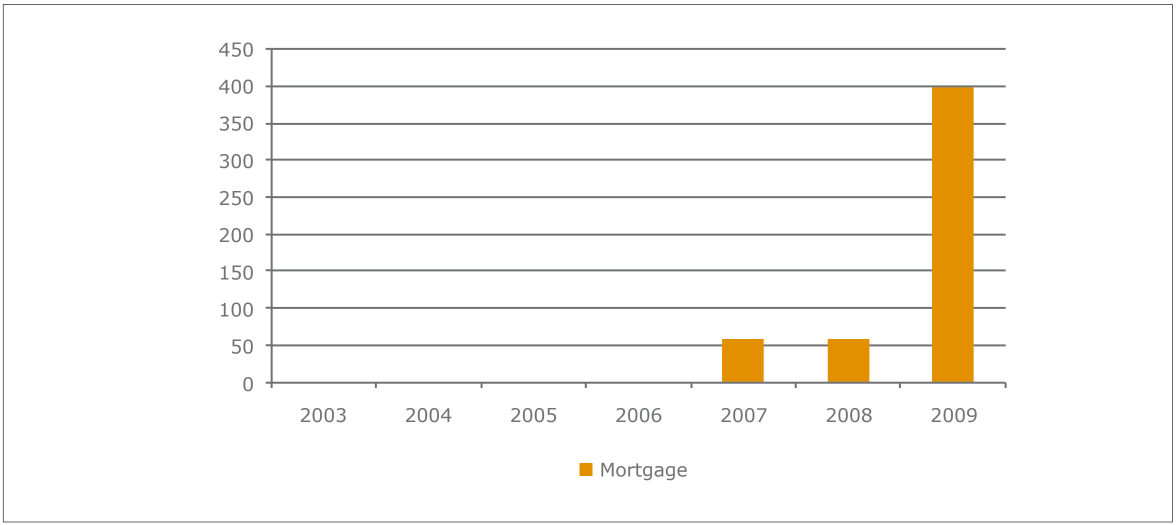
107 Art 15 sec 1 no 5 Non-commercial organisations law.

108 Art 16 sec 1 no 5 Savings-mortgage systems for military personnel. The mortgage securities have to be in public circulation (art 16 sec 4 no 2 Savings-mortgage systems for military personnel).

109 Art 25.1 sec 19 sent 1 subsec 6 Bankruptcy law. The supervisory authority of the self-regulation organisations can set up rating criterias for these bonds, what has not been done yet (art 25.1 sec 19 sent 2).

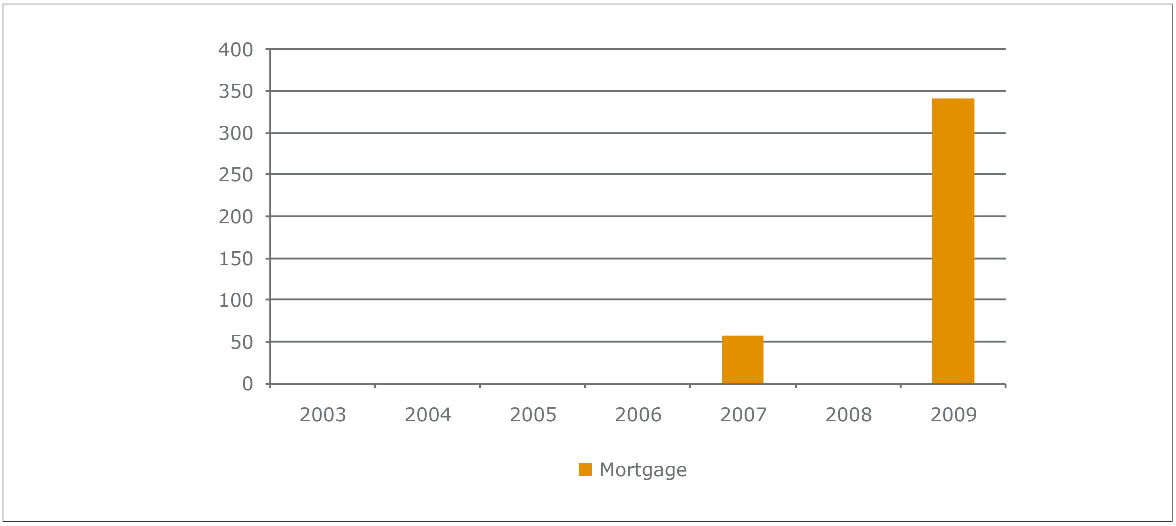
X. COVERED BOND STATISTICS AND ISSUERS

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2009, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2009, €M



Source: EMF/ECBC

Some banks and institutions in Russia are focusing on mortgage lending (mainly housing finance), e. g. ZAO Commercial Bank DeltaCredit[110], OOO Gorodskoy Mortgage Bank[111], AB GPB-Ipoteka (OAO)[112], federal Agency for mortgage housing lending[113] (AIZhK) and regional mortgage agencies.

The Commercial Bank "Moscow Mortgage Agency" (OAO)[114] issued the first Russian covered bond already 11 October 2007.[115]

On 16 December 2009 the **first large issue of a covered bond by a credit organisation** took place:

Bank VTB 24 (ZAO)[116] issued a bond on 15 bln RUB[117], maturity 5 years and interest rate 9,7%. Overcollateralisation amounts to 1,1%, the cover pool sustains fully of housing mortgage loans for real estate in Russia and is fully denominated in RUB.[118]

Investors have been Vnesheconombank[119], acting as manager for the state pension fund (buying 10 bln RUB), the AIZhK (3 bln RUB) and private investors.

More issues by credit institutions are planned later this year.

The AIZhK and others have issued mortgage securities by using mortgage agents.

XI. OUTLOOK

The first issue in fall 2009 and its acceptance in the market can be seen as a breakthrough. The new instrument was successfully introduced. Especially positive was the acceptance by institutional investors. More issues are expected in autumn this year.

By using the instrument it might be possible to enhance the legal framework for mortgage securities.

110 www.deltacredit.ru.
111 www.gorodskoi.ru.
112 www.gpb-ipoteka.ru. GPB Ipoteka is a subsidiary of of Gazprombank.
113 www.ahml.ru.
114 www.mia.ru.
115 Volume 2 bln RUB (on issuing date ~ 80,05 mln USD / ~ 56,71 mln EUR); maturity 8 years; interest rate 1 – 8 coupon – 9% p. a., 9 – 12 coupon – 12,5% p. a., 13 – 31 coupon – to be determined by the issuer.
116 www.vtb24.ru
117 On issuing date ~ 499 mln USD / ~ 341 mln EUR.
118 Average LTV of the cover pool is 42,15%.
119 www.veb.ru.

XII. LEGAL BASES[120]

Abbreviation	Legal document	Published
Laws of the Russian Federation		
Banking law	Federal law "On Banking and banking activities" dated 2 December 1990 No 395-I	Gazette[121], 1990, No 27, item 357; SZ[122], 1996, No 6, item 492
Insurance law	Law of the RF "On organisation of the insurance business in the Russian Federation" dated 27 November 1992 No 4015-I	Gazette, 1993, No 2, item 56
JSC law	Federal law "On joint stock companies" dated 26 December 1995 No 208-FZ	SZ, 1996, No 1, item 1
Securities market law	Federal law "On securities market" dated 22 April 1996 No 39-FZ	SZ, 1996, No 17, item 1918
LLC law	Federal law "On limited liabilities companies" dated 8 February 1998 No 14-FZ	SZ, 1998, No 7, item 785
Non-state pension funds law	Federal law "On non-state pension funds" dated 7 May 1998 No 75-FZ	SZ, 1998, No 19, item 2071
Mortgage law	Federal law "On mortgage (real estate pledge)" dated 16 July 1998 No 102-FZ	SZ, 1998, No 29, item 3400
Valuation law	Federal law "On valuation activity in the Russian Federation" of 29 July 1998 No 135-FZ	SZ, 1998, No 31, item 3813
Credit organizations bankruptcy law	Federal law "On insolvency (bankruptcy) of credit organisations" dated 25 February 1999 No 40-FZ	SZ, 1999, No 9, item 1097
Investment fund law	Federal law "On investment funds" dated 29 November 2001 No 156-FZ	SZ, 2001, No 49, item 4562
Central bank law	Federal law "On the Central Bank of the Russian Federation" dated 10 July 2002 No 86-FZ	SZ, 2002, No 28, item 2790
Pensions investment law	Federal law "On investment of funds for the financing of the savings part of labour pension in the Russian Federation" dated 24 July 2002 No 111-FZ	SZ, 2002, No 30, item 3028
Bankruptcy law	Federal law "On insolvency (bankruptcy)" dated 26 October 2002 No 127-FZ	SZ, 2002, No 43, item 4190
Covered bond law	*Federal law "On mortgage securities" dated 11 November 2003 No 152-FZ* *amended by* *- Federal law dated 29 December 2004 No 193-FZ* *- Federal law dated 27 July 2006 No 141-FZ* *- Federal law dated 9 March 2010 No 22-FZ*	*SZ, 2003, No 46, item 4448* *amended by* *- SZ, 2005, No 1, item 19* *- SZ, 2006, No 31, item 3440* *- SZ, 2010, No 11, item 1171*
Deposit insurance law	Federal law "On insurance of deposits of individuals in banks of the Russian Federation" dated 23 December 2003 No 177-FZ	SZ, 2003, No 52, item 5029
Savings-mortgage systems for military personnel	Federal law "On savings-mortgage systems for ensuring housing for military personnel" dated 20 August 2004 No 117-FZ	SZ, 2004, No 34, item 3532
Non-commercial organisations law	Federal law "On the order of forming and using the endowment on non-commercial organisations" dated 30 December 2006 No 275-FZ	SZ, 2007, No 1, item 38

120 Special regulations for mortgage securities are italic.
121 Gazette (Vedomosti) of the Congress of People's Deputies and the Supreme Soviet of the RSFSR.
122 Collection of the Legislation (Sobranie zakonodatel'stva) of the Russian Federation.

Abbreviation	Legal document	Published
	Decrees of the Government of the Russian Federation	
Government decree No 652/2002	Decree dated 31 August 2002 No 652 "On confirmation of the Rules for investing funds from the insurance payments for financing the savings part of the labour pension, received during the financial year by the Pension fund of the Russian Federation"	SZ, 2002, No 36, item 3489
Government decree No 379/2003	Decree dated 30 June 2003 No 379 "On setting additional limitations for investing funds from pension savings in several asset classes and fixing on maximum shares for several asset classes in the investment portfolio in connection in accordance with art 26 and 28 of the Federal law "On investment of funds for the financing of the savings part of labour pension in the Russian Federation" and art 36.15 of the Federal law "On non-state pension funds""	SZ, 2003, No 27, item 2804
Government decree No 540/2003	Decree dated 1 September 2003 No 540 "On confirmation of the investment declaration for the wider investment portfolio of the state managing company"	SZ, 2003, No 36, item 3521
Government decree No 411/2004	Decree dated 12 August 2004 No 411 "On confirmation of the Rules for revaluation of the market value of the investment portfolio for investments of pension savings and Rules for correction of the investment portfolio by management companies"	SZ, 2004, No 33, item 3498
Government decree No 63/2007	Decree dated 1 February 2007 No 63 "On confirmation of the rules for allocation of funds of pension reserves of non-state pension funds and control of the distribution"	SZ, 2007, No 6, item 769
	Orders of the Ministry of Finance	
MinFin order No 113n/2005	Order dated 7 September 2005 No 113n "On setting of criterias for securities, in which might be distributed and (or) invested temporarily free funds of the compulsory deposit insurance"	Bulletin[123], 2005, No 42, RegNo[124] 7061
MinFin order No 100n/2005	Order dated 8 August 2005 No 100n "On confirmation of the Rules for allocation of the insurance reserve funds by the insurers"	Bulletin, 2005, No 36, RegNo 6968 (2005, No 42, p. 48)
MinFin order No 149n/2005	Order dated 16 December 2005 No 149n "On confirmation of the Demands maintaining to the composition and structure of assets, admitted for coverage of the insurer's equity"	Bulletin, 2006, No 6, RegNo 7389
MinFin order No 71n/2009	Order dated 13 July 2009 No 71n "On introducing amendments to the Demands maintaining to the composition and structure of assets, admitted for coverage of the insurer's equity, confirmed by the Ministry of Finance of the Russian Federation on 16 December 2005 No 149n"	Rossiyskaya gazeta dated 18.09.2009 No 176, RegNo 14771 (15.09.2009)
MinFin order No 72n/2009	Order dated 13 July 2009 No 72n "On introducing amendments to the Rules for allocation of the insurance reserve funds by the insurers, confirmed by the Ministry of Finance of the Russian Federation on 8 August 2005 No 100n"	Rossiyskaya gazeta dated 16.09.2009 No 173, RegNo 14611 (25.08.2009)
	Instructions of the Central Bank of the Russian Federation (CBRF)	
General mandatory requirements instruction	Instruction dated 16 January 2004 No 110-I "On mandatory requirements for banks" last amendment Direction dated 03 November 2009 No 2324-U	Herald[125] No 11 (735) dated 11.02.2004 last amendment Herald No 77 (1168) dated 28.12.2009

123 Bulletin (Byulletin') of Normative Acts of Federal Executive Authorities.
124 Registration number (in the Ministry of Justice).
125 Herald (Vestnik) of the Central Bank of the Russian Federation.

Abbreviation	Legal document	Published
Mortgage cover mandatory requirements instruction	*Instruction dated 31 March 2004 No 112-I "On mandatory requirements for credit organisations, issuing securities with mortgage cover"* *amended by* *- Direction dated 18 February 2005 No 1550-U* *- Direction dated 1 June 2007 No 1831-U*	*Herald No 30 (754) dated 19.05.2004* *amended by* *- Herald No 19 (817) dated 13.04.2005* *- Herald No 38 (982) dated 04.07.2007*
Instruction No 128-I/2006	Instruction dated 10 March 2006 No 128-I "On rules for issue and registration of securities by credit organisations on the territory of the Russian Federation	Herald No 25 (895) dated 27.04.2006
Orders of the Federal Financial Markets Service (FSFR)		
Mortgage cover determination order	*Order "On confirmation of the Decree on the method of determination of the mortgage cover" dated 1 November 2005 No 05-59/pz-n* *amended by* *Order dated 30 November 2006 No 06-138/pz-n*	*Bulletin, 2005, No 51, RegNo 7265* *amended by* *Bulletin, 2070, No 7, RegNo 8831*
Special depositar decree *Register maintenance rules* *Order No 05-60/ pz-n/2006*	*Order dated 1 November 2005 No 05-60/pz-n "On confirmation of the Decree on the activity of the special depositar for the mortgage cover and the Rules of the maintenance of the register of the mortgage cover"* *amended by* *- Order dated 5 December 2006 No 06-142/pz-n* *- Order dated 3 July 2008 No 08-28/pz-n*	*Bulletin, 2006, No 4, RegNo 7329* *amended by* *- Bulletin, 2007, No 7, RegNo 8830* *- Bulletin, 2008, No 33, RegNo 12054*
Order No 06-117/ pz-n/2006	Order dated 10 October 2006 No 06-117/pz-n "On confirmation of the Decree on disclosure of information of issuers of issuing securities"	Bulletin, 2007, No 4, RegNo 8532
Order No 07-4/ pz-n/2007	Order dated 25 January 2007 No 07-4/pz-n "On confirmation of the Standards for securities' issuing and registration of securities' prospectus"	Bulletin, 2007, No 25, RegNo 9121
Order No 08-19/ pz-n/2008	Order dated 20 May 2008 No 08-19/pz-n "On confirmation of the Decree on the composition and structure of assets of joint stock investment funds and assets of share investment funds"	Bulletin, 2008, No 30, RegNo 11887
Mortgage cover administrator data reporting decree *Mortgage cover special depositor data reporting decree*	*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"*	*Bulletin, 2010, No 12, RegNo 16405*

3.21 SLOVAK REPUBLIC

By Viktória Múčková
Mortgage trustee[1], for CSOB

I. FRAMEWORK

According to §§14-17 of the Act on Bonds, a mortgage bond, or *Hypotekárny Záložný* List (HZL) in Slovak, is a bond which both in terms of face value as well as in terms of interest payment is guaranteed by a claim against a bank (§ 16 Subsection 4) or a branch of a foreign bank as well as by mortgage loans secured by a pledge on real estate or through a substitute coverage (collateral) (§ 16 Subsection 5). In order to become a mortgage bond issuing institution, the respective bank has to apply for a license. The minimum amount of cash contribution to the bank's equity capital necessary to establish a mortgage bond issuing institution is SKK 1,000,000,000 (EUR 33 mn) or an equivalent amount in fully convertible foreign currency, which is twice the amount necessary to establish a non-mortgage bond issuing bank. Furthermore, the license application has to contain details on the minimum requirements, as outlined in Section II.:

> Article 16
>
> (4) The total par value of issued mortgage bonds must be covered at least in the same amount and at least with the same yield as the par value of the mortgage bank's receivables from mortgage loans, and this shall represent due (ordinary) coverage.
>
> (5) Due coverage of issued mortgage bonds may be replaced by substitute coverage at most up to the level of 10% of the total par value of issued mortgage bonds.

- the methods of keeping a mortgage register;
- the proposal for appointment of the mortgage controller (trustee) and his/her deputy;
- the real estate assessment methods (valuation); and
- the method of keeping a separate analytical record of mortgage activities within the bank's accounting system.

As the criteria indicated in the criteria above, in order to be distinguishable from the insolvency estate of the bank, the mortgage loans serving as due (ordinary) coverage for mortgage covered bonds, just as all other items serving as substitute collateral, have to be recorded in separate mortgage (coverage) register by the issuing bank.

With respect to the general approach to covered bonds the model, applied by Slovakian lawmakers is similar to common practice in Germany and Spain.

However, what is significantly different is the introductory period. In order to allow for a smooth start of the covered bond business after a covered bond issuing license has been granted, the Slovakian covered bond law defines the conception of temporary mortgage bonds.

Within eighteen months following the effective date of mortgage business license, a bank may issue, upon a decision taken by its general meeting, temporary mortgage bonds in form of bearer securities

1 The term mortgage trustee can be used interchangeably with cover pool monitor or mortgage controller.

with a total nominal value not exceeding 50% of the bank's basic capital. The bank is obliged to exchange such temporary mortgage bonds for mortgage bonds covered in accordance with § 16 Subsections 4 and 5 (full collateralisation including maximum share of substitute collateral) of the covered bond law within two years of issue thereof. The provisions of the covered bond law shall not apply in time from issue of temporary mortgage bonds until their exchange for mortgage bonds covered in accordance with the above mentioned paragraphs.

Should a bank fail to exchange the temporary mortgage bonds for mortgage bonds covered within two years following issue of relevant temporary mortgage bonds, the bank is obliged to repay such temporary mortgage bonds in their nominal value including yields for the period from issue until repayment. In practise the conception of temporary mortgage bonds has not been realised up to now.

Another specialty of Slovakian Covered Bonds lies in the fact that a covered bond issued by a specific institution terminates automatically when bought back by the issuer. Hence, activities like market making in own issues or minor price nursing is very restricted. Certainly, this is not an issue for the time being as Slovakian Covered Bonds are not heavily traded products. However, this might become an issue in the future when the euro will be the dominating predominant currency and bonds might be placed more with international investors.

II. STRUCTURE OF THE ISSUER

The mortgage bonds issuers are universal credit institutions. In accordance with Act on Banks, No. 483/2001, amendments, and with relevant decree the minimum requirements to obtain and keep the special licence are as follows:

> the minimum amount of cash contribution to the bank equity capital, is EUR 33,193,919 (SKK 1,000,000,000) or an equivalent amount in fully convertible foreign currency;

> the methods of keeping a mortgage register;

> the proposal for appointment of the mortgage supervisor (trustee) and his/her deputy;

> the real estate assessment methods (valuation); and

> the method of keeping a separate analytical record of mortgage activities within the bank's accounting system.

Basic principles (rules, limits) of mortgage transactions are included in Part Twelve Mortgage Banking, Articles 67 – 88.

The issuer holds the cover assets on his balance sheet. A subsequent transfer of the cover assets to another legal entity does not take place. Given that a direct legal link between single cover assets and Hypotekárny záložný list (HZL) does not exist, all obligations relating to HZL are obligations of the issuing bank as a whole, to be paid from all the cover assets of the issuer.

III. COVER ASSETS

Slovak covered bonds benefit from coverage in the form of original collateral as well as substitute collateral. The latter must not exceed 10% of the total nominal value of mortgage bonds issued. The definition of ordinary collateral is based on the definition of mortgage loans stipulated in Art. 68 of the Slovak Banking Act Nr 483/2001. According to this article, a mortgage loan is defined as a loan with a maturity of at least four years and a maximum of thirty years, secured by the right of lien established upon a domestic real estate, (including on an uncompleted unfinished construction, which is at least to the amount of 90% complete), ***unless this Act requests otherwise***, financed by the issue and sale of mortgage bonds by a mortgage bank pursuant to the Slovak covered bond regulation. *The National Bank of Slovakia may, by its decision issued on the basis of an application of mortgage bank for reasons worthy of special attention maximum for a maximum period of two years stipulate special conditions for financing of mortgage and municipal loans,* ***at least 70 %****, even repeatedly. A reason worthy of special attention is in particular an attempt to maintain the stability of the financial sector*.

The loan in question is supposed to finance one of the following items:

> acquisition of domestic real estate or any part thereof;

> construction or modification of existing structures;

> maintenance of domestic real estate; or

> repayment of an outstanding loan drawn for purposes above;

> repayment of an outstanding loan drawn for purposes mentioned above.

In order to be eligible for collateral (coverage) purposes, the LTV of a mortgage loan is capped at 70%. A bank may grant loans also above this limit, however, the total amount of loans with LTV ratios larger than 70% are capped at 10% of the total amount of mortgage loans granted by the bank. These mortgage loans do not serve as mortgage bonds coverage, and therefore, the part above 70 % reduces relevant cover pool. A mortgage loan may not be secured by a lien on the real estate, on which a lien has already been established and continues in favour of a third party. As already indicated, substitute collateral may be used up to a share of 10% of the total nominal value of issued covered bonds. The following property values belonging to the mortgage bank may be used for the substitute coverage:

> deposits in the National Bank of Slovakia;

> National Bank of Slovakia bills;

> deposits in banks with registered offices in the Slovak Republic;

> deposits in branches of foreign banks in the Slovak Republic;

> cash;

> treasury bonds;

> treasury bills; and

> covered bonds issued by another bank;

It is important to note that neither ABS nor derivatives qualify for the cover pool.

IV. VALUATION AND LTV CRITERIA

Property valuation is regulated in the Act on Banks, Article 73: (1) For the purposes of this Act, the value of real estate shall be determined by a mortgage bank on the basis of an overall assessment of the real estate concerned. In determining the value, the mortgage bank may only take into account permanent features of the real estate and benefits that can be derived by the owner from the real estate in the long run. For real estate burdened by a lien or transfer restrictions in accordance with Article 74, paragraph 2, a mortgage bank shall lower the value of the real estate by the amount of claims guaranteed by such lien or transfer restrictions. Article 73 (2) A mortgage bank shall only be bound by its own valuation of real estate.

Monitoring requirements result from the Decree of the National Bank of Slovakia of 13 March 2007 on banks' own funds of financing and banks' capital requirements and on securities dealers' own funds of financing and securities dealers' capital requirements, Article 110, letter a) – d):

a) legal certainty exists, meaning that the bank's right arising under an agreement on establishing a lien or under an agreement on pledging a right or assigning a receivable is enforceable in all jurisdictions relevant in regard to the collateralising and payment function of the respective credit protection;

b) the property values are monitored, meaning that the value of the property is monitored on a sufficiently frequent basis and at a minimum once every once every three years for residential real estate. More frequent monitoring is carried out where the market is subject to significant changes in market conditions. Statistical methods may be used to monitor the value of the property and to identify property that needs revaluation. The property valuation shall be reviewed by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices. For loans exceeding EUR 3 million or 5% of the own funds of the bank, the property valuation shall be reviewed by an independent valuer at least every three years.

c) the types of residential real estate accepted by the bank under its lending policy are documented;

d) procedures are in place to monitor that the property taken as collateral (or the object of a pledged right) is adequately insured against damage.

For both commercial and residential property, the *LTV* limit is 70% of the mortgage lending value of the property. This LTV is a relative limit, i.e. when the loan exceeds the 70% limit, the part of the loan up to 70% LTV remains eligible for the cover pool. Over this limit a bank may grant mortgage loans exclusively if their total value does not exceed 10% of the total amount of mortgage loans granted by the bank.

V. ASSET-LIABILITY MANAGEMENT

Article 16 (4) of the Act on Bonds stipulates that the total volume of HZL outstanding must be covered at all times by assets of at least the same amount and with at least the same interest income. Thus, the nominal value of the cover assets must permanently be higher than the respective total value of the HZL and the interest yield must be at least the same.

Cash flow mismatch between cover assets and cover bonds is furthermore reduced by the prepayment rules applicable to fixed interest rate mortgage loans. Prepayments of mortgages during fixed rate periods are only permitted in cases of 'legitimate interest' of the borrower or after a period of the fixation term. (This is a part of loan agreement). If the mortgage is prepaid, the borrower has to compensate the damage of the lender caused by the prepayment.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

A cover pool monitor (mortgage trustee, mortgage controller) supervises the cover pool. He/she is appointed by the National Bank of Slovakia (central bank) and must possess the expertise and experience necessary to fulfil all duties. A mortgage controller or his deputy may only be a natural person who has the necessary professional competence and integrity to carry out this activity. A natural person with completed university education, who has at least five years experience in economics or law in the banking sector, shall be deemed professionally competent. A person shall be deemed to have the necessary integrity if he has not been lawfully sentenced for a criminal offence committed in the discharge of a management office or any intentional criminal offence.

Article 80, Act on Banks

(1) A mortgage controller shall supervise the issuance of mortgage bonds and municipal bonds with regard to their particulars and coverage pursuant to a separate regulation.

(2) Prior to each issue of mortgage bonds or municipal bonds, a mortgage controller shall be obligated to issue a written certificate testifying that they are covered in accordance with a separate regulation, and that an entry was made in the register of mortgages.

(3) A mortgage controller shall check whether a mortgage bank provides mortgage and municipal loans, including their securing through mortgage and whether a mortgage bank meets its obligations in respect of the mortgage register in accordance with this Act and other generally binding regulations.

(4) If requested by a mortgage bank, a mortgage controller shall be obligated to assist in activities related to the performance of mortgage operations, which could not be completed by the mortgage bank without his assistance.

How are segregation of cover assets and bankruptcy remoteness of covered bonds regulated?

A cover register permits the identification of the cover assets. The register records the cover assets being used to cover HZL. A list of mortgage and municipal loans and their amounts, liens and claims of a mortgage bank under mortgage and municipal loans that serve to cover mortgage and municipal bonds, or other assets serving as substitute coverage, must be kept separately by a mortgage bank in its *register of mortgages* (Article 76 paragraph 1, Banking Act). The register of mortgages and the documents on the basis of which the entries have been made in the register of mortgages must be kept by a mortgage bank separately from other documents and protected against misuse, destruction, damage or loss (Article 76 paragraph 2, Banking Act). By the end of January and July of each calendar year, a mortgage bank shall be obligated to notify the National Bank of Slovakia and the Ministry of all entries made in the register of mortgages in the last six months (Article 76 paragraph 3, Banking Act). The due form and method for keeping the register of mortgages pursuant to paragraph 2 and the due form of information disclosed pursuant to paragraph 3 shall be determined in detail by the National Bank of Slovakia and the Ministry of Finance by means of a generally applicable regulation (Decree No. 661/2004 Coll. on mortgages register and details over position and activities of a mortgage trustee (supervisor)).

Asset segregation

The cover pool is a part of the general estate of the bank as long as the issuer is solvent. If insolvency proceedings are launched, the assets recorded in the cover registers are governed by the Act No 7/2005 Coll. on bankruptcy (§8, §§ 28 (2), § 50, § 67), also § 72 (3) of Act on banks. See also preferential treatment of covered bond holders.

Impact of insolvency proceedings on covered bonds

Covered bonds do not automatically accelerate when the issuing institution is insolvent, but will be repaid at the time of their contractual maturity.

Preferential treatment of covered bond holders

Privilege right of mortgage (municipal) bonds owner is specified explicitly in the Slovak relevant acts:

"Mortgage (municipal) bonds owners shall have pre-emptive security right to assets used to secure issued mortgage (municipal) bonds, including the right of lien to real estate pursuant to Act on banks (Article 74); this security right in procedure according to Act on banks, No. 483/2001 Coll., or separate regulations - for instance, Article 8, Article 28 par. 2, Articles 69 and 176 to 196 of Act No. 7/2005 Coll. on bankruptcy as amended – shall secure secured receivables of mortgage (municipal) bonds owners against the mortgage bank for the payment of the nominal value and yields upon mortgage (municipal) bonds".

VII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Slovak "Hypotekárny záložný list" fully comply with the requirements of Art. 22 par. 4 UCITS Directive.

Article 45 (7) and (11) of Collective Investment Act

(7) The value of bonds issued by a single bank, or by a foreign bank in a Member State which is subject to supervision that protects the interests of bondholders, may not constitute more than 25% of the value of an open-end fund's assets. Funds raised by the issue of bonds shall be invested in such assets which, until the maturity of the bonds, cover the issuer's liabilities related to the bond issue and which may, in the event that the issuer becomes insolvent, be used to redeem the nominal value of the bonds and to pay the income on them. The aggregate value of bonds acquired for an open-end fund's assets under the first sentence may not exceed 80% of the value of the open-end fund's assets.

(11) Bonds which are issued in the Slovak Republic and meet the criteria laid down in paragraph (7) shall be deemed to include **mortgage bonds** and **municipal bonds** (municipal debt) issued by a bank which, with the funds raised from their sale, provides a municipal loan to a municipality or higher territorial fund share, and provided that these municipal bonds are guaranteed in accordance with the conditions stipulated by a separate law (Act on Bonds).

In regard to the bonds mentioned in paragraph (7) that are issued in a Member State, the management company shall take into account the similar list of bonds compiled in accordance with the law of this Member State, provided that such a list exists.

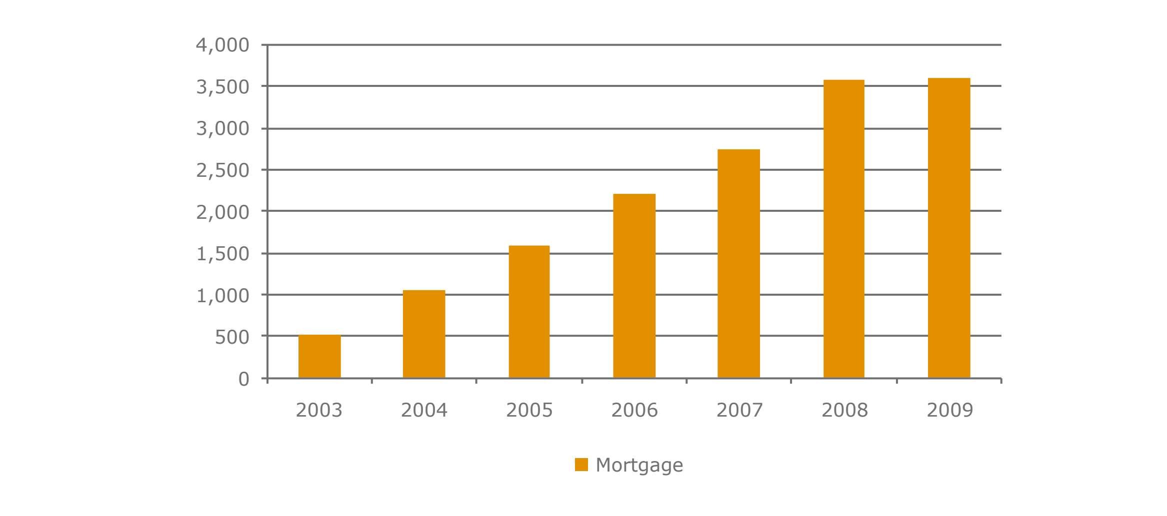
Finally, Slovak institutional investors investment legislation allows:

> mutual funds to invest up to 25% of their assets in HZL;,

> insurance companies up to 20 % of their technical reserves in HZL; and,

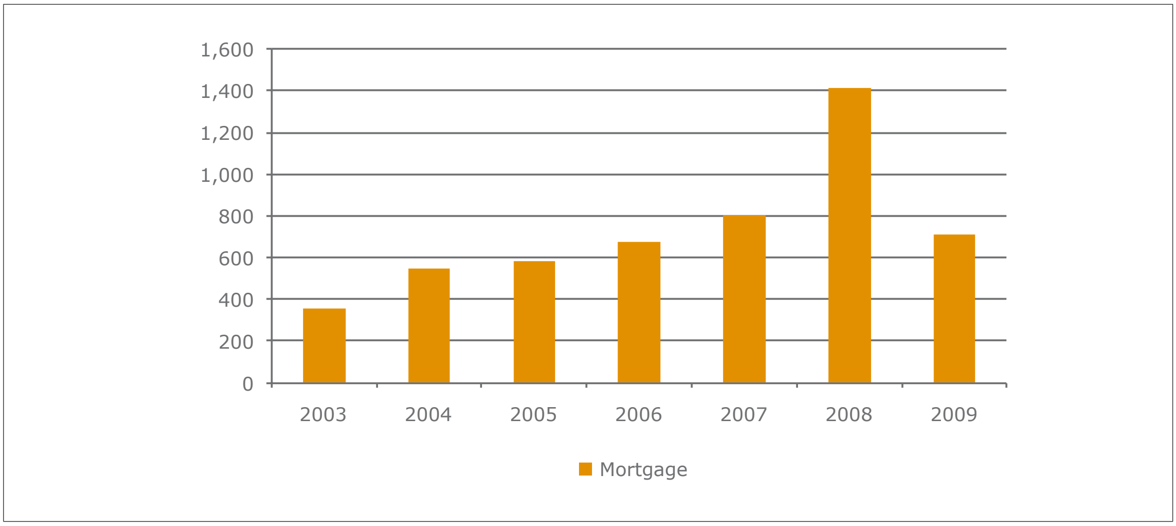
> pension funds up to 15 % of their assets in HZL.

> Figure 1: Covered Bonds Outstanding 2003-2009, €m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2009, €m



Source: EMF/ECBC

Issuers: There were nine issuers in Slovakia as of the end of 2009: CSOB, Dexia Banka, Istrobanka, Volksbank, OTP Banka Slovensko, Slovenská sporitelna, Tatra Banka, UniCredit Bank (Slovakia) and Všeobecná úverová Banka.

3.22 SLOVENIA

By Sonja Anadolli, Bank Association of Slovenia

I. FRAMEWORK

Legal basis for Cover bond issuance in Slovenia is Mortgage Bond and Municipal Bond Act (ZHKO, Official Gazette of Republic of Slovenia, No. 17/06, dated 17.6.2006). Together with a secondary legislation it represents a sufficient legislative framework for mortgage and municipal bonds. Secondary legislation governing the issue of mortgage and municipal bonds with regard to the Mortgage Bond and Municipal Bond Act comprises:

> **Regulation on the conditions for acquiring an authorisation to issue mortgage bonds and municipal bonds** (Official Gazette of Republic of Slovenia, No. 78/06, dated 25.7.2006), which regulates in detail how it is determined for banks whether the conditions for acquiring an authorisation to issue mortgage or municipal bonds have been met. Bank shall demonstrate its capability to have adequate systems for identifying, measuring, controlling and assessing all risks linked to covered bond issue, first of all credit, liquidity, operational, interest-rate and market risks. Taking the business plan into account, the bank shall have organizational and technical qualification, rules regarding conducting of cover register;

> **Regulation on the calculation of the net present value of cover assets** (Official Gazette of Republic of Slovenia, No. 78/06, dated 25.7.2006), which determines detailed rules for matching cover assets and liabilities from issued mortgage or municipal bonds based on the net present value principle, and other rules for matching the maturities, interest rate and currency exposure of the cover assets with the liabilities from issued mortgage or municipal bonds;

> **Regulation on the inclusion of derivatives in cover assets** (Official Gazette of Republic of Slovenia, No. 78/06, dated 25.7.2006) sets out the maximum level of the inclusion of derivatives in cover assets, the type and credit ratings of the parties conducting such transactions, and other detailed instructions for the use of derivatives;

> **Regulation on custodian of the cover register** (Official Gazette of Republic of Slovenia, No. 78/06, dated 25.7.2006) regulates the conditions for appointing the custodian of a cover register and for acquiring a Bank of Slovenia's authorisation to act as the custodian of a cover register.

II. STRUCTURE OF THE ISSUER

The issuer of mortgage and municipal bonds can be a bank with license of Bank of Slovenia pursuant to a Banking act (ZBan-1). A bank which has intention to issue covered bonds according to the Mortgage Bond and Municipal Bond Act (ZHKO, Article 9) should meet the following conditions in order to obtain a special license of Bank of Slovenia:

> A bank shall have adequate systems for managing risks connected with issue of mortgage and municipal bonds and risks connected with cover assets;

> A bank shall insure an adequate number of qualified employees and shall be organizationally and technically qualified for issuing mortgage and municipal bonds and financing of real estate and public sector entities;

> A bank should ensure ongoing business activities concerning granting mortgage loans and loans to public sector entities and issuing mortgage and municipal bonds apart from the other business activities;

> A bank shall prepare rules regarding conducting a cover register;

> A bank shall prepare rules concerning assessment of real estate and employ an appraiser who is independent from the credit decision process (persons who are licensed independent appraisers pursuant to the law governing auditing shall be considered to have necessary qualifications, ability and experience for the assessment);

> A bank shall give a statement to the Bank of Slovenia that it has appropriate contractual relations with its creditors. It means that concluded agreements (contracts) do not contain clauses that allow creditor to rescind a contract to an extent which could threaten a liquidity or solvency of the bank.

The issuer holds cover assets on his balance sheet and at the same time ensures separate activity according to the 3rd indent of this section. A subsequent segregation of the cover assets and obligations from the other assets and obligations of the issuer takes place only in the case of insolvency or dispossession of a special license of Bank of Slovenia (ZHKO, Article 15, 47). In these cases Bank of Slovenia names a receiver of cover assets (ZHKO, Article 48). A transfer to another legal entity is possible only in the case of insolvency on the basis of the contract which is a subject of the written approval of the Bank of Slovenia (ZHKO, Article 50). There is no direct legal link between single cover assets and bonds, all obligations related to bonds are obligations of the issuing bank as a whole, and have to be paid from all the cover assets of the issuer.

III. COVER ASSETS

Cover assets are produced by mortgage and public sector lending. In accordance with the Mortgage Bond and Municipal Bond Act (ZHKO, Article 19-24) cover pool of mortgage bonds may consist of receivables related to credits secured by mortgages on residential properties, credits secured by mortgages on commercial properties, substitutional cover assets (up to 20% of cover assets), financial derivative instruments. Real estate shall be located in area of EEA and Switzerland.

Cover pool of municipal bonds may consist of receivables related to credits granted to public sector entities (state, local community or other public sector entities with a guarantee of the state), substitutional cover assets (up to 20% of cover assets), financial derivative instruments.

Substitutional cover assets comprise:

> cash on the account at Bank of Slovenia,

> marketable securities issued by Member state EEA or its central bank or ECB,

> other debt securities issued by EIB, EBRD or other bank according to criterion of ECB

Issuer may apply financial derivative instruments if they contribute to the reduction of risks connected with cover assets. Financial derivative instruments may present not more than 12% of cover assets pursuant to the "Regulation on the inclusion of derivatives in cover assets" (Point 8-9).

There are certain limits concerning cover assets which comprise cover pool:

> credits secured by mortgages on residential property under construction shall not exceed 5% of cover assets,

> credits secured by mortgages on commercial property shall not exceed 20% of cover assets,

> credits secured by mortgages on property outside Republic of Slovenia shall not exceed 50% of cover assets,

> credits to affiliated parties shall not exceed 20% of cover assets and shall never exceed the maximum allowable exposure according to ZBan-1 and Regulation on large exposures of banks and savings banks (Article 8).

IV. VALUATION AND LTV CRITERIA

Mortgage lending value is the value of the property determined by a prudent assessment of its future marketability, taking into consideration the long-term sustainable aspects of the property, the normal and local market conditions and the current and alternative appropriate uses of the property. Persons who are licensed appraisers pursuant to the law governing auditing (Slovenian Institute of Auditors) shall be considered to have necessary qualifications, ability and experience to assess mortgage lending value of the property. Every issuer of mortgage and municipal bonds shall apply methodology for valuation of mortgage lending value in the special document Rules of valuation. This document has to be confirmed by Slovenian Institute of Auditors (ZHKO, Article 25-27).

The value of receivables related to an individual mortgage credit, which could be considered as the cover asset, may not exceed 60% of the mortgage lending value of the pledged property.

All other details about the valuation process, qualifications of appraisers, valuation and monitoring are prescribed in the Mortgage Bond and Municipal Bond Act (ZHKO, Article 28). Monitoring requirements are in accordance with the Capital Requirements Directive (once a year for commercial real estate and once every three years for residential real estate), in addition Mortgage Bond and Municipal Bond Act explicitly requires a review of the underlying assumptions of the mortgage lending value when the market value of the property has declined for more than 10%.

V. ASSET - LIABILITY MANAGEMENT

Total volume of cover bonds outstanding must be covered by assets of at least the same nominal value at all times. At the same time, the congruence between bonds and assets should be assured on the basis of net present value principle (ZHKO, Article 22).

"Regulation on the calculation of the net present value of cover assets" determines rules for matching cover assets and liabilities from issued mortgage bonds or municipal bonds based on the net present value principle, and other rules for matching the maturities, interest rate and currency exposure of the cover assets with the liabilities from issued bonds. (Point 1-3)

The calculation of net present value shall be carried out for all kinds of bonds every day. If the net present value of mortgage bonds or municipal bonds exceeds the net present value of cover assets, the issuer has to cover the difference with additional funds. In addition, stress tests shall be performed at least once a week. The difference between current net present value and net present value on the basis of stress test shall be covered with immediate enhancement of cover assets. (Point 10-11)

Yield curve which can be used for the calculation of net present value shall be shifted with application of static or dynamic approach in order to assess the influence of change in interest rates. Issuer can use internal model for the assessment of interest rate and foreign exchange risk on the basis of previous notification at Bank of Slovenia and under certain conditions which should be fulfilled. The difference between the net present value of cover assets and the net present value of covered bonds shall be calculated also for individual currencies. (Point 12-23)

VI. COVER REGISTER, CUSTODIAN OF COVER REGISTER AND BANKING SUPERVISION

A cover register enables the identification of cover assets and covered bonds. Covered assets are recorded on the individual basis (individual receivables which arise from mortgage or municipal credits, substitutional cover assets and financial derivative instruments). Nominal value of cover assets and covered bonds outstanding shall be known at all times (ZHKO, Article 38). Issuers are obliged to manage their cover registers and they shall not turn the business over to another transactor. Every issuer shall have an independent custodian of cover register. He is appointed by the issuer and has to be either an authorized auditor who must comply with conditions in accordance to the law governing auditing or he must possess other necessary expert qualifications. Custodianship is possible only on the basis of license from Bank of Slovenia (ZHKO, Article 40-41).

Cover assets could be recorded in the cover register only on the basis of the custodian's approval. Receivables from mortgage credits which beside the registration of mortgage in the land register include a note in the land register, that a secured receivable is earmarked for the registration in the cover register, are eligible receivables for the cover register (ZHKO, Article 39).

Pursuant to the Mortgage Bond and Municipal Bond Act (ZHKO, Article 52) and "Regulation on the conditions for acquiring an authorisation to issue mortgage bonds and municipal bonds" cover register should be managed separately for mortgage bonds and municipal bonds, whereas particular cover register should consist of at least 4 sub-registers: sub-register of mortgage or municipal credits, sub-register of substitutional cover assets, sub-register of financial derivative instruments and sub-register of mortgage or municipal bonds issued by the bank. Each sub-register should have its own analytical support. According to the "Regulation on the calculation of the net present value of cover assets" the calculation of net present value of cover assets should be carried out for each kind of mortgage and municipal bonds separately and should take into consideration characteristics of a particular sub-register. "Regulation on custodian of the cover register" regulates conditions for appointing the custodian of a cover register and conditions for acquiring an authorisation of Bank of Slovenia to act as the custodian of a cover register. (Point 18-22)

The custodian of cover register supervises the cover pool. He has to ensure that prescribed cover for the covered bonds exists at all times and that the cover assets are recorded correctly in the cover register. Without his approval, no assets may be removed from the cover pool and no mortgages may be erased from the land register. If cover assets are not sufficient to cover bonds outstanding and issuer has not assured additional assets, a custodian of the cover assets is obliged to inform Bank of Slovenia. (ZHKO, Article 39, 42)

Issuer shall submit to the Bank of Slovenia an extract of the cover register (signed by the custodian of the cover register) within 10 days after expiration of the quarter for the report as of the last day of the quarter. Issuer's annual report shall include a number of mortgage credits, amounts of mortgage credits with regard to mortgage on commercial and residential properties, a number of sales based on compulsory executions and a number of compulsory executions started in the previous year, a number of closed executions in the previous year. Annual report should provide information separately for commercial and residential properties. Bank of Slovenia as the banking supervisor supervises banks which issue mortgage and municipal bonds. Securities Market Agency shall exercise supervision over the initial public or non-public offering of mortgage bonds or municipal bonds, prospectus for public offering, resolution of bond issue. (ZHKO, Article 53-54)

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

Cover assets could be simply identified in case of insolvency of the issuer on the basis of the record of cover register, where cover assets are stated in contrast to mortgage or municipal bonds issued. In addition, mortgage assets could be identified by means of a special notice in the land register, that a secured receivable is earmarked for the registration in the cover register. Note in the land register indicates that compulsory execution of the collateral and any change in the mortgage are possible only on the basis of written confirmation by the custodian of the cover register. (ZHKO, Article 35, 38)

The legal effect of registration is that in the case of insolvency of the issuer, the assets which form part of the separate legal estate can be identified: All values contained in the register would be qualified as part of the separate legal estate.

Asset segregation

Assets from the cover pool are a part of the issuer's assets as long as the issuer is solvent. In case of insolvency of the issuer, cover assets recorded in the cover registers (including financial derivative instruments) are segregated from the insolvency estate and designated for further uninterrupted repayment of holdersof the mortgage or municipal bonds. Bankruptcy senate names a receiver of cover assets upon the proposal of Bank of Slovenia. Receiver of cover assets carries out the administration of the cover assets and shall not be the same person as the bankruptcy receiver. (ZHKO, Article 47-48)

Receiver of cover assets is entitled to administer that part of receivables related to the mortgage or municipal credits that is not a part of cover assets (the value of receivables related to an individual mortgage or municipal credit, which exceeds 60% of the mortgage lending value of the encumbered property). Such residual is transferred into insolvency estate. (ZHKO, Article 49)

Impact of insolvency proceedings on Covered Bonds and derivatives

Covered Bonds do not automatically become due when the issuing institution is insolvent, but will be repaid at the time of their contractual maturity (ZHKO, Article 47). The same applies to derivatives which are registered in the cover register and form part of the cover pool. Receiver of cover assets represents holders of the mortgage or municipal bonds in court (ZHKO, Article 49).

Preferential treatment of Covered Bond holders

Covered bond holders have preferential rights to be repaid (including costs) from the cover assets prior to any other creditors of the issuer (ZHKO, Article 46). If cover assets are not sufficient for further uninterrupted repayment of total debt from the mortgage or municipal bonds, Bank of Slovenia shall institute separated bankruptcy proceedings above cover assets of the issuer. If holders of the mortgage or municipal bonds in separated bankruptcy proceedings are not fully repaid from the cover assets, remaining receivables may participate in the regular bankruptcy proceedings of the issuer. (ZHKO, Article 51).

Sale and transfer of cover assets to other issuers

Receiver of cover assets may transfer entire cover assets and liabilities from issued covered bonds to another issuer on the basis of the contract which is a subject of the written approval of the Bank of Slovenia. (ZHKO, Article 50).

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk weighting of Covered Bonds is regulated by the "Regulation on the calculation of capital requirements for credit risk under standardised approach for banks and savings banks", transposing the Capital Requirements Directive into Slovene legislation.

Risk weight shall be assigned to exposures in the form of covered bonds with regard to the risk weight of the credit institution that issued them. For instance, covered bonds of the credit institution with 20% risk weight would have a 10% risk weighting.

In accordance with the Investment funds and management companies Act (ZISDU-1, Article 69, Paragraph 3-4) an investment fund may invest up to 25% of its assets in certain types of bonds issued by the same issuer, which is a bank with a registered office or branch in the Republic of Slovenia or in a Member State, and which is subject to special public supervision intended for the protection of the rights of bond holders. The monetary assets or the assets gathered with the sale of bonds must be placed only in assets which would over the entire period of validity, up to the time the bonds shall be due, enable the issuing institution to pay its obligations arising from these bonds and which shall be used to purchase the principal and repay the accrued interest in the case of the issuer's default.

Insurance act (Zzavar, ZZavar B, 121-122) regulates the types of investments permitted and restrictions on the individual investments. The value of individual types of investment of the assets covering technical provisions must not exceed 5%of the total technical provisions and for bonds or other debt securities traded on an organised securities exchange in the Republic of Slovenia, a Member State or an OECD Member State, may reach 40% of the technical provisions if such securities meet conditions from Article 121.

3.23 SPAIN

By Gregorio Arranz, Spanish Mortgage Association

I. FRAMEWORK

The legal framework for Spanish Covered Bonds --"Cédulas Hipotecarias" (CHs) -- is determined by the Law 2/1981, of 25th March, on the regulation of the mortgage market (hereinafter, "Law 2/1981"), Law 41/2007, of 7th December, by which Law 2/1981, of 25th March, regulating the mortgage market and other rules of the mortgage and financial system are modified, reverse mortgages and long-term care insurance are regulated and certain tax regulations are established (hereinafter Law "41/2007") and the Royal Decree 716/2009, of 24th April, which develops certain aspects of Act 2/1981 and other rules of the mortgage and financial system (hereinafter "RD 716/2009").

Regarding bankruptcy regulation, article 14 of Law 2/1981 (modified by the 19th final provision of Law 22/2003, of 9th July hereinafter, the "Insolvency Law" and by Law 41/2007 provides for a special treatment for the holders of the CHs in case of insolvency of the issuer. According to this article, CH holders have special privileged claims (*créditos con privilegio especial*) as established in article 90 of the Insolvency Law.

Article 12 of Law 2/1981 defines that the capital and interests of the CH are secured by the entire mortgage loan book registered in favour of the CH issuer (excl. loans used in securitisations or loans securing mortgage bonds).

Moreover, article 14 of Law 2/1981 determines that in case of issuer insolvency claims of CH holders shall be treated as privileged claims against the insolvency estate (*créditos contra la masa*). It shall be considered as credits against the mass: all the payments which correspond to the repayment of the capital and interest of the issued cédulas hipotecarias and, if any, to the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to the issues. (art. 14 Law 2/1981) Pursuant to article 84.2.7, in combination with article 154, of the Insolvency Law, claims against the insolvency estate have to be paid on their respective due dates without delay of payment, regardless of the status of the bankruptcy proceedings.

In addition, the second additional provision of the Insolvency Law, modified by Royal Decree – Law 3/2009, of 27th March, establishes that in case of insolvency of credit institutions their specific legislation, specifically articles 10, 14 y 15 of Law 2/1981 of mortgage market, shall be applicable. As a result, the mortgage market law supersedes the Insolvency Law.

II. STRUCTURE OF THE ISSUER

Issuers of CHs have to be credit institutions, entitled to participate in the mortgage market and thus, to grant the mortgage credits or loans that comply with the requirements of the Spanish Mortgage Market Legislation. In practice, issuers of CH are mainly: Commercial Banks, Saving Banks, and Cooperative Banks.

The issuer of the CHs holds the Cover Assets on his balance sheet and they are not transferred to a different legal entity.

The CHs, in addition to being direct, unconditional obligations of the issuer and without prejudice to the unlimited universal nature of the liability, comprise a special privileged credit right of its holder against the issuer, and if any, against the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to each issue. This right is guaranteed by the entire mortgage loan book registered in favour of the issuer. The effectiveness of this right is also guaranteed by the existence of mandatory over-collateralisation.

Although there is no direct link between the Covered Bonds and the underlying mortgaged properties, there is a direct link between CHs and the Cover Assets.

Due to the status of the issuer as a credit institution, one of the requirements to conduct business is to have adequate human and material resources pursuant to the credit institution legislation.

The degree of outsourcing Covered Bond issuance activities is quite low, almost irrelevant. Usually, the outsourced service has to be provided by a well-known servicer with an adequate rating. In any case the issuer is responsible and liable for the performance of the service.

Additionally, several entities can group their CHs issuances in a CDO structure (called multi-seller structure). This is based on the issuance of securitisation bonds, backed by the cash-flow generated by such CHs, by an open vehicle that, under Spanish law, is created as a separate fund without legal personality, serviced by a securitisation fund trustee or management company. The Bondholders of each of the series issued by the fund will bear the risk of default on the CHs backing the bonds,. The holders of these securities, known as "cédulas multicedentes" enjoy all of the advantages of the covered bond but as well of a higher degree of risk diversification.

It is important to point out that there is another Spanish Covered Bond called Cédulas Territoriales (CTs) with the same special privilege claim status as CHs. In this case, the cover asset pool consists of all loans to the Spanish State, its autonomous communities and local authorities, as well as their entities and dependent public companies and entities of a similar nature in the European Economic Area. The credit institutions may issue CTs up to 70% of the eligible public loan portfolio, resulting in a minimum over-collateralisation of 43%. A last type of covered bonds is the Bonos Hipotecarios, that although contemplated in Law 2/1981, there have not been used for the time being. These bonds have specific mortgages as collateral and not the whole portfolio.

III. COVER ASSETS

A distinction shall be made between cover assets and eligible assets.

Cover assets consists of the entire mortgage loan book registered in favour of the issuer. The special privileged claims of the holders of CHs are guaranteed by the cover asset pool and if any, by the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to each issue.

The Law 2/1981 does not establish specific requirements for mortgage loans that constitute the cover asset pool.

For issuance purposes and their limits, it shall be considered as eligible assets in order to determine the maximum amount of CH issued and outstanding for a particular issuer.

All mortgage loans which comply with the following criteria are taken into account for the calculation of the maximum amount of CH issued and outstanding:

(i) The object of the loan or credit must be the financing of the construction, reconstruction, or acquisition of residential premises, zoning works and social equipment, construction of agrarian buildings, tourist, industrial and commercial and any other activity or work and any other loan, regardless its purpose.

(ii) The mortgage that guarantees the loan or credit must be a first-ranked mortgage.

(iii) The loan or credit guaranteed may not exceed 60% (art. 5 Law 2/1981 modified by Law 41/2007) of the mortgage lending value of the mortgaged asset, except for the financing of the construction, reconstruction or acquisition of residential premises, in which case it may reach 80% of such value.

The 80% limit in the ratio between the guaranteed loan or credit and the value of the mortgaged home mentioned in the previous section can be exceeded, without under any circumstances exceeding 95%, if the mortgage loan or credit has a bank guarantee provided by a different credit institution to the creditor or is covered by credit insurance. The bank guarantee or insurance shall be direct and will cover at least the amount of the guaranteed loan or credit which exceeds 80% of the valuation of the mortgaged asset and interests (Art. art. 5 RD 716/2009)

Notwithstanding, mortgaged loans or credits that initially exceed these percentages can be used as Cover Assets for the issuance of CHs when, as a consequence of the repayment of their principal amount or the modification of the market value of the mortgaged properties the values do not exceed said LTV, in relation to the initial or revised valuation of the mortgaged asset.

The mortgaged properties must have been valued previously by the so-called "Sociedades *de Tasación*" or by the valuation services of the issuer.

(iv) The mortgaged assets must be insured against damages.

All mortgage loans that do not fulfil at least one of the above mentioned criteria cannot be taken into account for the calculation of the maximum amount of CH.

Excluded from cover asset pool are special types of mortgage credits or loans, such as:

> Those documented by way of registered securities, either to the order or bearer securities.

> Those which are partially or totally due.

> Those which have already been the subject of mortgage participations ("Participaciones Hipotecarias", i.e. loans used in securitisations).

> Those subject to senior mortgages or seizure.

The right to use and enjoy ("derecho de usufructo") administrative concessions, rights to extended areas ("derechos de superficie") and real estate properties which do not have building codes (i.e. those which are outside the zoning regime) are excluded as well.

The cover asset pool is defined as a dynamic cover pool. ABS/MBS or other assets are not allowed in the cover pool, but mortgages are allowed.

It is market practice for the issuer to hedge the interest rate risk by using the corresponding derivative instrument.

The institution issuing the cédulas hipotecarias will keep a special accounting register of the loans and credits that serve as collateral of the issues of cédulas hipotecarias and, if any, of the substitute assets fixed that cover them, as well as the derivative financial instruments linked to each issue. The annual accounts of the issuing institution shall contain the essential details of said register (art. 12 Law 2/1981, art. 21 RD 716/2009 and Circular 6/2008, of 26th November of the Bank of Spain).

In order to guarantee the transparency of the cover assets, the issuers have to provide the Bank of Spain with a monthly cover pool report. Moreover, there is a general duty of disclosure as a result of the continuous supervisory power of the Bank of Spain.

IV. VALUATION AND LTV CRITERIA

According to mortgage market legislation, the value of the mortgaged property has to be appraised prior to the issuance of the CHs by specialised companies, the so-called *Sociedades de Tasación or by the valuation services of the issuers*.

If for market reasons or due to any other circumstance the value of the mortgaged asset drops below the initial valuation by more than 20%, and therefore exceeds, according to the capital outstanding, the issuance limits referred to in article 5.1 of Law 2/1981, the issuer, following valuation performed by an independent sociedad de tasación, can demand from the debtor the extension of the mortgage to other assets sufficient in order to cover the required ratio between the value of the asset and the loan or credit that it guarantees (Art.5 of Law 2/1981 and Art.9 of RD 716/2009).

In the event that the debtor is an individual, the drop referred to in the previous paragraph must have remained for a period of one year counting from the time when the creditor institution has recorded said drop in the special accounting register of the loans and credits that serve as collateral of the issues.

The debtor, after being requested to make the extension, can opt to refund the entire loan or credit or the part of it which exceeds the amount resulting from applying to the current value the percentage used to initially determine its amount.

If within the period of two months from the extension request, the debtor has neither done this nor refunded the part of the loan or credit referred to in the previous paragraph; it will be considered that he/she has opted to refund all of the loan or credit, which can be immediately demanded by the creditor institution.

The mortgage markets legislation also determines the regulation for the appraisal service and the requirements with which the specialised companies have to comply, such as, an exclusive corporate object, minimum corporate capital requirement, registration with the corresponding registry at the Bank of Spain. Moreover, those entities are supervised and subject to inspection by the Bank of Spain. These rules were developed by the Ministerial Order of 27th March of 2003 in relation to the appraisal of real estate goods.

V. ASSET - LIABILITY MANAGEMENT

The volume of CHs issued and outstanding by a particular Issuer cannot exceed 80% (art. 16 Law 2/81) per cent of the sum of the unpaid principal amounts corresponding to all the mortgage credits or loans included in the Issuer's portfolio that comply with the requirements mentioned above under III. Cover Assets. The issuer cannot issue CHs beyond these percentages at any time.

The cédulas hipotecarias can be backed up to a limit of 5 percent of the issued capital by substitution assets (fixed income securities issued by the State and other EU Member States, cédulas hipotecarias, mortgage bonds, securities issued by Mortgage Securitisation Funds or Asset Securitisation Funds and other fixed-income securities listed on an official secondary market or on a regulated market, with a credit rating equivalent to that of the Kingdom of Spain –art. 15 and 17 Law 2/1981)

Notwithstanding this general statement, if the limit is surpassed due to increases in the redemption of the Elegible Assets or any other event whatsoever, the Issuer shall re-establish due balance by means of any of the following actions:

(a) Cash deposit or deposit of government paper in the Central Bank of Spain.

(b) Acquisition of CHs in the relevant marketplace.

(c) Execution of new mortgage loans or acquisition of mortgage participations, provided that they are eligible to cover CHs.

(d) Redemption of CHs by the pertinent amount until balance has been reinstated, which, if necessary, can be executed through early redemption and drawing the number of securities to be redeemed by lot.

As a general remark it should be noted that it is market practice for the issuer to hedge interest rate risk.

Moreover, regulation provides for some particular rules in this respect that can be summarised as follows: Issuers shall adopt the necessary measures to avoid inappropriate imbalances between the flows from the cover portfolio and those derived from the payments due for the cédulas that they issue (article 17.6 of RD 716/2009).

Concerning foreign exchange risks, there is no legal provision in relation to the following areas

> The currency of the Covered Bonds

> Limiting FX risks between Cover Assets and the CHs

> Limiting, managing or hedging the exchange risk as in the case of the interest rate risk. Notwithstanding, it is universal market practice to denominate the CHs in Euro if the currency of the Cover Assets is Euro.

Other risks such as early repayment, reinvestment, etc. are also mitigated by the 25% overcollateralisation as well as by the dynamic nature and structure of the cover pool.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The institution issuing the cédulas will keep a special accounting register. Please refer to Section III Cover Assets. The Spanish legislation does not require a special pool monitor other than the prudential supervision on a continuous basis by the Bank of Spain which includes the periodic disclosure of information regarding cover assets by credit institutions.

The Bank of Spain is responsible for supervising compliance with the limits and regulatory requirements and is entitled to adopt measures in order to mitigate any breach or deviation from the regulation, including sanctioning such breach or failure in accordance with article 5 of the Law 26/1988, of 29th July.

The issuer is also responsible and liable for cover and eligible assets pool monitoring. The quantitative mandatory limits have to be maintained at all times, thus the monitoring is carried out continuously by the issuer as a part of the risk management and auditing of its activity.

The "special" supervision - as per reference to UCITS Art. 22(4) - is carried out by the *Comisión Nacional del Mercado de Valores* (hereinafter, "*CNMV*"). The CNMV may also monitor and supervise compliance with statutory requirements and limits upon approval of the issuance and clearly supervise the placing process

The role of the rating agencies shall be decided by the issuer on a case-by-case basis, either for commercial or market reasons, although as matter of fact most issues are rated.

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

Identification of the cover assets

Any mortgage that is originated in Spain must be registered in the Land Registry. Consequently, the Land Registry is the cover registry which records all the mortgages serving as the collateral for the CHs. The institution issuing the cédulas will keep a special accounting register.

Asset Segregation from the insolvency's estate.

Article 14 of the Law 2/1981 of the regulation of the mortgage market stipulates that the institution issuing the cédulas will keep a special accounting register. This provides the legal framework regarding the position of the rights of the holders of the CHs in case of insolvency of the Spanish issuer.

In this respect, it is worth pointing out the following relevant issues:

1. According to article 14 of Law 2/1981 claims of CH holders have to be treated as privileged claims against the insolvency estate (*créditos contra la masa*). Article 84.2.7 and article 154 of the Insolvency Law require that claims against the insolvency estate have to be paid by the insolvency administrators on their respective due dates without delay of payment, regardless of the status of the bankruptcy proceedings.

In the case of CH, the claims of the CH holders are secured by the entire mortgage loan book registered in favour of the CH issuer (article 12 of Law 2/1981) and if any, by the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to each issue. The definition as stated by the Insolvency Law implies the application of the special rule of payment without enforcement of the collateral.

The Insolvency administration is not entitled to adopt any decision against said legal provision and has to use the proceeds from the issuer's mortgage loan book to satisfy CH principle and interest payments on their respective due dates without delay of payments.

2. The Insolvency administrators are obliged to pay such amounts as long as the cash flows produced by the Cover Assets are sufficient to meet the CHs payments pursuant to article 84.2.7 of the Insolvency Law.

In this respect, the Insolvency Law provides a clear definition of the claims of CH holders as special privileged claims without enforcement of the collateral. It also provides an unequivocal classification of the claims of CH holders, as claims against the insolvency estate and clear identification of the cover assets, which are reserved to meet the claims of the CH holders.

Thus, the clarity of the provision leaves no room for a different interpretation. In other words, the same legal provision that states the privilege, states the extent and limits of the same.

All of the holders of cédulas hipotecarias, whatever their date of issue, shall have the same preference over the loans and credits covering them and if any, to the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to each issue.

3. The payments to be effected by the debtor comprise all those deriving from principal and interest of the issued and outstanding CHs on the date on which the Insolvency is declared. All CH payments have to be met on their respective due dates, regardless of the status of the bankruptcy proceedings. In the case where the cover assets are insufficient to meet the CH payments, the claims of the CH holders will be realised. This realisation will not be subject to the 1 year term (or to the approval of the convention, if before) of "suspension or delay" provided for the execution of guaranties in rem pursuant to article 55.1 of the Insolvency Laws in the event of the alienation of properties and rights affected to the cédulas hipotecarias. The payment to all of the cédulas hipotecarias owners shall be done on a pro rata basis, regardless of the issue date of their securities. (art. 14 Law 2/1981). In the case of insufficient cover assets, all CH holders' claims will be met on a pro-rata basis together with ordinary claims (Art. 157.2 of the Insolvency Law).

A judicial stay (moratorium) on the insolvency's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of interest and the principle on CHs.

In case of insolvency of the issuer, liquidity is ensured by the means discussed above, by the flows derived from the Cover Assets.

In order to comply with the payment obligations to the holders of the cédulas hipotecarias in the event of a temporary lap in the revenue received by the debtor, payments shall be made by means of liquidating the substitution assets serving as collateral of the issue. If this was insufficient, payments shall be made by means of funding operations via subrogation of the debtor in the position of the holder of the cédulas (art. 14 Law 2/1981)

Administration of the cover assets

In case of insolvency, it is the normal insolvency administrator who administrates the Cover Assets. In this respect, under Spanish Insolvency Law, the bankruptcy is directed by commercial court of competent jurisdiction and managed by a specific body called the "bankruptcy authority" ("administración concursal") comprising three persons: an attorney, an auditor or accountant and a creditor with ordinary debt or general privilege.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk weight of the CHs that comply with the requirements of Law 2/1981 is dependent on the risk weight against the issuer, according to the following table:

Risk Weight against the issuer	CH's Risk Weight
20	10
50	20
100	50
150	100

(Rule 16, section L "Covered Bonds" of the Circular 3/2008, of 22 May, of the Bank of Spain)

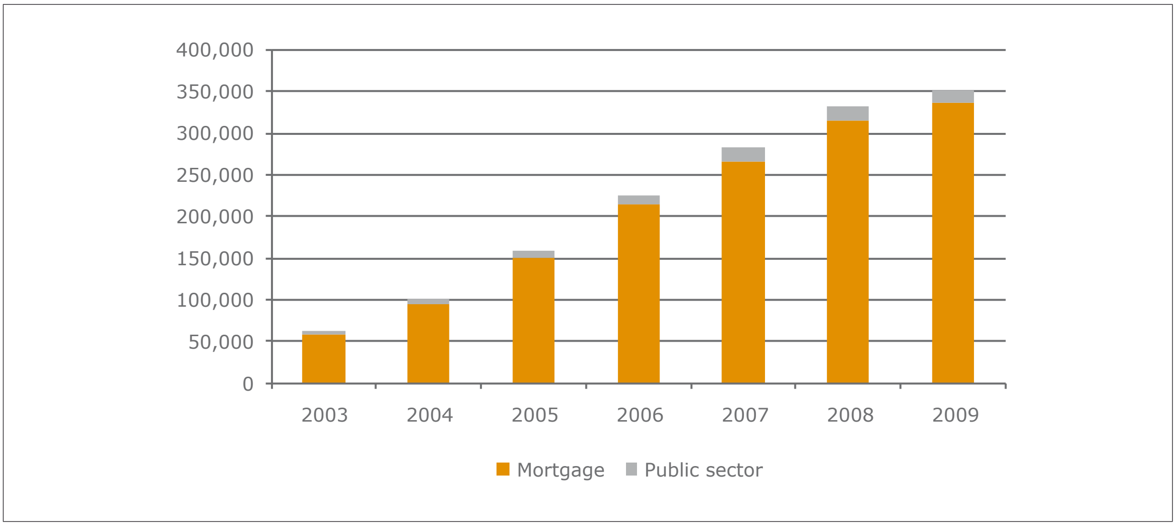
The CHs listed on a recognised secondary market (as AIAF) are eligible for investing the assets of the UCITS up to 25% of its net worth.

Provided that the requirements of the Law 2/1981 are met, the CHs are eligible as "Covered Bonds". The applicable law comprises Law 36/2007, of 16 November and Royal Decree 216/2008, of 15 February, by which Directives 2006/48/EC and 2006/49/CE, of 14 June 2006 are transposed into the Spanish Law.

The CHs are also eligible in repo transactions with the Spanish Central Bank and the European Central Bank provided that they comply with the requirements of the Law 2/1981.

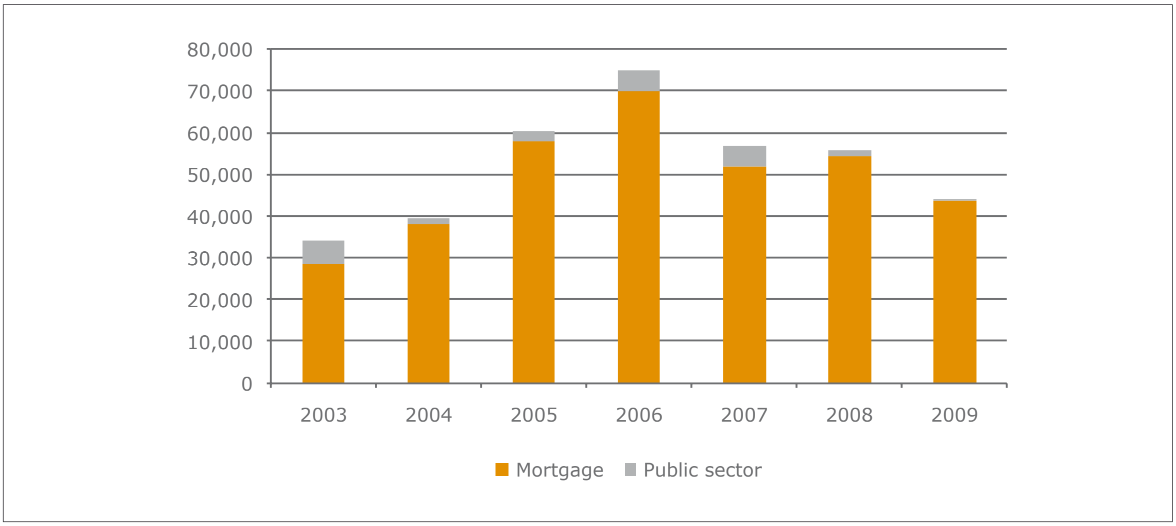
Finally, the CHs upon being listed or applied for listing are eligible for: i) investment by insurance companies of their technical provisions obligations; ii) the investment by mutual guarantee companies; iii) investment by Pensions Funds.

> Figure 1: Covered Bonds Outstanding 2003-2009, €m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2009, €m



Source: EMF/ECBC

Issuers: At the end of 2009, there were 70 issuers in Spain.

3.24 SWEDEN

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

DEVELOPMENTS

> The Swedish Parliament has approved a Government bill with amendments of the Covered Bond Issuance Act. The amendments, which entered into force on 1 June 2010, gives the receiver-in-bankruptcy – in case of the insolvency of the issuer – an explicit mandate to take out liquidity loans on behalf of a bankruptcy estate in order to maintain the liquidity matching (see also chapter VII Segregation of cover assets and bankruptcy proceedings).

> The Swedish covered bond issuers have agreed on a recommendation to calculate and present certain basic key statistics concerning their respective cover pools as uniformly as possible ("Max LTV per property"; see also chapter X Activities of ASCB).

> The Association of Swedish Covered Bond Issuers (ASCB) has initiated projects aiming at further improving transparency in the Swedish covered bond market in order to maintain the position of Swedish covered bonds as being a highly secure product for financing of mortgage and public lending.

I. FRAMEWORK

In Sweden, the issuance of Covered Bonds is governed by the Swedish Covered Bonds Issuance Act, which came into force on 1 July 2004 (Lag 2003:1223 om utgivning av säkerställda obligationer, hereinafter the 'CBIA')[1]. The CBIA supersedes the general bankruptcy regulation and grants Covered Bond investors a priority claim on eligible cover assets (CBIA: Chapter 4, Section 1). Regulatory provisions (FFFS 2004:11, hereinafter 'CBR')[2] established by the Swedish Financial Supervisory Authority (Finansinspektionen, hereinafter 'SFSA') complement the legislation. These regulations define in more detail the criteria for obtaining an issue licence, the universe of eligible cover assets, valuation procedures for eligible cover assets, asset and liability management, and the form and maintenance of the cover register.

II. STRUCTURE OF THE ISSUER

The CBIA does not apply the specialised banking principle but allows all banks and credit institutions to issue Covered Bonds provided they have obtained a special licence from the SFSA (CBIA: Chapter 2, Section 1). The issuer must meet certain criteria to qualify for the licence. These criteria include the submission of a financial plan proving the issuer's financial stability for the next three years, the conversion of outstanding mortgage bonds into Covered Bonds, and the conduct of business in compliance with the CBIA. The SFSA has the right to withdraw the licence should the institution be in material breach of the CBIA or have failed to issue Covered Bonds within one year of receiving the licence (Table 1). If the SFSA withdraws a licence, it must determine a plan to wind down the operation.

1 Lag 2003:1223 om utgivning av säkerställda obligationer [Covered Bonds Issuance Act].
2 FFFS 2004:11 Finansinspektionen's Regulations and General Guidelines Governing Covered Bonds.

> TABLE 1: LICENCE NEEDED TO ISSUE COVERED BONDS

Requirements for issuance licence:

> The institution's articles of association, by-laws or regulations must comply with the CBIA.

> The issuer must conduct the covered bonds business according to the CBIA and related regulatory provisions.

> Outstanding mortgage bonds to finance loans that may be included in the cover pool must be converted into covered bonds or administered in an equivalent manner with respect to the creditors.

> The issuer must submit a financial plan for the next three financial years indicating that its financial situation is sufficiently stable so that the interest of other creditors is not jeopardised when it issues covered bonds. The report must be substantiated by auditors.

> The issuer must submit an operational plan that calls for sound management and supervision of the covered bond business (including information on the IT business).

The SFSA may withdraw a licence if:

> The institution is in material breach of its obligations pursuant to the CBIA; and/or

> The institution has failed to issue a covered bond within one year of receiving the licence.

Source: Lag 2003:1223, FFFS 2004:11

Despite the absence of a specialised banking principle, the history of the Swedish mortgage market suggests that, in practice, specialised mortgage banks will be the main active Covered Bond issuers. Prior to the CBIA, commercial banks were restricted on their mortgage lending activities, and mortgage loans were extended by specialised mortgage institutions, which were allowed to issue mortgage bonds. Most of the Swedish mortgage credit institutions have a strong affiliation with Nordic universal banking groups, outsourcing their activities to their respective parent. The degree of outsourcing varies among issuers. The SFSA has published general requirements regarding outsourcing.

The cover assets represent claims of the covered-bond-issuing entity and remain on the balance sheet. There is no subsequent transfer of cover assets to another legal entity. The Covered Bonds are direct, unconditional obligations on the part of the issuer. Outstanding Covered Bonds are backed in their entirety by the cover pool. Hence, there is no direct legal link between single cover assets and particular Covered Bond series. In the event of issuer insolvency, the cover pool is bankruptcy-remote from the general insolvency estate of the issuer and exclusively available to meet outstanding claims of Covered Bond holders. Moreover, Covered Bond investors enjoy ultimate recourse to the insolvency estate of the issuer, ranking pari passu with senior unsecured investors.

III. COVER ASSETS AND COVER REGISTER

Eligible cover assets are mortgage loans and public-sector assets (CBIA: Chapter 3, Section 1). The CBIA does not specify separate cover pools for mortgage and public sector cover assets. Both asset classes are mixed in one cover pool. However, the main emphasis of Swedish issuers will be on mortgage Covered Bonds.

Eligible assets are mortgages:

> on real estate intended for residential, agricultural, office or commercial use;

> on site-leasehold rights intended for residential, office or commercial use;

> pledged against tenant-owner rights; and

> against similar foreign collateral.

The CBIA restricts mortgages against offices and commercial property to 10% of the total cover pool. Mortgage loans can be secured only with collateral comprising property located in Sweden and the European Economic Area (EEA)[3]. Neither asset-backed securities nor mortgage-backed securities are permissible as cover assets. The mortgage loans must meet valuation procedures and certain loan-to-value ratios defined by the CBIA and the CBR (see page 3).

Eligible public-sector assets are defined as securities and other claims:

> issued by or guaranteed by the Swedish state, Swedish municipality or comparable public body;

> issued by or guaranteed by a foreign state or central bank, where the investment is in the foreign state's currency and is refinanced by the same currency[4];

> issued by or guaranteed by the European Communities, or any of the foreign states, or central banks as prescribed by the Swedish government; or guaranteed by a foreign municipality or public body that has the authority to collect taxes.

The cover pool is a dynamic pool, and nonperforming loans due over 60 days cannot be recognised for the purposes of meeting the matching requirements set forth by the CBIA (CBR: Chapter 3, 4§).

Derivative contracts

The CBIA provides for the use of derivatives for hedging interest and currency risk. The derivatives must be structured such that premature termination is not triggered by an issuer default or on demand of the counterparty. Derivative counterparties must have a minimum long-term rating of A3/A-/A- (Moody's/S&P/Fitch) or a short-term rating of P-2/A-2/F2. The law stipulates asymmetrical collateralisation, in that it requires collateral, a guarantee or replacement language in the event that the counterparty's rating falls below the minimum rating level. There is no reciprocal requirement by the Covered Bond issuer, given that derivative counterparties have a priority claim on the cover pool (CBR: Chapter 4, 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

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.

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, 7§, Chapter 5, 4§). The valuer is normally an employee of the issuer, but independent valuers are also used.

For the various mortgage types eligible as cover, the following maximum LTV ratios apply (CBIA: Chapter 3, Section 3):

> 75% of the value for real estate, site-leasehold rights and tenant-owner rights where the property is intended for residential use;

> 70% of the value for real estate intended for agricultural use;

> 60% of the value for real estate, site-leasehold rights and tenant-owner rights where the property is intended for office or commercial use.

These LTV limits are relative, not absolute, limits. A loan with a higher LTV ratio can be included in the cover pool up to the legal threshold. The balance must be refinanced with other funding instruments (e.g., senior unsecured funding) (CBR: Chapter 5, 3§).

V. ASSET - LIABILITY MANAGEMENT

The CBIA requires that the nominal value of the cover assets all times exceeds at the aggregate nominal value of claims arising from outstanding Covered Bonds against the issuer (CBIA: Chapter 3, Section 8). In addition, the law requires that on a net present value (NPV) basis, cover assets, including derivatives, always exceed the corresponding value of the interest and principal of outstanding Covered Bonds, taking into account the effects of stress-test scenarios on interest and currency risk set by the SFSA. The SFSA defines the stress test for interest-rate risk as a sudden and sustained parallel shift in the reference swap curve by 100bps up and down, and a twist in the swap curve. Likewise, it defines currency risk as a 10% sudden and sustained change in the relevant foreign exchange rate between the currency of Covered Bonds and the currency of cover assets (CBR: Chapter 4, 2§, 3§). The CBIA does not require a mandatory level of minimum overcollateralisation (OC). However, the issuer can adhere to a self-imposed OC level for structural enhancement, as the CBIA protects any OC in the cover pool in the event of issuer insolvency).

Finally, the issuing institution shall ensure that the cash flow with respect to the assets in the cover pool, derivatives agreements and the Covered Bonds are such that the institution is always able to meet its payment obligations towards holders of Covered Bonds and counterparties in derivatives agreements (CBIA: Chapter 3, Section 9). The issuer should be able to account for these funds separately.

VI. COVER POOL MONITORING AND BANKING SUPERVISION

The Covered Bond issuers fall under the special supervision of the SFSA. The financial regulator monitors the institutions' compliance with the CBIA and other related regulatory provisions (e.g., CBR). If the Covered Bond issuer is in material breach of its obligations under the legal framework, the SFSA can issue a warning or revoke the issue license altogether. The SFSA may also revoke a license if the institution has declared that it waives the license or if the institution has not made use of the license within a year from the date of receiving the license. The revocation may be combined with an injunction against continuing the operations and with the imposition of a conditional fine. In any case, the SFSA must determine how the operations should be wound up (CBIA: Chapter 5, Sections 2 to 6).

For each issuing institution, the SFSA must appoint an independent and suitably qualified cover pool inspector (cover pool trustee), who is paid by the Covered Bond issuer. The duties of the cover pool inspector are to monitor the register and verify that Covered Bonds, derivatives agreements and the cover assets are correctly recorded. The inspector also ensures compliance with matching and market risk limits in accordance with the CBIA. The institution is obliged to provide the Covered Bond inspector with any information requested relating to its Covered Bond operations. The cover pool monitor must submit a report of the inspection to the SFSA on an annual basis, and must notify the SFSA as soon as he/she learns about an event deemed to be significant to the supervisory authority (CBIA: Chapter 3, Section 12 to 14, and CBR: Chapter 6, 2§ to 5§).

VII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY PROCEEDINGS

Cover register

The issuer must keep a register of eligible cover assets, substitute assets, derivative contracts, and outstanding Covered Bonds (CBIA: Chapter 3, Section 10). The law specifies the form and content of such a register, which must be easily accessible for the SFSA and the cover pool inspector. The registration legally secures Covered Bondholders and derivative counterparties a priority claim on the cover pool in the event of issuer insolvency (CBIA: Chapter 4, Section 4). Prior to an issuer being declared insolvent, cash flows accruing from the cover assets must be accounted for separately by the issuer. In the event of issuer default, Covered Bond investors and derivative counterparties have the same priority claim on these funds as they have on the cover pool. Moreover, cash flows accruing from the cover assets after issuer insolvency must be registered in the cover pool register.

Issuer is a subsidiary

Under the Swedish bankruptcy code, the mere insolvency of the parent company does not automatically trigger the insolvency of a subsidiary.

Issuer insolvency

In the event of issuer insolvency, the registered cover assets and the respective Covered Bonds are segregated from the general insolvency estate. Covered Bonds are not accelerated as long as the cover pool fulfils the requirements set out in the CBIA, notwithstanding the existence of 'only temporary, minor deviations' (CBIA: Chapter 4, Section 2).[5] Also, mere issuer default does not trigger the premature termination of registered derivative contracts. Covered Bond holders and registered derivative counterparties have a priority claim on the cover pool and cash that derives from the pool, ensuring timely repayment to original agreed terms, as long as the pool complies with the CBIA. However, the cover pool does not constitute a separate legal estate. According to legal opinion, the bankruptcy of the issuer should not lead to a debt moratorium on Covered Bonds.[6]

5 According to preparatory works to the Act, this would be, for example, "temporary liquidity constraints".

6 There are no means in the Act that could disrupt or delay payment to Covered Bondholders. However, the Act does not explicitly derogate from the general provision of the Code of Procedures 1948 or the Bankruptcy Act 1987, of which neither explicitly ensures the integrity of payments on Covered Bonds.

Cover pool insolvency and preferential treatment

In the event that the cover pool breached eligibility criteria, Covered Bonds would be accelerated. Covered Bond investors and derivative counterparties would have a priority claim on the proceeds from the sale of the cover assets, ranking pari passu among themselves but prior to any tax claims and salary payments (pursuant to Section 3a of the Rights of Priority Act [SFS 1970:979]). If the proceeds are insufficient to repay all liabilities on outstanding Covered Bonds, Covered Bond investors and derivative counterparties would have an ultimate recourse to the insolvency estate of the issuer, ranking pari passu with senior unsecured investors.

Survival of OC

Any OC present in the cover pool at the time of issuer insolvency is bankruptcy-remote provided it is identified in the cover pool register. Indeed, the CBIA requires full repayment of outstanding claims on Covered Bonds, and registered derivatives, before cover assets would be available to satisfy claims on unsecured creditors.

The law does not provide for the appointment of a special cover pool administrator. The receiver-in-bankruptcy represents the interests of both the Covered Bond investors and the unsecured investors. The receiver has the right to use OC to pay advance dividends to other creditors of the bankrupt issuer, if the pool contains more assets than necessary.[7] If the cover assets later prove to be insufficient, these advance dividend payments can be reclaimed.

Access to liquidity in case of insolvency

In the cases of issuer insolvency, the law does not enable the receiver-in-bankruptcy to refinance maturing Covered Bonds of the issuing institution by issuing new Covered Bonds against the cover pool, as the latter does not constitute a legal entity. Likewise, the receiver is not able to substitute ordinary cover assets for alternative assets. However, the receiver can use available liquid substitute assets included in the pool. In addition, the receiver can sell part of the cover pool in the market to create the necessary liquidity without raising debt.

The receiver-in-bankruptcy has also got an express mandate, on behalf of the bankruptcy estate, to take out liquidity loans and enter into other agreements for the purpose of maintaining matching between the cover pool, covered bonds and derivative contracts. The receiver has an extensive mandate to enter into agreements, not only to achieve a liquidity balance but also to achieve a balance in respect of currencies, interest rates and interest periods. The receiver should only enter into agreements if, on the date of execution of the agreement, the agreement is deemed to favour bondholders and derivative counterparties and if the assets in the cover pool are deemed to fulfil the terms and conditions imposed in the Act. When the receiver enters into an agreement the contracting party receives a claim against the bankruptcy estate that ranks ahead of the secured creditors and creditors with rights of priority.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Swedish Covered Bonds comply with the criteria of UCITS 22 (4) and with the Covered Bond criteria defined in the EU CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f). The CBIA explicitly lists mortgages against property for agricultural purposes, and mortgages against the pledging of tenant-owner rights

7 According to legal opinion, the receiver-in-bankruptcy would have take into account a substantial safety margin to ensure that the cover pool's integrity and compliance with the Act is not jeopardized, which would be difficult to prove unless outstanding Covered Bonds were due to mature imminently.

as eligible cover assets, while the EU CRD does not. However, general opinion of the parties involved is that the EU CRD's term "commercial real estate" should be interpreted in a broader sense, including agricultural property. In addition, issuers can impose self restrictions to ensure that their Covered Bond issues comply with EU CRD. Swedish Covered Bonds are eligible for repo transactions with the Riksbank (the Swedish Central Bank). The share of the total collateral in relation to the payment system that can be comprised of covered bonds is 100 per cent. This applies to covered bonds issued by the borrower or by an institution with close links to the borrower.

The Riksbank's collateral requirements are harmonised with those applied within the Eurosystem. Moreover, Swedish Covered Bonds denominated in euros are likely to qualify as Tier 1 assets with the ECB.[8]

Derivatives that are part of the cover pool do not benefit from any special capital treatment. They currently carry the same risk weighting as the credit institution counterparty. The implementation of EU CRD into Swedish law grant derivative contracts included in the cover pool the same capital treatment as Covered Bonds.

Foreign Covered Bonds enjoy the same preferential capital treatment in Sweden if the foreign supervisory authority of that Covered Bond issuing institution has also assigned those Covered Bonds preferential risk weightings (principle of mutual recognition).

The law regulating insurance companies in Sweden (Försäkringsrörelselagen 1982:713) makes no distinction between mortgage bonds and Covered Bonds. Swedish insurance companies can invest up to a maximum of 25 % in the Covered Bonds of a single issuer. Swedish legislation on investment funds (Lag 2004:64 om investeringsfonder) allows mutual funds to invest up to 25% of their assets in Swedish Covered Bonds, instead of the 10% generally applicable to other asset classes.

IX. ISSUING AND TRADING OF SWEDISH DOMESTIC COVERED BONDS

In order to issue covered bonds mortgage companies and banks need an authorisation by the Swedish Financial Supervisory Authority (SFSA). Normally the bonds are registered at the Nordic Exchange Stockholm (NASDAQ OMX Group), although no actual bond trading takes place there. Offering circulars with the detailed issue conditions are following a standard based on the Prospectus Directive with acceptance from the SFSA, OMX and the market participants. The normally used technique for issues is "on tap".

The Swedish bond market investors appreciate liquidity. Because of these "requirements" the large issuers issue their bonds as benchmarks which mean that large amounts (SEK 3 billion and more) are issued and that a number of dealers, under normal circumstances, show both bid and offer prices. Also, only benchmarks are deliverable in the future contracts. When a new benchmark-loan is issued, the issuers make sure that the amount issued meets the requirements for a benchmark sized deal. After the initial day of issuance the issuer can, without further notice, issue "on tap" the size he requires to match the lending.

The bonds are sold into the primary market through banks acting as agents for the issuer. These banks also act as market makers in the secondary market. Currently, there are seven banks and securities firms that act as market makers in treasury bonds and bills on the secondary market. A majority of the market makers in government bonds are also market makers in covered bonds. The market for government and

8 In general, the ECB grants marketable debt instruments the status of Tier 1 assets, if the security is denominated in euros, compliant with UCITS Art. 22 (4) and issued by a credit institution situated in the EEA area (ECB: "Implementation of Monetary Policy in the Euro Area", Feb, 2005).

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 (the PMI Information system) which is instantaneously relayed by Reuters and Telerate. Fixed prices are quoted on request and most deals are concluded via telephone. Trading in the secondary market takes place on all business days between 09.00 and 16.15 (local time). The number of loans to be quoted is regulated in an agreement between the issuer and the market-maker.

Bonds are quoted on a yield basis with bid and ask spread of (under normal market conditions) 2 bp for the liquid benchmark bonds. The settlement day for bonds is three business days after the trading date. T-bills are quoted on a simple yield basis and are settled two business days after the trading day. The normal trading lot in government securities and liquid mortgage bonds is SEK 100-200m. Of course, prices are given for other lots as well.

Sweden has a liquid and smoothly operating repo market with almost all banks and broker firms involved in the trading. The repo market in Sweden started in the late 1980s, and has developed fast over the last few years. The Swedish Debt Office offers a repo-facility in government bonds and treasury bills and mortgage companies offer their market makers a repo-facility in their own bonds. The repo transaction is viewed as a 'sell-buy back' or 'buy-sell back' deal and the ownership of the security has to be transferred. There are no standard conditions for a repo transaction and the counterparties have to agree on maturity, settlement day and delivery for each deal. Most often, though, repos are settled two banking days after the trading day. Repo rates lie within the spread between treasury bill yields and deposit rates. The spread between bid and ask prices are between 5 and 10 basis points depending on the maturity.

Almost all public listed securities in Sweden are registered at the Euroclear Sweden. In general, Swedish bonds are domestically settled via the Euroclear. Domestic settlement requires a custodian account with one of the Swedish banks or securities firms. Foreign investors can either have a custodian service with a Swedish bank or securities firm or settle via Euroclear or Cedel.

Accrued interest is calculated from the previous coupon date to the settlement day. The interest rate is calculated by using ISMA's 30E/360 day count - "End-of-month" convention.

Swedish government and covered bonds have five ex-coupon days which means that there is negative interest when settlement occurs within five business days before the coupon date.

Most Swedish bonds pay coupon annually. There are, however, bonds that pay coupon semi-annually. All domestic banks act as paying agents.

Swedish krona bonds redeem at par upon maturity.

A special small bond Exchange called "SOX", is a special part of NASDAQ OMX Nordic. All bonds registered at "SOX" must have low denominations in order to be suitable for private investors. The trade in the "SOX" market is held by the Swedish Commercial banks and some stock brokers.

The trade in the SOX market is fully computer based. A normal "trading amount" in the SOX market is SEK 100.000 per transaction.

X THE ACTIVITIES OF ASCB

The Association of Swedish Covered Bond issuers (ASCB),which was established in 2009, has an ongoing work to further improve the conditions for the Swedish covered bonds. Two recent results of these efforts are firstly an amendment of the law with the purpose to grant the receiver-in-bankruptcy access to short-term liquidity in case of insolvency (see chapter VII) and secondly an agreement on the method of calculating the LTV for the cover pool.

According to the agreement the Swedish covered bond issuers are recommended to calculate and present certain basic key statistics concerning their respective cover pools as uniformly as possible ("Max LTV per property").

> Cover pool data shall comprise only loans and collateral included in the pool. When a loan is only partially included in the pool, only the eligible part is accounted for.

> In case a loan is secured by both mortgage deeds and a guarantee from the state or municipality, the part of the loan with guarantee will be treated as a public loan, and not included in LTV calculation.

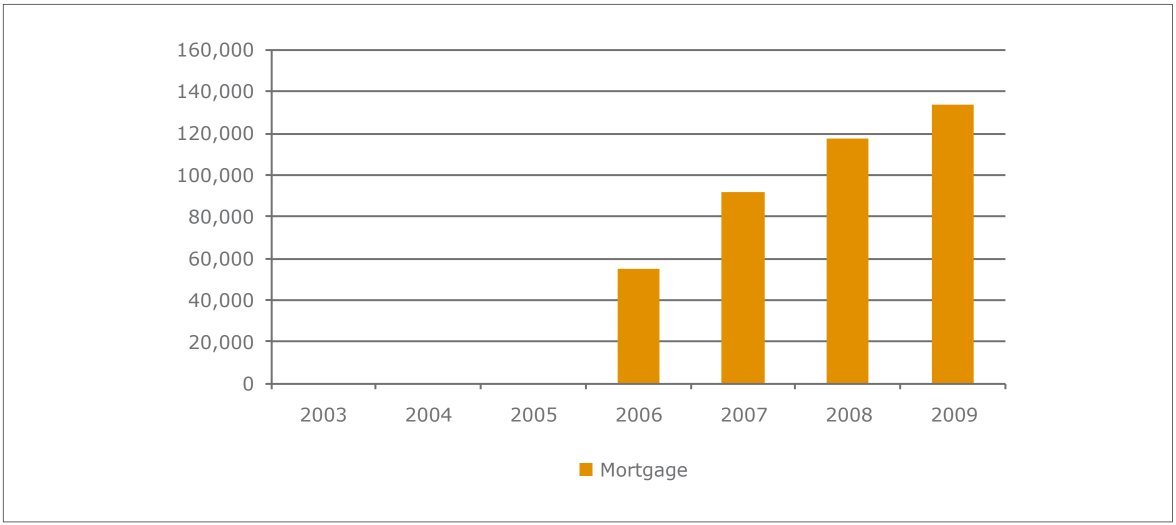
> Loan to Value will be calculated on the principal only.

> Calculation of the aggregate weighted average LTV for a cover pool, will follow a method called "Max LTV per property". The method is chosen because it is fairly simple and the result is independent of the number of loans or mortgage deeds charging a property. It is also independent of the order of priority for the individual mortgage deeds.

> The weighted average LTV should be supplemented with a diagram showing the distribution of principal balance in "LTV buckets" based on the exact order of priority for the individual mortgage deeds.

Further information concerning the LTV-method as well as the Swedish covered bond market is accessible at the website of ASCB (www.ascb.se).

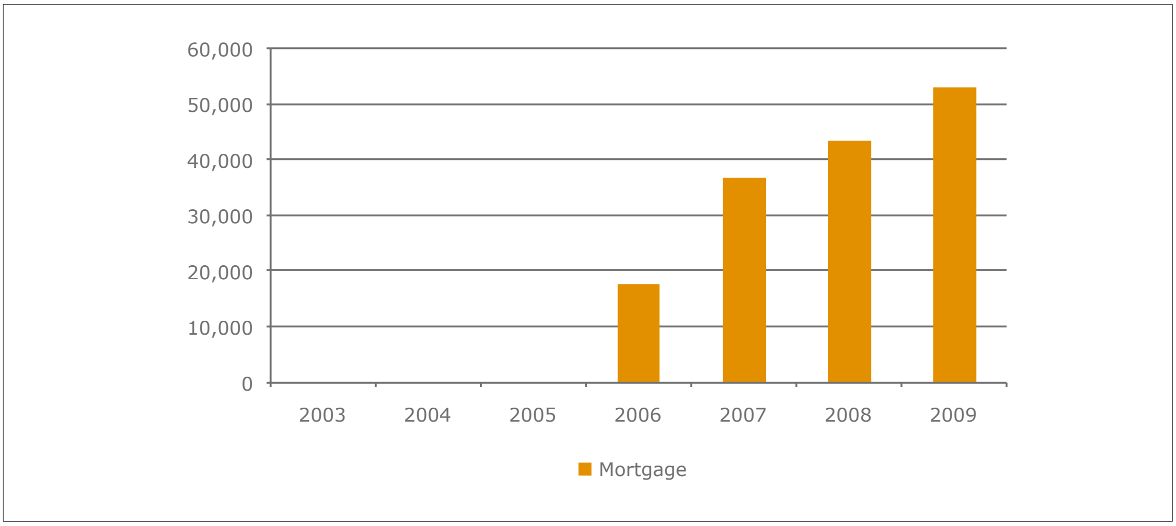
> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2009, €M



Source: EMF/ECBC

Notes: The first covered bonds were issued in 2006 with the application of the Covered Bonds Issuance Act. Prior to 2006 only mortgage bonds were issued in Sweden and as they are not directly comparable to covered bonds they are not included in the figures. A large part of the mortgage bond stock has been converted into covered bonds. The figures include both the converted bonds and the new bonds issued during the year.

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2009, €M



Source: EMF/ECBC

Issuers: The Swedish covered bonds market in 2010 consists of seven issuers: Stadshypotek, Swedbank Mortgage, Nordea Hypotek, Swedish Covered Bond Corporation (SCBC), SEB, Länsförsäkringar Hypotek and Landshypotek. The market is dominated by the first five of them and the majority of their exposure is to domestic residential mortgages, with the remainder consisting of commercial property loans and public sector loans.

APPENDIX

Essential Terms and conditions of a typical Swedish market maker agreement

The market maker has a duty

> to help the issuer sell bonds under it's benchmark-loans on tap into the market,

> to actively support trading of these bonds in the secondary market, and

> to continuously quote indicative rates in the PMI-system

These obligations apply to a limited number of the issuer's loans – the benchmark-loans. Typically 5-6 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 20-30 bn. After that the volume falls due to active repurchase operations by the issuer. With one year to go to maturity a loan is no longer of benchmark status. This paves the way for a controlled redemption of the remaining part of the loan.)

The bid ask spread shall be in line with present market conditions and the trading lots shall typically exceed SEK 50 million.

The obligations of a market maker are conditional upon a number of things of which the following could be mentioned;

> that no change in the economic, financial or political conditions have occurred which in the reasonable opinion of the market maker would create a major obstacle to the fulfilment of the obligations;

> that the bonds, in the reasonable opinion of the market maker, can not be placed in the primary or secondary market on normal market conditions.

If so, the market marker shall notify the issuer and may withdraw from the duties wholly or in part for a shorter or longer time.

The market maker also has an obligation to trade two futures (2 and 5 year) of the issuer in a similar way as that of the benchmark bonds.

The issuer on his side has an obligation to (under normal market conditions) supply the market maker with a repo facility in the outstanding benchmark bonds. (This facility used to be unlimited. Today however the limit is set by the available cover in the cover pool of the issuer.)

With respect to transparency the issuer shall make public at the end of each week figures on outstanding benchmark loans as of the last day of the previous week.

3.25 SWITZERLAND

By Jörg Schmid, Pfandbriefbank schweizerischer Hypothekarinstitute AG
& Michael Bloch, Pfandbriefzentrale der schweizerischen Kantonalbanken AG

I. FRAMEWORK

The issuance of Swiss Pfandbriefe – a term protected by law - is governed by the 'Pfandbriefgesetz' (PfG) effective 25 June 1930. Since then the PfG was marginally modified four times. It contains only 52 articles and is complemented by the 'Pfandbriefverordnung' (PfV) and the valuation regulations.

The Swiss Pfandbrief is not the same as a common Swiss covered bond because in case of the Swiss Pfandbrief the coverage is legally determined in comparison to a covered bond with a coverage which is only based on a private agreement between issuer und investor.

As of article 1 of the PfG the Pfandbrief institutes have the purpose to grant real estate owners long term mortgages at constant and cheap interest rates. Generally speaking, the Swiss Pfandbrief is a major means to close the refinancing gap of member banks.

II. STRUCTURE OF THE ISSUER

The PfG grants the right to issue Swiss Pfandbriefe exclusively to two Swiss Pfandbrief institutes, namely the Pfandbriefzentrale der schweizerischen Kantonalbanken AG (PBZ) and the Pfandbriefbank schweizerischer Hypothekarinstitute AG (PBB). The fist operates as the Pfandbrief issuing vehicle of the Swiss cantonal banks and the latter of all other Swiss banks. The PfG grants these two institutes the right to merge. Both are special banks with their business scope limited to the issuance of Swiss Pfandbriefe, to granting loans to their member banks and to investing their share capital and reserves. They are owned by their member banks.

The cantonal banks are public-sector banks and majority-owned by the canton (Swiss region) in which they are incorporated. Most cantonal banks benefit from a state guarantee extended by their canton[1].

To issue Swiss Pfandbriefe the authorisation of the government is required. Both Pfandbrief institutes are supervised by the Swiss banking regulator, the Eidgenössische Finanzmarktaufsicht (FINMA).

Even if it looks like it at first glance, it is not a duopoly. The two Pfandbrief institutes are self-help-organizations, or in other words, the bond issuing departments and cover pool of their member banks outsourced to the Pfandbrief institutes. Switzerland is too small a country for every bank to issue Swiss Pfandbriefe. Pooling makes sense and is an additional strength.

PBZ was founded in 1931. Only cantonal banks have the right to be members of the PBZ (PfG Art. 3). PBZ does not have its own staff but has fully outsourced its operations to Zürcher Kantonalbank. As of 31 March 2010 the total outstanding Swiss Pfandbriefe of PBZ amount to CHF 22.6 billion (EUR 15.9 billion).

PBB was founded in 1930. Any Swiss bank has the right to become a member of PBB, provided that it is headquartered in Switzerland and that Swiss mortgages account for at least 60 % of the bank's balance sheet. The board of directors can accept banks with a lower mortgage/balance sheet ratio. As of 31 December 2009 the total outstanding Swiss Pfandbriefe of PBB amount to CHF 41.8 billion (EUR

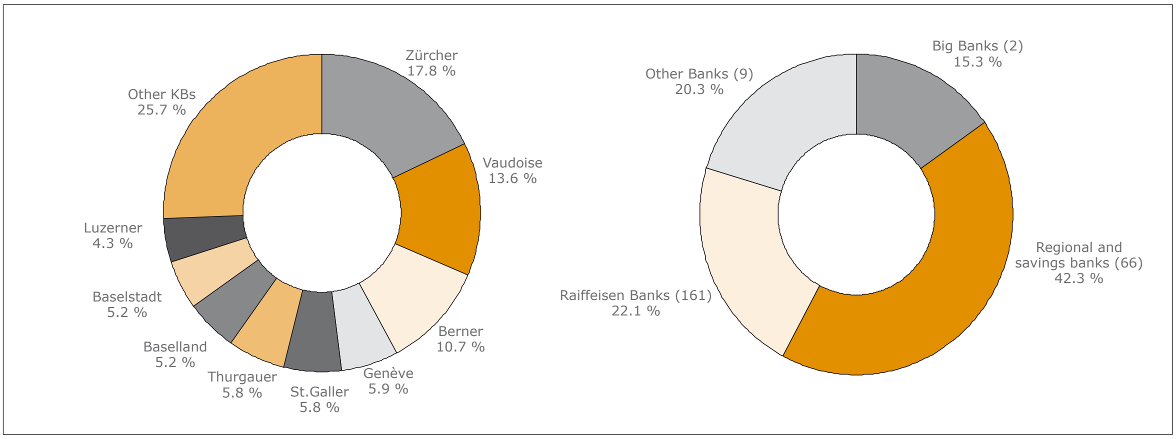
1 Three of PBZ's member banks do not benefit from a cantonal guarantee or have a limited guarantee, namely Banque Cantonale de Genève AG (no guarantee), Banque Cantonale Vaudoise AG (no guarantee) and .Berner Kantonalbank (limited guarantee).

29.4 billion). PBB operates with 7 employees, a cost income ratio of 8 % and a profit of CHF 41.2 million (EUR 28.8 million) for the business year 2009.

The chart below shows the structure of the shareholders:

> CHART 1: SHAREHOLDERS OF PBZ

> CHART 2: SHAREHOLDERS OF PBB



Source: PBZ, as of 31.03.2010

Source: PBB, as of 31.03.2010

From the beginning Moody's has rated Swiss Pfandbriefe with Triple A. The Swiss National Bank accepts Swiss Pfandbriefe as collateral for the repo pool.

Swiss Pfandbriefe are standardised to a great extent. They are a commodity, denominated only in Swiss francs, with a long-term duration of 3 to 20 years and always with a fixed coupon. They are issued at the due date of a matured Pfandbrief, if the conditions for a new issuance are favourable or tailor-made on the basis of an investor demand. The size of an issuance depends either on the demand of the member banks for Pfandbrief loans or on the demand of the investors, whichever is smaller. The average size is about CHF 330 million. Whenever possible, existing bonds are reopened. The maximum size should not exceed CHF 1 billion.

Swiss Pfandbriefe are issued either as public bonds or as private placements. Public bonds are issued through a banking syndicate at fixed conditions, while private placements are issued by the Pfandbrief institutes themselves.

The issuing price or investor's yield depends on the duration of the bond, the interest curve, the coupon and the issuing volume. We obtain further pricing information from the secondary market of all other outstanding Swiss Pfandbriefe and from the comparison with other bond issuers. For example: on 7 May 2010 PBB issued series 513 with a duration of 4 years at Swap Mid minus 18 basis points.

All of the about 100 publicly issued Swiss Pfandbriefe are listed on the Swiss Exchange. Swiss Pfandbriefe amount to 21 % of all bonds listed on the Stock Exchange. Private placements are not listed.

The total volume of all outstanding Swiss Pfandbriefe amounts to CHF 64.4 billion (EUR 43.4 billion). For years the two Swiss Pfandbrief institutes have been the major bond issuers in Switzerland, even more important than the government. In 2009 they issued Swiss Pfandbriefe amounting to CHF 18.9 billion (EUR 12.8 billion).

About 30 % of our investors are pension schemes, 25 % institutional investors (such as asset managers), 20 % banks and investment funds, 18 % insurances und the rest are retail investors and others.

III. COVER ASSETS, VALUATION AND LTV CRITERIA

As a principle, Swiss Pfandbrief loans are only given against a pledge of first rank mortgages on Swiss properties. Within PBZ the cover pool is managed by the member banks.

PBB has got an electronic cover pool. Mortgages are pledged to PBB by member banks through entry of the "cover proposal" into the electronic pool register, which all 240 member banks are linked with. The system immediately evaluates the member bank's "cover proposal", which is then reviewed by one employee and authorized by another. The valuation of PBB is independent of the valuation of the member bank. Substantial cover proposals are reviewed by the cover pool committee. Member banks can check on their screen, whether its "cover proposals" are accepted or refused for improvement.

PBB supervises the cover pool electronically. If coverage tends to become insufficient, an exception list is produced and the member bank will be informed automatically. Based on PfG member banks are obliged to increase coverage in case of impaired or non-performing mortgage loans or if total interest payable of the Pfandbrief loans is smaller than the total interest receivable on the pledged mortgages.

The cover pool of PBB consists of more than 100'000 individual mortgages all over Switzerland, which provides a good diversification. 95 % are residential and only 5 % commercial properties.

The PfG defines the maximum loan to value (LTV) of two thirds (Art. 5 PfG) and the valuation principles, which are detailed in the valuation regulations and approved by the federal council. FINMA can ask for a reassessment of the collateral if its market value or other economic conditions have deteriorated substantially.

External audit firms audit the annual reports of member banks and Pfandbrief institutes and the compliance of member banks' cover registers with the PfG. The auditors must report their findings to FINMA.

In total 9 % of all Swiss mortgages are financed through Swiss Pfandbriefe.

IV. ASSET - LIABILITY MANAGEMENT

Cover principles

The PfG stipulates that the principal amount and interest payments of outstanding Pfandbriefe be at all times covered by an equivalent amount of loans to the member banks (PfG Art. 14). The Pfandbrief loans granted by Swiss Pfandbrief institutes to their member banks must be collateralised by eligible liens on real property (PfG Art. 19). The Pfandbrief institutes will only pay out Pfandbrief loans to member banks if the cover value of the cover register asset pool meets the criteria of the PfG.

Overcollateralisation

Additionally to eligibility and valuation principles (LTV of less than 2/3), the cover value of the cover register assets have to exceed the Pfandbrief loans given to member banks by 8 % within PBB und by 15 % within PBZ. The higher percentage of PBZ compensates the fact that PBZ does not have an electronic cover pool register.

Additional Risk Limits

Swiss Pfandbriefe are issued in individual series which must match the repayment profile of the Pfandbrief loans to member banks, eliminating interest rate and funding risks. Currency risk does not exist as both the loans to member banks and the Pfandbriefe are issued in Swiss Francs. Therefore there is no need for derivatives to hedge market risks. Liquidity concentration risk is limited by individual limits for each member bank. The investment policy for free assets limits credit and market risks on counterparty and portfolio level. All Swiss Pfandbriefe are part of the Swiss National Bank repo basket and can immediately be pledged against cash to any Eurex Repo member.

Growth of the Pfandbrief institutes is limited as the required capital must exceed 2 % of the total Pfandbrief issuance volume of the respective institute (PfG Art. 10).

Insolvency scenarios

In the event of the insolvency of a member bank, the Pfandbrief institute has a priority claim on the registered collateral (PfG Art. 23). The insolvency of a member bank does not trigger the acceleration of outstanding Pfandbriefe because the investors have no direct contractual relationship with the member bank. In this respect, the Pfandbrief institute functions as a buffer between the investors and the member banks. FINMA cannot delay payments on the Pfandbrief insitute's claims, which are themselves backing the Pfandbriefe (BankG Art. 26, Abs. 1, h). Moreover, FINMA can demand the transfer of the collateral pool under its control and then act as fiduciary (PfG Art. 40) or arrange for a sale of the cover assets to other banks[2].

The Pfandbrief institutes have a certain amount of flexibility with regard to ensuring timely payments on Pfandbriefe, even if one or several member banks default. First, the Pfandbrief institutes collect the interest on the member loans on a semi-annual basis while coupon payments on Pfandbriefe are annual. Second, the Pfandbrief institutes have own funds at their disposal and maintain a portfolio of liquid investments, providing an equity buffer for investors and ensuring sufficient liquidity to cover for future coupon and principal of maturing Pfandbrief series.

The insolvency of a Pfandbrief institute is highly unlikely as it only occurred if several member banks defaulted at the same time, combined with a severe deterioration of the respective registered mortgage collateral. Moreover, FINMA is highly likely to use supervisory efforts to avoid a bankruptcy of a Pfandbrief institute. In the improbable case of bankruptcy of a Pfandbrief institute, Pfandbriefe would accelerate and Pfandbrief investors would rank pari passu among themselves on the proceeds of the asset sale (PfG Art. 29). Again, FINMA has the power to assume control of the respective cover pool and to act as fiduciary.

In the case of PBZ there is an additional security as the majority of cantonal banks benefit from a state guarantee extended by their canton.

Risk-weighting

Switzerland implemented Basel II into national law and modified it to account for national specifics contained in the Swiss Capital Adequacy Ordinance (CAO). The CAO has three approaches to measure

2 In the early 1990s, Spar- und Leihkasse Thun, a member bank of PFB, no longer met regulatory capital requirements and was closed by the FINMA. Cover pool mortgages were sold to other banks and the proceeds were used to amortise the loans granted by PFB.

credit risks in banking books: 1) The Swiss standard approach, 2) the BIS standard approach and 3) the internal ratings-based approach. Under the Swiss standard approach Swiss Pfandbriefe have a 25 % risk weighting, while under the BIS standard approach they have a final risk weighting of 22 % (taking into account a risk weighting of 20 % and the multiplier of 1.1).

V. INVESTORS BENEFITS

An investor in Swiss Pfandbriefe benefits from

> the special bank principle with no currency and no interest change risk.

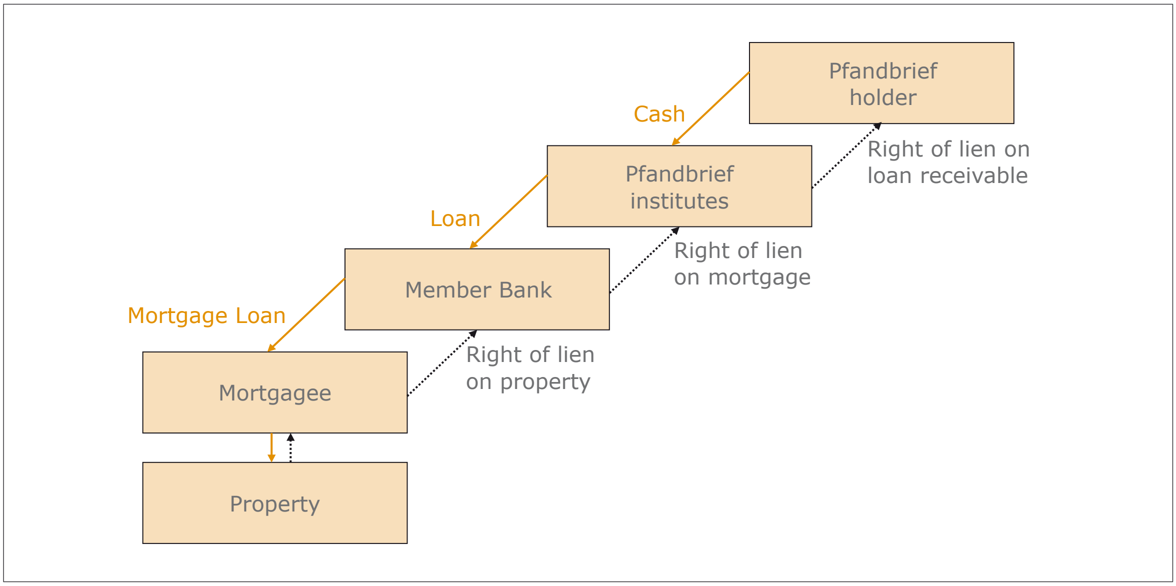
> the cover pool, which only includes mortgages on Swiss properties and thus excludes ship or airplane mortgages, derivates, foreign mortgages etc.

> the fourfold security which is 1) the creditworthiness of the Pfandbrief institute, 2) the creditworthiness of the member bank, 3) the creditworthiness of the proprietor the property and 4) creditworthiness of the property itself.

> in the case of PBZ: State guarantee for most of its member banks

> in the case of PBB: The value of the property is determined by PBB and not the member bank.

> Chart 3: The Swiss Pfandbrief Model



Source: Credit Suisse AG

Since the establishment of the PfG in 1930 neither an investor nor a Pfandbrief institute have ever suffered a loss.

In 2009 UBS has started a EURO covered bond program with Swiss mortgages. Since then they have issued several covered bonds totalling in EUR 5.75 billion by the end of June 2010. The UBS covered bond program is not a Swiss Pfandbrief and is not ruled by the PfG.

VI. FACTS AND FIGURES

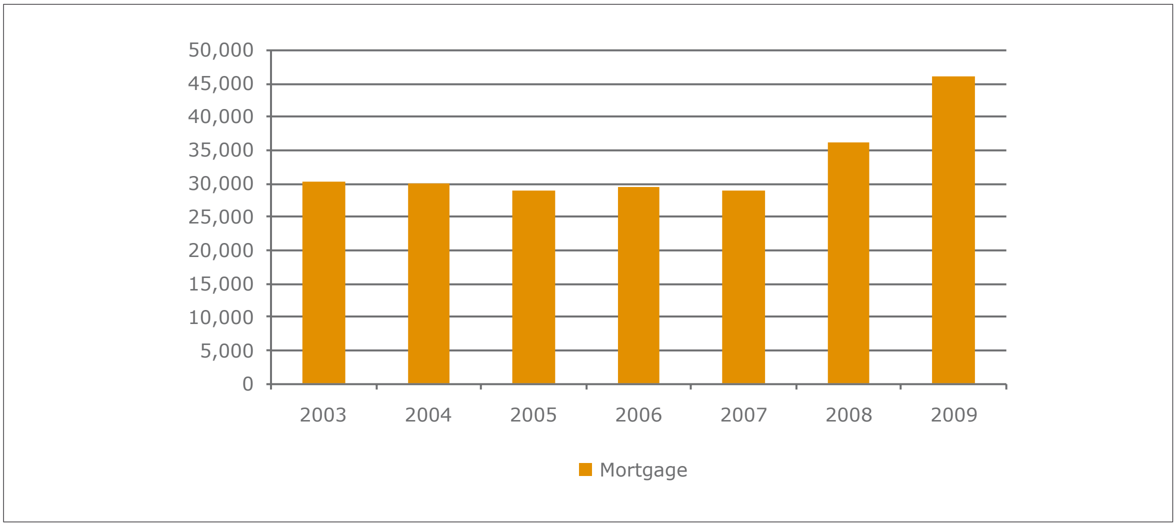
(CHF million)	PBB	PBZ
As of	31.12.2009	31.03.2010
Swiss Pfandbriefe outstanding	41'820	22'599
Average interest rate for outstanding Pfandbriefe (%)	2.509	2.906
Balance sheet total	43'527	23'901
Free Assets	1'156	642
Equity capital (PfV Art. 18)	1'071	790
Moody's rating	AAA (stable)	AAA (stable)

VII. CONTACT ADDRESSES

For PBB: Pfandbriefbank schweizerischer Hypothekarinstitute AG
Nansenstrasse 16
CH-8050 Zürich (ZH)
+41 44 315 4455
www.pfandbriefbank.ch

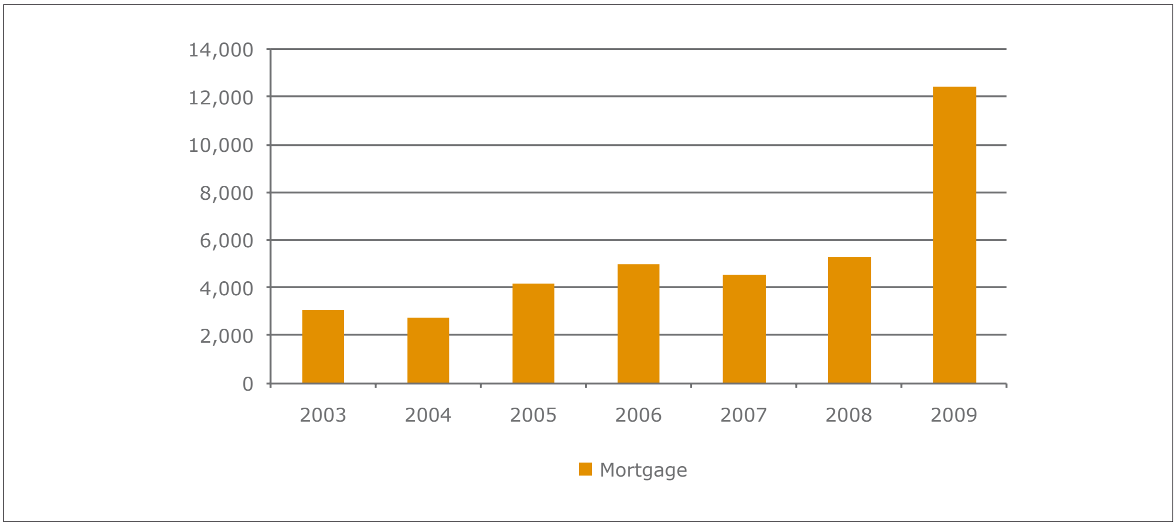
For PBZ: Pfandbriefzentrale der schweizerischen Kantonalbanken AG
Bahnhofstrasse 9
CH-8001 Zürich
+41 44 292 2778
www.pfandbriefzentrale.ch
www.cldg.ch (French)

> Figure 1: Covered Bonds Outstanding 2003-2009, €m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2009, €m



Source: EMF/ECBC

3.26 TURKEY

By Fritz Engelhard, Barclays Capital
and Batuhan Tufan, Garanti Bank

I. FRAMEWORK

In Turkey, the legal basis for Turkish Covered Bonds is the by-law published by the Capital Markets Board (CMB) on 4 August 2007 (Serial: III, No: 33, Mortgage Covered Bonds).

Turkish Covered Bonds are defined as "İpotek Teminatlı Menkul Kıymetler (İTMK)" or "Turkish mortgage covered bonds" and are trademarked by the legislation.

The İTMK by-law is part of a series of legislations, which follow the enactment of "The Housing Finance Law (No: 5582)" by the Parliament, which includes basic definitions and amendments to certain laws, aimed at establishing a healthy and functioning housing finance system on 6 March 2007.

II. STRUCTURE OF THE ISSUER

Banks defined in Article 3 of the Banking Law (No: 5411 dated 19/10/2005) as well as mortgage finance companies are allowed to issue İTMK. The authorisation to issue İTMK is subject to the issuance of a licence by the Capital Markets Board, which can only be achievable following the fulfilment of certain conditions. Banks and mortgage finance companies who wish to issue İTMK must provide "the office, technical facilities and organisational structure" in addition to "a risk management system that will monitor the risk that may rise due to the issuance of İTMK".

Further, if the issuer is a bank issuer, the consent of the Banking Regulatory and Supervision Agency (BRSA) is also a pre-requisite.

Provided the above conditions are met together with supporting evidence, a licence to issue İTMK may be granted.

İTMK bonds are debt securities, which are general obligations of the issuer and secured by cover assets. The cover assets are held on the balance sheet of the issuer and a subsequent transfer of assets to another legal entity does not take place.

The issuer must apply to the CMB for registration of the İTMK before any issuance, public or private placement, can take place. Before such application, a cover monitor must have been appointed by the issuer.

III. COVER ASSETS

Eligible assets are residential and commercial mortgage loans. Assets originated or purchased by the issuers can be registered in the cover register if they meet the below criteria:

a) Granted after the Housing Finance Law (No: 5582). If originated before, should meet the criteria defined by Article 11 of the Housing Finance Law. (Assets acquired from Housing Development Administration of Turkey are excluded from this criteria)

b) All interest and principal payments have been secured by a mortgage and all obligations have been met on time.

c) The property must be located in Turkey and must possess a certificate of occupancy.

d) For the entire life of the loan, the real estate has to be fully insured against earthquakes, fire and any kind of natural hazard.

e) The value of the property must be appraised by an officially listed real estate appraisal company and be in accordance with the by-law (Serial: VIII, No: 35, Principles Regarding Appraisal Companies)

Loans that meet the above criteria may be recorded in the cover pool up to 75% of their appraised value for residential mortgage loans and up to 50% of their appraised value for commercial mortgages.

Up to 15% of the net present value of the cover pool may comprise of substitute collateral which are cash, short term debt instruments issued by the Central Bank of Turkey, public debt instruments (domestic and foreign), securities issued under treasury reimbursement guarantee (as defined in Law No: 4749 dated 28 March 2002), securities issued or guaranteed by governments or central banks of OECD countries, or any other assets that may be approved by CMB.

Derivative instruments that are publicly traded or transacted with a bank, an insurance company or central clearing agency which are rated at least investment grade by rating agencies, can be included in the cover pool up to 15% of its net present value.

IV. ASSET & LIABILITY MANAGEMENT

The issuer is expected to perform a risk management system that will measure, analyse and devise risk policies against risks such as credit risk, interest rate risk, exchange rate risk, liquidity risk, market risk as well as operational risk and counterparty risk. Further, it has to involve certain written guidelines to reduce the before mentioned risks and adapt to changing market dynamics. It should be revisited at least once a year.

In addition to the risk management system, the cover pool must also comply with certain cover matching principles. The matching principles involve:

a) Nominal Value Matching: The total volume of the İTMK must be covered at all times by assets of at least the same amount. Derivative instruments are excluded from this calculation and debt instruments are included with their face value.

b) Interest Revenue Matching: The interest revenue of the cover assets for one year following the calculation date must not be less than the interest expenditures of the İTMK.

c) Net Present Value Matching: The net present value of the cover assets must at all times be at least 2% more than the net present value of all obligations of the İTMK.

The issuer has to monitor the matching of the above criteria daily and has to carry out weekly stress tests that include the parallel shifting of yield curves of matching maturity and foreign currency values. The interest rate shifts for YTL denominated bonds is determined as 300 bps, whereas the same value is 150 bps for foreign currency denominated bonds. Further, to measure the effect of exchange rate risks on cash flows a 30% parallel shift is performed on the purchase rate of the relevant currency published by Central Bank of Turkey.

V. COVER MONITOR AND BANKING SUPERVISION

A cover monitor supervises the cover pool. The cover monitor is appointed by the issuer and must possess the expertise and experience necessary to fulfil all duties. A qualification as a certified auditor by the CMB suggests that the necessary expertise is provided.

The monitor has to ensure that the prescribed cover for the İTMK exists at all times and that the cover assets are recorded correctly in the cover register. Without the cover monitor’s approval no assets may be added to or removed from the cover pool. The monitor also ensures that the cover matching principles are met once every 15 days and submits a summary report to the issuer.

The cover monitor is required to report any inconsistencies in the cover register or failures in matching principles directly to the CMB.

S/he is also authorised to conduct a discretionary review of the cover assets, including substitute assets as well as the derivative instruments in place. Further, the cover monitor can also check the land registries of the mortgages and request any other information that may be necessary for the cover monitor's review.

VI. HOW ARE SEGREGATION AND BANKRUPTCY REMOTENESS OF COVERED BONDS REGULATED?

A cover register held by the issuer permits the identification and segregation of the cover assets. The collateral backing the İTMK is to be registered in book and/or in electronic form.

In case the issuer fails to meet the standards to be an issuer, the CMB simultaneously appoints another authorised bank or mortgage finance corporation, cover monitor or another audit firm as the manager to pursue the best interests of the İTMK holders. Following the loss of the issuer status, the right to actively manage the cover assets, including selling and buying of assets, is transferred to the manager automatically.

Until the İTMK are completely redeemed, cover assets cannot be sequestered, including collection of public receivables, cannot be subject to injunctive decisions of courts and cannot be included in the bankruptcy estate of the issuer.

The manager may transfer all or a part of the assets recorded in the cover register to another issuer that meets the İTMK issuer criteria. Following such transfer, the ownership of the cover assets is also passed on to the new issuer who can merge the newly acquired assets with its existing cover assets. The new issuer also automatically becomes the beneficiary of any excess cash flows from the cover assets.

If the cover assets cannot be transferred to another issuer or if the cash flows from the cover assets do not suffice, the manager can allocate the residual cash to İTMK holders according to their respective shares and further request from the CMB that the İTMK be early redeemed. Should the collateral not suffice to cover all outstanding İTMK plus interest, the İTMK holders rank pari-passu with unsecured debtors of the issuer.

VII. RISK WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

İTMK comply with the requirements of Art. 22 par. 4 UCITS Directive as well as with those of the Capital Requirements Directive (CRD), Annex VI, Part 1, Paragraph 68 a) to f). Therefore, they may qualify for a beneficial treatment under the CRD.

The EU opened accession negotiations with Turkey on 3 October 2005. As a candidate for EU membership, Turkey will be obliged to be compliant with EU Directives in case of full membership. Thus, in recent years Turkish authorities were strongly aligning banking regulations to EU standards. The revised Accession Partnership of the EU with the Republic of Turkey from 18 February 2008 foresees that Turkey adapts its regulations to the CRD. The EU progress report on Turkey, published in November 2008, states that "further efforts are needed to continue alignment with the new capital requirements for credit institutions and investment firms".

3.27 UKRAINE

By Anton Sergeev, Arsen Nizelsky and Konstantin Kuczerenko
Ukrainian National Mortgage Association

I. FRAMEWORK

In Ukraine the legal basis for Covered Bond issuance is the Law on Mortgage Bonds, adopted on December 22nd, 2005. It supersedes certain provisions of general bankruptcy legislation (Art. 8 par. 4, art. 15 par. 1 no. 8 and other provisions of the Law on Mortgage Bonds).

In 2006 the legal basis for Covered Bonds has been complemented by several supervisory regulations of the State Securities and Capital Markets Commission. The most important is the Regulation No. 774 "On the mortgage coverage of common mortgage bonds, administration of the mortgage coverage register and the management of mortgage coverage of Covered Bonds" (the Mortgage Coverage Regulation) which was passed on 1st September 2006.

II. STRUCTURE OF THE ISSUER

The issuer may be any bank or a non-bank financial institution which is entitled to grant loans secured by mortgages or to which mortgage loan claims were transferred from another entity. Non-bank financial institutions under Ukrainian law are: credit unions, pawnshops, leasing companies, trust companies, insurance companies, pension funds, and investment funds. The issuer does not need to be a specialized bank or financial institution.

Banks and non-bank financial institutions issuing Covered Bonds may pursue all business activities which are permitted for their respective types of financial institutions. Insurers, pension funds and investment funds are restricted to granting loans (secured by mortgage), although they might acquire loans from other entities.

The only specific legal rule in relation to bank employees is set out in general banking licensing guidelines (art. 19 par. 3 Law on Banks and Banking Activities). Indirectly, the National Bank Directive (from 29.01.2004 "Methodical Directives Concerning Organization and Functioning of a Risk Management System at the Banks of Ukraine") sets stricter rules concerning bank officials who are responsible for risk management functions. Ukrainian law does not prescribe any specific limitations for outsourcing.

The issuer holds cover assets on its balance sheet. Cover assets are not transferred to a different legal entity acting as a guarantor of Covered Bonds.

III. COVER ASSETS

Cover assets are ex lege pledged to secure performance of the issuer's obligations to the Covered Bondholders. Other creditors of the issuer are not allowed to extend claims against covered assets, to impose seizures or otherwise encumber covered assets, unless the claims of mortgage bond holders have been satisfied in full. The issuer may not alienate cover assets as long as there are no legal grounds for replacement of cover assets (such grounds are: revealed nonconformity of individual assets with the quality requirements of the law; initiation of the foreclosure on mortgage property or early termination of the mortgage; more than a three-month payment delay by the debtor; and bankruptcy of the debtor). In case of insolvency of the issuer the cover pool is excluded from the general insolvency estate of the issuer and continues to serve as a pledge for the performance of the issuer's obligations to the bond holders.

For every issue of Covered Bonds a separate cover pool must be formed.

In accordance with the Law on Mortgage Bonds, mortgage assets may be included in the mortgage coverage under the following conditions:

1) Mortgage assets are owned by the issuer and can be alienated in case of non-performance of obligations under mortgage bonds;
2) Debtor obligations secured by mortgages are subject to performance in monetary form;
3) Data that the issuer is a mortgagee under a corresponding mortgage agreement and is duly registered in respective state register in the manner prescribed by legislation;
4) Mortgage assets are not pledged or encumbered in any other manner to secure issuer's obligations other than its obligations under mortgage bonds;
5) There was no decision of foreclosure or bankruptcy procedure regarding the debtor of the respective mortgage or credit agreement;
6) Respective mortgage agreement does not provide for possibility to replace or alienate mortgaged property by a mortgagor without consent of a mortgagee;
7) Mortgaged property is located on the territory of Ukraine and is insured for its overall value against risks of accidental destruction, accidental damage or spoiling;
8) Mortgage assets are not included in the composition of mortgage coverage of another issue of mortgage securities, unless otherwise provided by this Law;
9) The ratio of the initial principal obligation secured by mortgage does not exceed 75 percent of the appraised value of the subject of mortgage;
10) The debtor obligation is not secured by a subsequent mortgage;
11) Mortgage assets comply with the other requirements provided by the Law.

Derivatives may not be included into the cover pool. However the Law on Mortgage Bonds provides for use of the agreements on preservation of real value (now derivative contracts) – agreements intended to reduce credit, currency and interest rate risks associated with the bonds, or to management of the flow of receivables of the mortgage coverage, including without limitation swaps, options, future and forward contracts and equivalent *financial instruments*. Use of derivative contracts is a complex issue which may be further regulated by the National Bank and Securities Commission to assure the safety of the bonds.

The issuer forms a separate cover pool for each issue. Only in certain cases new mortgage assets may be added to the cover. In accordance with the article 13 of the Mortgage Bonds Act, if during the period of maturity of common mortgage bonds the mortgage coverage correlation exceeds figures prescribed herein, the issuer shall be obliged to include new mortgage assets in composition of mortgage coverage in order to comply with mortgage coverage correlation provided by law.

Due to article 14 of the mentioned Act, individual mortgage assets shall be excluded from the composition of mortgage coverage of common mortgage bonds only in connection with their replacement. Replacement of individual or inclusion of new mortgage assets in the composition of mortgage coverage shall be carried out in the following cases:

1) nonconformity of individual mortgage assets in the composition of mortgage coverage to requirements set by the law or in prospectus;
2) initiation of foreclosure on mortgaged property or early termination of mortgage for any other reasons;
3) more than a three-month delay of payments by a debtor under an obligation secured by mortgage;
4) bankruptcy proceedings are taken against a debtor under a mortgage asset;
5) exceeding of mortgage coverage correlation prescribed by Article 13 herein;
6) addition of mortgage assets to the mortgage coverage in connection with issuance of new bonds secured by a common mortgage coverage or as required to observe the balance principles.

The explicit transparency requirements regarding cover assets are provided by article 28 of the Law on Mortgage Bonds "Publication and Disclosure of Mortgage Bond Information". Issuers, who have placed mortgage bonds, shall be obliged to publish and disclose complete information on the financial and economic position and results of their activity; any legal facts (deeds and/or events) that may affect performance of obligations under mortgage bonds; correspondence of the state of mortgage coverage to requirements of the Law. Time limits, manner and form of such disclosure is prescribed by the Regulation of the State Securities and Capital Markets Commission No. 1591 "On disclosure of information by the issuers of securities" adopted on 19th December 2006. This Regulation provides for the duty of Covered Bond issuers to disclose the ad-hoc information (e. g. changes in the cover pool, replacement of the cover pool manager, acceleration of the Covered Bonds) as well as regular information on the cover pool on the quarter-year basis.

IV. VALUATION AND LTV CRITERIA

Property valuation shall be conducted by the certified natural persons or legal entities under the Property Evaluation Act. The National standards of valuation of immovable property approved by the Cabinet of Ministers provides for a valuation of immovable property based on market value.

In the meantime no regular property value monitoring is provided by the legislation of Ukraine.

In accordance with the Article 8 of the Mortgage Bonds Act the ratio of the nominal principal amount of the mortgage asset to the appraised market value of the mortgaged property, determined by the certified valuer is 75%, while article 13 of the said Act establish this ratio in amount of 60% for non-residential property.

V. ASSET - LIABILITY MANAGEMENT

Art. 13 par. 3 no. 2 Law on Common Bonds stipulates, that the average weighted interest of the Covered Bonds must exceed the average weighted interest of the mortgage assets. No. 3 of this paragraph prescribes, that the size of the periodical payments against interest receivables from the cover assets must be identical to the size of the issuer's payments against interest receivables on Covered Bonds. The Mortgage Coverage Regulation on the cover pool of Covered Bonds specifies these rules as follows:

> The average weighted interest rate of the cover assets must exceed the average weighted interest rate of the Covered Bonds. This criterion may, however, be disregarded, if the market situation after the issue of Covered Bonds does not allow to comply with it, always provided that the interest yield of the cover assets exceeds the interest yield of the Covered Bonds;

> The interest yield of the cover assets must exceed the interest yield of the Covered Bonds.

Additionally, the Law provides for a duration test: the average weighted duration of the cover assets must exceed the duration of the Covered Bonds. According to the Mortgage Coverage Regulation, only the contractual (and not the factual) duration of the assets must be taken into account.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

During the period of maturity of mortgage bonds, the issuer shall be obliged to ensure audits of the mortgage coverage at his own cost.

The external audits shall be conducted annually. Unscheduled audits may be conducted on demand of the manager or the Securities and Stock Market State Commission.

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

In accordance with the Article 10 of Law on Mortgage bonds the cover assets are identified by the cover register. A register of mortgage coverage is defined as information on each mortgage asset in mortgage coverage. The register of mortgage coverage must contain information on the initial and current value of mortgage coverage, its composition, as well as the following data on each mortgage asset:

1) details of the mortgage and credit agreement and name of the borrower;
2) original principal amount and interest rate on the debt;
3) outstanding principal amount;
4) maturity;
5) description of mortgaged property sufficient for identification of the latter, information on state registration of mortgage (date and number);
6) appraised value of mortgaged property under the mortgage agreement;
7) LTV as of the date of mortgage agreement conclusion;
8) other data according to prospectus.

The register of mortgage coverage shall include a description of substitute assets, included in the mortgage cover and the derivative contracts.

According to art. 8 of the Law on Mortgage Bonds, mortgage coverage of mortgage bonds shall be deemed to be pledged to secure performance of obligations of an issuer/pledger to holders of mortgage bonds/pledge. Pledge of mortgage and other assets entered into the register of mortgage coverage arises according to the Law from the moment of inclusion of mortgage assets into the register.

Each issue of a Covered Bonds has to be registered with the Securities and Stock Market State Commission. In order to register an issue of mortgage bonds, a mortgage coverage register shall be submitted. Extracts from the register of mortgage coverage shall be submitted to the Securities and Stock Market State Commission within the time limit and according to the form prescribed by the Securities and Stock Market State Commission. Thus without the register, an issue would not be valid.

Asset segregation

Segregation of the assets is accomplished by separate accounting for the mortgage coverage. For issuers-banks, mortgage coverage and transactions with it shall be recorded by the issuer separately in the manner prescribed by the National Bank of Ukraine, and for issuers that are non-banks – by a specially authorized executive body in the area of regulation of financial services markets.

Mortgage coverage shall not be included in insolvency's estate of the issuer. The issuer shall not be entitled to alienate, pledge, or otherwise encumber mortgage and other assets included in the composition mortgage coverage unless a decision on replacement of respective mortgage assets is taken pursuing to this Law. The issuer shall not be entitled to dispose of mortgage coverage otherwise than to perform obligations under respective issue of mortgage bonds.

Impact of insolvency proceedings on Covered Bonds and derivatives

According to the provisions of the Law and the Mortgage Coverage Regulation there are two possible scenarios in case of insolvency of the issuer:

1) the mortgage coverage manager assumes the servicing of the mortgage coverage or transfers it to another servicer of its choice. In this case the bondholders continue to receive payments according to the terms of the Covered Bonds;

2) the mortgage coverage manager alienates the mortgage coverage and prepays the Covered Bonds. This leads to an acceleration of the Covered Bonds.

Further details may be regulated in the prospectus (terms of the Covered Bonds). It may be stipulated in the terms of the Covered Bonds that the general assembly of the bondholders shall decide which of the scenarios is to be chosen.

Preferential treatment of Covered Bond holders

The Covered Bond holders have the right to demand early repayment of the Covered Bonds in case of the insolvency of the issuer (art. 17 par. 1 no. 2, par. 2 Law on Covered Bonds). They may exercise this right only through the monitor, who is also competent to decide whether to sell the cover pool or to leave it on the balance sheet of the issuer.

Cover assets are legally separated from the insolvency estate of the issuer. First of all, Covered Bond holders shall be fully satisfied out of the cover assets. Only the remaining assets may be returned to the issuer (art. 11 par. 3 Law on Covered Bonds).

The Covered Bond holders may seek satisfaction not only from the cover assets, but also from the other assets of the issuer, if the cover assets are not sufficient to satisfy them (art. 17 par. 2 no. 4 Law on Covered Bonds).

Access to liquidity in case of insolvency

There are no specific regulations in the Law concerning access to liquidity in case of insolvency. Generally, a certain level of liquidity is guaranteed by the relatively high mandatory over-collateralization (10%) which may be held in liquid assets (cash, state securities).

Sale and transfer of mortgage assets to other issuers

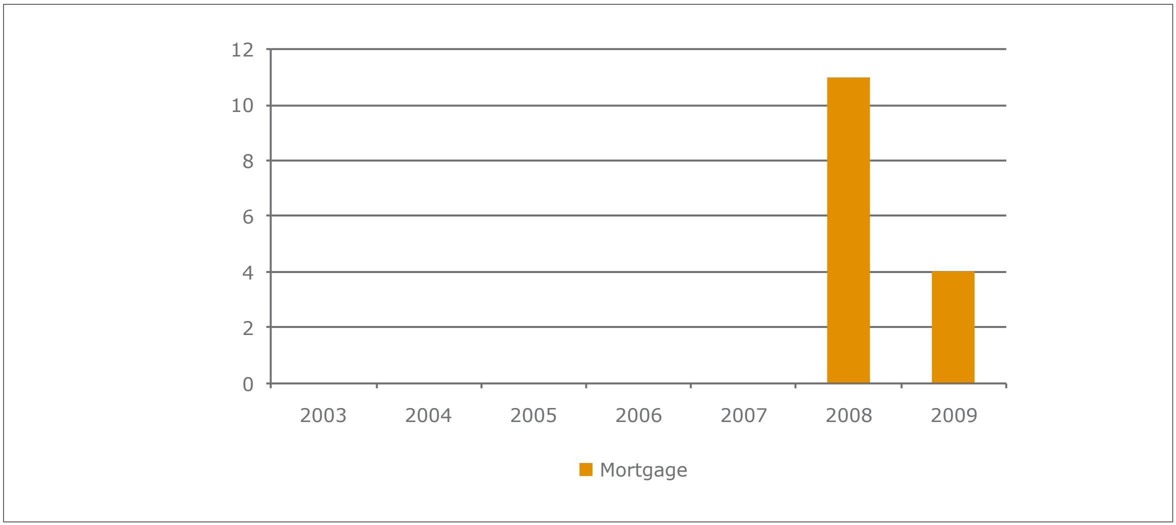
Art. 11 Law on Covered Bonds stipulates that the execution into the cover pool may be levied through *selling* of the cover pool or in another way not prohibited by the law. The monitor gains the right to sell the cover assets in case of insolvency or an essential violation of the duties of the issuer; then, the monitor has to satisfy the cover bond holders out of the proceeds. It is important to note, that the selling of the cover assets to another bank or financial institution does not transfer the issuer's liabilities out of the Covered Bonds. The selling of the cover pool is effected in accordance with the general civil law rules (cession or transfer of collateral note).

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The National Bank of Ukraine ruling on risk-weighting does not contain any specific provisions concerning Covered Bonds so far. According to a general provision debt securities of other credit institutions are 100%-risk-weighted.

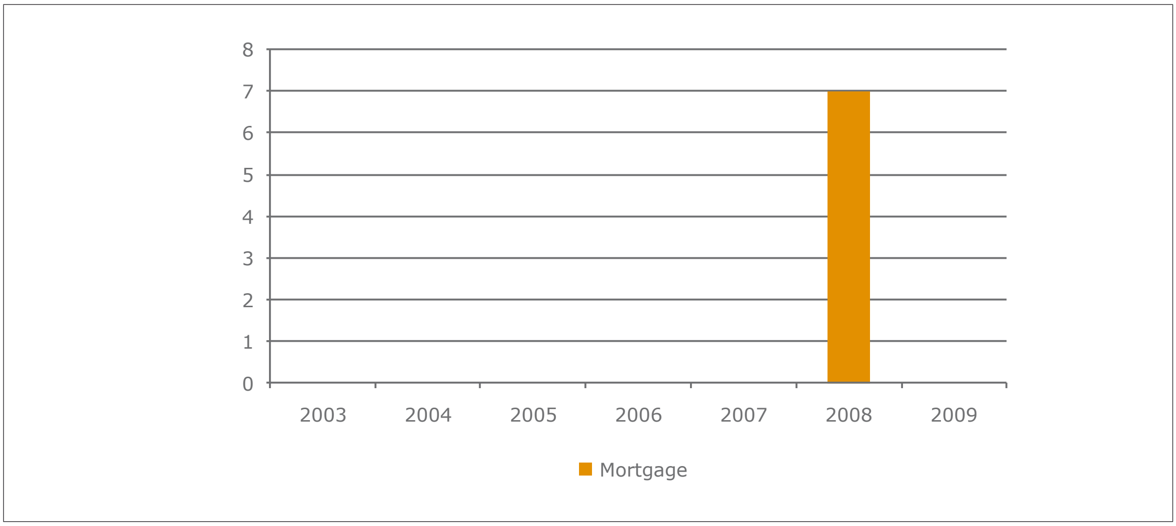
The Ukrainian Covered Bonds fulfill the criteria of Paragraph 68 (d) and (e) of the Annex VI, Part 1, of the Capital Requirements Directive (CRD). The criteria of UCITS 22 (4) are fulfilled with the exception of the creation by the Ukrainian Banks of their registered office in a Member State of the European Union.

> Figure 1: Covered Bonds Outstanding 2003-2009, €m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2009, €m



Source: EMF/ECBC

Issuers: There are two issuers in Ukraine: Bank Khrestschatyk and Ukrgazbank.

3.28 UNITED KINGDOM

By Michaela Seimen, Barclays Capital
and John Millward, HSBC

UNITED KINGDOM

The UK covered bond market has a somewhat recent history, with the first UK covered bond being issued in 2003 by HBOS Treasury Services. Despite very strong competition from the ABS market as a popular funding tool in the UK, the UK covered bond market grew substantially from Q4 05 until Q3 07.

The underlying size of the UK covered bond market was also boosted in 2008 by the eligibility of covered bonds as collateral under the Bank of England's Special Liquidity Scheme.[1] Consequently, the amount of public issuance outstanding for UK covered bonds is currently considerably smaller than the total amount outstanding as a result of the volume of retained issuance..

Due to the absence of dedicated covered bond legislation up until 2008, the first UK covered bonds were issued using structured finance techniques. As UK covered bonds were not originally subject to explicit regulation under a national legislative framework, they did not fulfil all the criteria as set out in Article 22.4 of the EU Coordination Directive on Undertakings for Collective Investment in Transferable Securities (85/611/EC) (UCITS), therefore not qualifying for the higher prudential investment limits and a preferential risk weightings, and limiting the ability of investors in these kind of exposures. In order to provide the necessary underpinnings for UCITS 22(4) compliance whilst helping to both increase investor confidence and provide robust bondholder protection, HM Treasury and the Financial Services Authority (FSA) conducted a joint consultation process in 2007 for the proposed implementation of a UK legislative framework. The "Regulated Covered Bond Regulations 2008", were eventually laid before parliament on 14 February 2008, with the FSA being responsible for supervising the regime pursuant to the "Regulated Covered Bonds Specialist Sourcebook 2008" which was published on 6 March 2008.

Structured covered bonds issued by UK entities are recognised as secure products in their own right and have inspired similar structured covered bonds to be issued in other jurisdictions. However, the subsequently introduced covered bond regime enabled UK covered bonds to benefit from higher prudential investment limits and preferential risk weighting.

As of today, regulated covered bond issuance dominates the UK covered bond market, which we expect to continue. We confine this summary to the principal features of Regulated Covered Bonds – covered bonds issued under the UK legislation.

1 Under the SLS, banks were able to enter into asset swaps for one year (by pledging high quality collateral in return for 9-month Treasury Bills), with the opportunity to renew these transactions or a total of up to three years. By January 2012, all assets will have been returned to the banks and the Scheme will close. In the course of 2008, many institutions set up new covered bond programmes, which were used to contract liquidity under the SLS. According to BoE official SLS usage statistics, a total nominal value of £287bn of collateral was pledged under the SLS, most of which would consist of RMBS and covered bonds, with total drawings after valuation and haircuts amounting to £185bn. Between October 2007 and December 2008, the amount of total outstanding covered bond increased from £50bn to £155bn. Given that most of the new issuance since Q3 08 has been floating rate note covered bonds denominated in GBP, we estimate that the vast part of this amount was retained by the respective issuers and used as collateral for the SLS scheme.

UK REGULATED COVERED BONDS

I. FRAMEWORK

Under the Regulations, in order to attain "regulated status" there are two broad sets of requirements, those relating to issuers and those relating to the covered bonds. Issuers are permitted (but are not required) to submit their covered bond programmes to the the FSA for recognition. The application process is comprehensive, as described in Section VI below. Those issuers and covered bonds that meet all of the criteria set out in the Regulations are added to the register of Regulated Covered Bonds maintained by the FSA.[2] The Regulations only apply to those covered bonds which have been admitted to the register, the issuers of which as at June 2010 are: Abbey National Treasury Services plc, Barclays Bank plc, Bank of Scotland plc (residential mortgage programme), HSBC Bank plc, Leeds Building Society, Lloyds TSB Bank Plc, Nationwide Building Society, Royal Bank of Scotland plc and Yorkshire Building Society.

Regulated Covered Bonds are subject to special public supervision by the FSA. The FSA is required to have regard to "the need to preserve investor confidence in, and the desirability of maintaining the good reputation of, the Regulated Covered Bond sector in the United Kingdom …" in the exercise of its functions under the Regulations. Regulated Covered Bonds comply with the requirements of Article 22(4) of the the UCITS Directive. At time of writing, all Regulated Covered Bonds also comply with the definition of covered bonds set out in the EU Capital Requirements Directive (Directive 2006/48/EC, referred to as the CRD).

Certain elements of the Regulated Covered Bond structure are governed by contract: for example, the cover assets are ring-fenced by means of a "true sale" to a special purpose entity and several cover pool collateral sufficiency tests are set out in the programme documents. However, the FSA has a veto over material amendments to the contracts and broad powers to enforce its provisions. In addition, the priority of claims against the cover pool in a winding up scenario is as set out in the Regulations – no counterparty may have any claim against the cover pool in priority to bondholders, regardless of what is set out in the contracts.

II. STRUCTURE OF THE ISSUER

The Regulations require the issuer to be a credit institution authorised in the UK to carry out regulated activities, such as deposit-taking. It must also have a registered office in the UK and meet certain additional requirements set by the FSA. The Regulations do not place any additional restrictions on the business activities of the issuer beyond those set out in existing financial institution regulations.

Regulated Covered Bonds are direct, unconditional obligations of the issuer; however, investors also have a priority claim over a pool of cover assets in the event of the insolvency or default by the issuer. The Regulations require all cover assets (including any substitution assets) to be segregated from the insolvency estate of the issuer by being sold to a special purpose entity (referred to in the Regulations as the "owner"), which guarantees the issuer's obligations under the bonds. All transactions to date have used a limited liability partnership (LLP) for this purpose. The purchase price paid by the LLP for the cover assets is either cash (funded by an inter-company loan from the issuer) or a partnership interest in the LLP. The transfer of mortgages to the LLP is by way of 'silent' (equitable) assignment; however,

2 The register may be found at
http://www.fsa.gov.uk/Pages/Register/rcb_register/index.shtml

the mortgage borrowers must be notified of the assignment (which perfects legal title in favour of the LLP) following the occurrence of certain trigger events, such as the downgrade of the issuer below investment grade (if the issuer is a bank) or an issuer insolvency event (if the issuer is a building society).

The LLP guarantees the issuer's obligations in respect of the covered bonds and provides security over the cover assets to a security trustee on behalf of the investors. If there is a call on the guarantee (see Section VII below), the LLP will use the natural cash flows from the cover pool (e.g., payments of interest and principal from the mortgage borrowers, after taking account of any swap payments) to service the covered bonds. If these cash flows are insufficient, the LLP is permitted to sell cover assets, subject to meeting certain tests to ensure equality of treatment of bondholders. There is no direct legal link between the mortgages and the covered bonds.

III. COVER ASSETS

The Regulations allow those assets which are listed in Annex VI, Part 1, Section 12, Paragraph 68 a) to f) of the CRD to be permitted in the cover pool, subject to the following restrictions:

> deposits and other exposures to credit institutions with ratings below Credit Quality Step 1 (AA-) are not permitted; and

> in order to ensure transparency to the end investor, RMBS and CMBS are only allowed in the cover pool if: (i) the underlying mortgages were originated or acquired by the issuer or one of its affiliates; (ii) they are rated AAA; and (iii) in the case of mortgages originated by an affiliate, the affiliate is a credit institution with a registered office in the UK.

The Regulations also allow certain assets which are not permitted under the CRD: loans to registered social landlords and loans to public-private partnerships (subject in each case to certain restrictions).

The Regulations require cover assets to be of high quality, and the FSA is permitted to reject any application for Regulated status if it believes that the quality of the proposed assets will be detrimental to the interests of investors in Regulated Covered Bonds or the good reputation of the Regulated Covered Bonds sector in the United Kingdom.

Cover assets must be situated in EEA states, Switzerland, the US, Japan, Canada, Australia, New Zealand, the Channel Islands or the Isle of Man. If an issuer includes non-UK assets in its cover pool, it must get confirmation that the laws of the relevant jurisdiction would not adversely affect the rights of the LLP or the security trustee.

In all of the programmes that have to date been registered, the cover pools consist of assets with narrower eligibility criteria than those allowed required under the Regulations, and comprise only UK residential mortgages and the substitution assets described below. Mortgage LTV criteria are as described in Section IV below.

Substitution assets can be included in the cover pool. In most programmes their aggregate value can make up to 10% of cover assets, although HSBC has explicitly linked its substitution asset limits to those set out in the CRD and the Regulations (whichever is more strict). In all programmes, substitution assets are limited to short-term investments in sterling, namely bank deposits and debt securities with a minimum rating of double-A minus or P-1/A-1+/F1+, triple-A rated RMBS and government debt, in each case subject to the restrictions described above.

IV. VALUATION AND LTV CRITERIA

The properties securing the mortgage loans are valued using UK mortgage market accepted practice. A surveyor is often used, although other methods (such as desktop valuations) are also accepted depending on the issuer's underwriting criteria. Residential property values are indexed to either the Halifax or Nationwide real estate price index, each of which reports quarterly on a region-by-region basis. Price decreases are fully reflected in the revaluation, while in the case of price increases a haircut (15% in all programmes) is applied.

The LTV limit for mortgages varies across the different programmes (see Figure 1), but in all existing programmes it is below the 80% level for residential mortgages stipulated by the CRD and the Regulations. It is important to note that loans above the LTV limit are included in the pool, but the amount of the loan which exceeds the LTV limit is excluded from the Asset Coverage Test (see Section V below). Loans which are in arrears are either repurchased by the issuer or subject to specific haircuts (see Figure 1).

V. ASSET - LIABILITY MANAGEMENT

The Regulations do not prescribe a minimum level of overcollateralisation (OC). Instead, they require the cover pool to be capable of covering all claims attaching to the bonds at all relevant times. The minimum OC level for any programme is considered by the FSA on a case-by-case basis, taking into account the quality of the cover assets, risk-mitigation measures, such as swaps and downgrade triggers, asset-liability mismatches, and so on. The FSA has the power to order the issuer to transfer additional assets to its cover pool if it believes the collateral in the pool is insufficient.

Issuers must also carry out a dynamic Asset Coverage Test (ACT) on a monthly basis to ensure that minimum OC requirements are satisfied. The ACT requires the principal balance of the mortgages in the cover pool (after applying the haircuts listed below) to equal or exceed the principal amount of covered bonds then outstanding. The following haircuts are applied:

> The issuer only gets credit for mortgages up to the indexed LTV limit specified in the programme documents (see Section IV above) or the asset percentage of the mortgages, whichever is lower.[3] The LTV limit for performing mortgages is between 60-75%; for non-performing mortgages (i.e., greater than three months in arrears) it is between 0% and 40%, depending on the programme. The asset percentage is determined from time to time by the rating agencies, subject to a 'base', or maximum, asset percentage set out in the programme documents. Figure 1 below sets out the LTV limits, maximum asset percentage and current asset percentage (and the minimum levels of OC that these imply) for each Regulated Covered Bond programme.

> Additional haircuts are applied to mitigate set-off risk, redraw risk on flexible mortgages, and potential negative carry.

The issuer is required to rectify any breach of the ACT by the next calculation date by transferring additional cover assets to the LLP. If the breach is not rectified by the following calculation date, the trustee will serve a notice to pay on the LLP. This will require the LLP to pay interest and principal on the covered bonds as originally scheduled under the guarantee, as described further in Section VII below.

3 For example: Let us assume a cover pool which contains two loans. Each loan has a principal balance of £80 and is secured by a property worth £100. If the ACT applies an LTV cap of 75% and an asset percentage of 90%, the issuer will get credit for £144 of loans: applying the LTV cap would allow £150 (maximum 75% LTV for each loan); but the asset percentage allows a lower amount (£160 x 90% = £144) and therefore governs.

The issuer may also become liable to enforcement action by the FSA. An amortisation test is run on each calculation date after the delivery of a notice to pay (see Section VII below). It is designed to ensure that the cover pool will be sufficient to enable the LLP to make payments under the covered bonds on their originally scheduled payment dates as required under the guarantee. The amortisation test is similar to the ACT, but requires a lower level of OC to reflect the fact that the cover pool is being wound down. If the test is failed, the covered bonds will accelerate against the LLP, as described further in Section VII below. The LLP is required under the programme documents to enter into swaps with suitably-rated counterparties (in public deals, typically A-1+/P-1 for currency swaps and A-1/P-1 for interest swaps) at the time each covered bond is issued to fully hedge any mismatches between the currencies and interest rates of the bonds and the cover assets. In addition, downgrade triggers for swap counterparties, the pre-maturity test, the ACT, maturity extension rules and the amortisation test all ensure cash low adequacy.

Most UK covered bond transactions have a soft-bullet maturity. Following the service of a notice to pay, the legal final maturity may be extended, typically by 12 months, in order to allow the realisation of the cover assets.[4] It is important to note that the issuer does not have the option to extend the bond's maturity; failure by the issuer to repay the bond in full on the originally-scheduled maturity date is an event of default.

In some programmes, a **pre-maturity test** is designed to ensure that the LLP has sufficient cash available to repay the bonds, in full, on the original maturity date in the event of the issuer's insolvency.[5] If, in a specified period before a maturity date (6-12 months, depending on the issuer and the rating agency), the issuer's ratings fall below certain specified triggers (typically A-1+ / P-1 / F1+), the pre-maturity test requires the LLP to cash-collateralise its potential obligations under the guarantee. The LLP can raise this cash through contributions from the issuer or by selling randomly-selected loans.

All Regulated Covered Bond programmes include a number of other safeguards. In particular, there are minimum rating requirements for the various third parties that support the transaction, including the swap counterparties and cash managers, and independent audits of the cash manager's calculations are undertaken on a regular basis.

If the issuer's short-term ratings are downgraded below A-1+ (S&P), P-1 (Moody's) or F1+ (Fitch), the LLP is required to establish and maintain, from the income it receives from the cover assets, a reserve fund in an amount sufficient to meet the next interest payment on each series of covered bonds. This amount is retained in a GIC account. If a notice to pay is delivered, the LLP can use the reserve fund to meet its obligations under the guarantee.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

An applicant under the Regulations must be a credit institution authorised in the UK to carry out regulated activities, such as deposit-taking. Issuers must satisfy the FSA that their programmes comply with the criteria set out in the Regulations and provide, among other things:

> details concerning the programme structure, such as the cover pool eligibility criteria, the formulae used to calculate compliance with minimum OC requirements and ratings triggers;

4 Some programmes also allow the issue of bonds which become pass-through (ie, principal repayments by mortgage borrowers are passed along to the covered bondholders) if the issuer fails to repay the bond on its scheduled maturity date; however, no bonds in this format have been publicly issued.

5 Within the Barclays Bank, Bank of Scotland, HSBC and Nationwide programmes, only covered bonds which are issued as "hard bullet Covered Bonds" are subject to the prematurity test. The programmes also allow for the issue of bonds with a 12 month maturity extension.

> details concerning asset and liability management, audit and controls;

> arrangements for the replacement of key counterparties;

> cover pool data; and

> legal and audit opinions.

The issuer is responsible for monthly cover pool monitoring; however, the ACT calculation is checked by an independent auditor on an annual basis. The FSA must be notified by the issuer of any breaches of the ACT, and may also require the issuer to provide such additional information about the cover pool as it considers fit. Finally, rating agencies are heavily involved in the programme and need to re-affirm the ratings of the programme as a condition to each issuance.

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

The Regulations require all cover assets (including any substitution assets) to be segregated from the insolvency estate of the issuer by being transferred to a special purpose entity (referred to as the "owner" in the Regulations), which guarantees the issuer's obligations under the bonds. All transactions to date have used an LLP for this purpose. All cover pool hedges are entered into directly by the LLP.

The Regulations require that the cover assets be recorded on a register maintained by or on behalf of the issuer and the LLP. The register must be available for inspection by the FSA. The issuer is responsible for ensuring that all cover assets meet the relevant eligibility criteria set out in the Regulations and, if applicable, any additional criteria set out in the programme documents.

The LLP becomes obligated to pay the covered bondholders under the guarantee upon delivery by the bond trustee of a notice to pay following the occurrence of an issuer event of default or other trigger event. The events which can trigger a notice to pay typically include:

> Failure by the issuer or any group guarantors to pay any interest or principal on the covered bonds when due;

> Bankruptcy or similar proceedings involving the issuer or any group guarantors;

> Failure to rectify any breach of the asset coverage test; and

> Failure to rectify any breach of the pre-maturity test (if applicable).

The delivery of a notice to pay does not accelerate payments by the LLP. To the extent that an issuer event of default has occurred, the bond trustee may commence proceedings against the issuer and any group guarantors on an unsecured basis on behalf of the covered bondholders. Nevertheless, for so long as an LLP acceleration event has not occurred (as described below), the LLP will only be required to make the originally scheduled payments of interest and principal on the covered bonds.

LLP acceleration events typically include:

> The LLP fails to pay any interest or principal when due under the guarantee;

> Bankruptcy or similar proceedings are commenced involving the LLP; and

> After delivery of a notice to pay, the LLP breaches the "amortisation test".

The occurrence of an LLP acceleration event causes the acceleration of payments by the LLP to covered bondholders and the redemption of the bonds at the relevant early redemption amount.

The LLP is reliant on the proceeds derived from the cover assets to make payments under the guarantee. Under the Regulations, in a winding up scenario, no claims against the cover assets can rank ahead of the Regulated Covered Bondholders. If the proceeds from the cover pool are insufficient to meet the obligations to bondholders in full, investors will continue to have an unsecured claim against the issuer and any group guarantors for the shortfall

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The list of eligible assets under the Regulations is in some respects narrower than that set out in the CRD. Residential mortgage backed securities, for example, are severely restricted. However, certain assets which are excluded from the CRD – such as loans to UK housing associations – are permitted in the cover pool under the Regulations. Therefore, some Regulated Covered Bonds may not qualify for preferential risk weightings in the hands of regulated investors. To date, however, all Regulated Covered Bonds are CRD compliant and therefore benefit from the same preferential treatment as covered bonds from other EU jurisdictions.

> Figure 1: Overview – UK covered bond programmes*

	Abbey National	Barclays Bank	Bank of Scotland	HSBC	Lloyds TSB Bank	Leeds Building Society	Nation-wide	Royal Bank of Scotland	York-shire
Programme volume in € bn	25	35	60	15	60	7	35	15	7.5
LTV cap	75%	75%	60%	75%	60%	75%	75%	75%	75%
House price index	Halifax	Halifax	Halifax	Halifax	Halifax	Nation-wide	Nation-wide	Halifax	Avg. of Halifax & Nation-wide
Maximum asset percentage applied in ACT	91.00%	94.00%	92.50%	92.50%	92.50%	93.50%	93.00%	90.00%	93.50%
Minimum over-collateralisation	109.90%	106.38%	108.10%	108.10%	108.10%	109.90%	107.50%		107.00%
Current asset percentage applied in ACT	82.00%	77.30%	78.00%	78.20%	79.90%	77.10%	84.50%	79.00%	78.00%
Current over-collateralisation	122.00%	129.40%	128.20%	127.90%	125.20%		118.30%		128.20%
In arrears accounting	Max. 40% if LTV £ 75%, max 25% if LTV >75% or repurch.	Max. 40% if LTV £ 75%, max 25% if LTV >75% or repurch.	No recognition	Max. 40% if LTV £ 75%, max 25% if LTV >75% or repurch.	Full recognition in case in arrears = <3M, otherwise 70%	Max. 40% if LTV £ 75%, max 25% if LTV >75% or repurchase	Max. 40% if LTV £ 75%, max 25% if LTV >75% or repurchase	Max. 40% if LTV £ 75%, max 25% if LTV >75% or repurch.	Max. 40% if LTV £ 75%, max 25% if LTV >75% or repurchase
Hard bullet	No; 12-month maturity extension	Yes; pre-maturity test	Yes; pre-maturity test	Yes; pre-maturity test	No; 12-month maturity extension	No; 12-month maturity extension	No; 12-month maturity extension	Yes; pre-maturity test	No; 12-month maturity extension
Asset monitor	Deloitte LLP	PWC	KPMG	KPMG	KPMG	Deloitte LLP	PWC	Deloitte LLP	PWC

Source: Barclays Capital

Note: *Issuers of Jumbo UK Regulated Covered Bonds. Source: Transaction documents

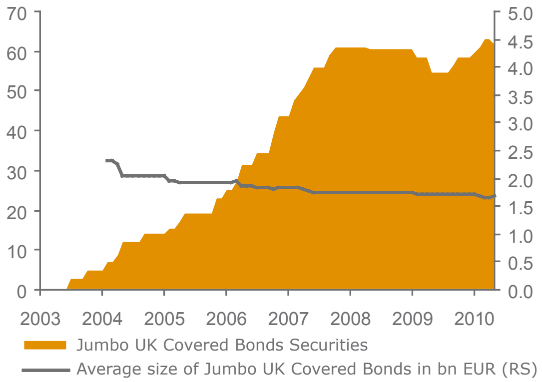
IX. DEVELOPMENT OF THE MARKET

The volume of outstanding UK regulated covered bonds amounts to about £145.5bn as of June 2010.

Figure 2 below shows the overall development of covered bond issuance in the UK.

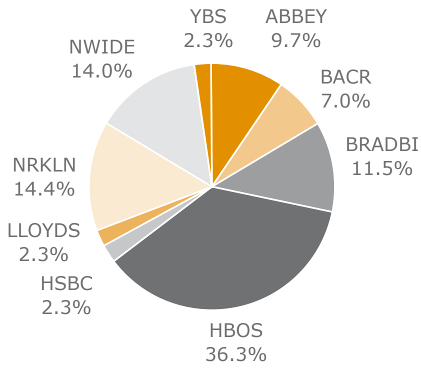
Going forward, we expect the majority of new issuance to be regulated covered bonds, as we believe that investors will take more confidence from the additional layers of supervision.

> FIGURE 2: DEVELOPMENT OF OUTSTANDING VOLUME AND AVERAGE SIZE (€ BN)



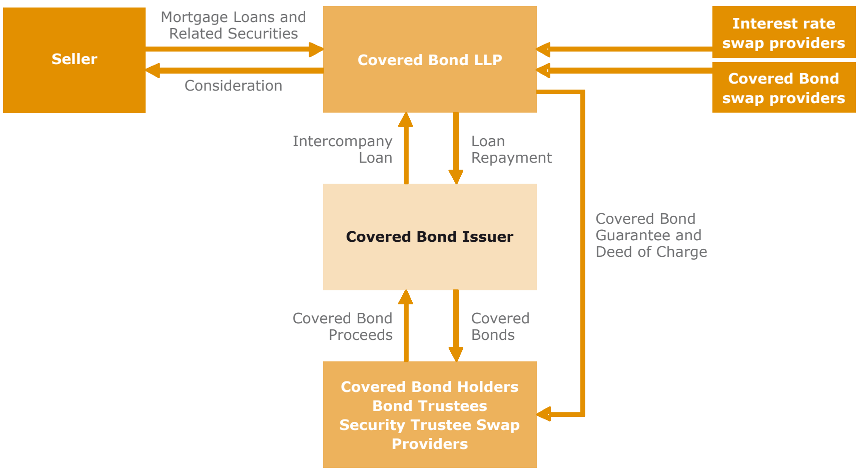
Source: Barclays Capital

> FIGURE 3: MARKET SHARE, MAY 2010



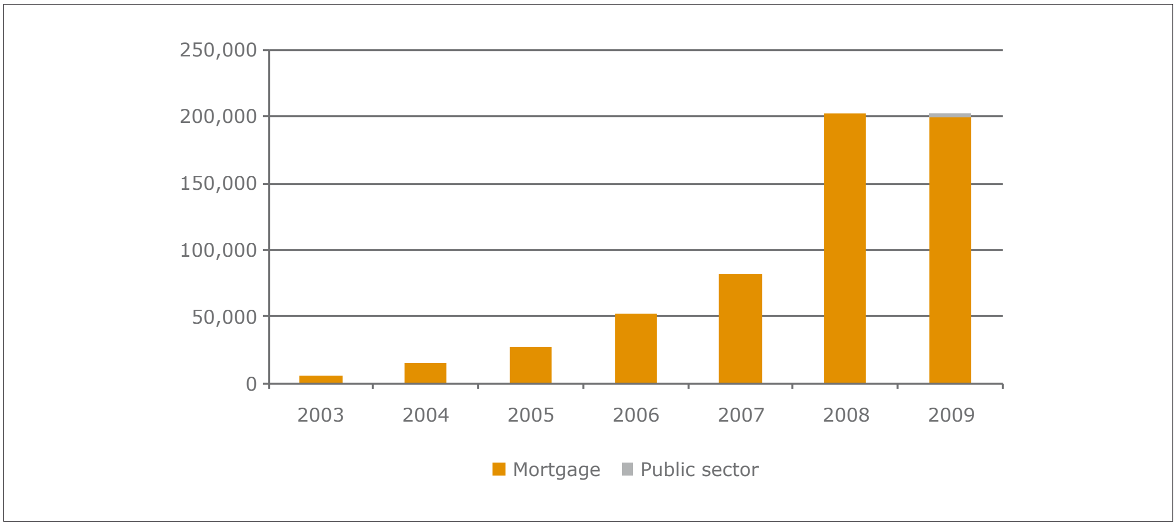
Source: Barclays Capital

> FIGURE 4: GENERIC UK COVERED BOND PROGRAMME STRUCTURE



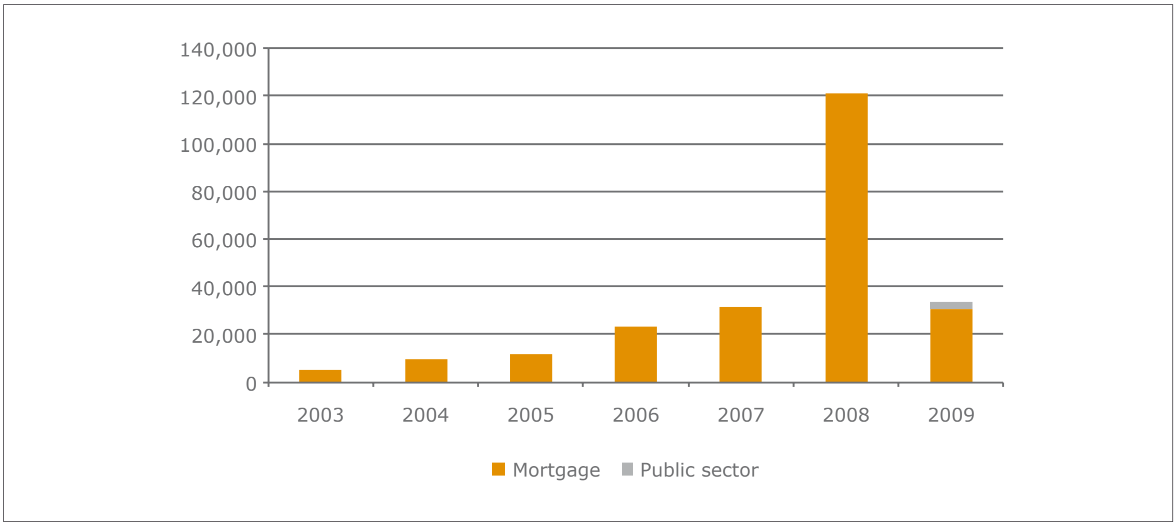
Source: Barclays Capital

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2009, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2009, €M



Source: EMF/ECBC

3.29 UNITED STATES

By Sabine Winkler, Bank of America Merrill Lynch

I. FRAMEWORK[1]

Development of a unique US (qualifying) covered bond regime

The issuance of US covered bonds is not governed by dedicated legislation. In the absence of covered bond legislation, Bank of America and Washington Mutual Bank have employed structured finance elements to replicate recognised covered bond characteristics to set up their covered bond programmes. In September 2008, subsequent to Washington Mutual Bank's closure, JPMorgan Chase Bank assumed the WM Covered Bond Program from the Federal Deposit Insurance Corporation ('FDIC') as receiver for Washington Mutual Bank. The two existing covered bond programmes are governed by, and construed in accordance with, the laws of the State of New York and the State of Delaware. There are a number of other US federal laws and regulations implicated, including, but not limited to, the Uniform Commercial Code ('UCC'), Rule 144A under the Securities Act, Regulation S under the Securities Act and the US Federal Deposit Insurance Act ('FDIA').

In the US, the UCC – as implemented in the relevant state – provides the legal basis to pledge collateral by creation of a first priority perfected security interest. In general, such security interest is obtained via the use of a 'contractual grant' by an entity that clearly identifies pledged collateral in its books and records. For example, an insured depository institution ('IDI', 'sponsor bank') grants to a Mortgage Bond Indenture Trustee ('MBIT') a first priority perfected security interest in the cover pool for the benefit of the mortgage (collateralised) bondholders, and a special purpose vehicle ('SPV') grants a first priority perfected security interest in the covered bond collateral to a Covered Bond Indenture Trustee ('CBIT') for the benefit of the covered bondholders. In this example, since there is no sale or conveyance of ownership, pledged collateral remains on the balance sheet of the entity granting the first priority perfected security interest.

On 9 July 2008, the FDIC approved the final Covered Bond Policy Statement, clarifying its position on qualifying covered bond transactions and their treatment in a conservatorship or receivership of an IDI. On 29 July 2008, the US Treasury released the Best Practices for Residential Covered Bonds statement ('Best Practices Guide') with the support of the FDIC, the Office of Thrift Supervision, the Office of the Comptroller of the Currency ('OCC'), the Federal Reserve and the Securities and Exchange Commission ('SEC'). The Best Practices Guide provides a common template to promote the development of a standardised covered bond market in the US. In July 2008, Bank of America, Citigroup, JPMorgan Chase Bank and Wells Fargo announced their support for the FDIC and US Treasury statements and have shown interest in setting up programmes using such guidelines or in aligning existing programmes to them (although this has not been completed).

Several market participants had hoped that these regulatory initiatives would serve as an adequate substitute for a legal framework and foster growth of the US covered bond market. Since the announcement of the statements, it has however become apparent that regulatory guidance alone is insufficient to

1 The description of the framework in the US is merely a summary of certain aspects of the (proposed) legislation. As a summary, it is not complete. For details refer to the specific (draft) laws, regulations, statements and base prospectuses. This summary does not constitute legal advice by the author.

promote the development of a robust US covered bond market. There is now an active effort underway to adopt a legal framework for US covered bonds. Dedicated legislation may facilitate US covered bond issuance by providing greater clarity and certainty with respect to investor rights, especially upon IDI insolvency or other events of default, and a comprehensive oversight and regulation of US covered bond programmes. It may also reduce some of the costs related to the structure currently used by US banks and level their playing field relative to European peers.

In March 2010, Representative Scott Garrett (R-NJ) introduced a covered bond bill into the House of Representatives for the fourth time since the beginning of the crisis. This bill, the United States Covered Bond Act of 2010, was co-sponsored by Representative Paul E. Kanjorski (D-PA) and Representative Spencer Bachus (R-AL). The United States Covered Bond Act of 2010 is similar to Representative Scott Garrett's (R-NJ) proposed amendment to the Wall Street Reform and Consumer Protection Act of 2009 that was introduced in November 2009 but later withdrawn at the request of Representative Barney Frank (D-MA), and more comprehensive than the Equal Treatment of Covered Bonds Act of 2009 and the Equal Treatment of Covered Bonds Act of 2008.

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The content of the United States Covered Bond Act of 2010 is likely to be further amended as it makes its way through the legislative process. Proposed bills first go to committees that deliberate, investigate and revise them before they go to general debate. On 28 July 2010, the House Financial Services Committee brought a new version of the United States Covered Bond Act of 2010, introduced into the House of Representatives on 22 July 2010, to the floor of the House of Representatives. This bill is now eligible for a vote by the full House of Representatives. A bill must be passed by both the House of Representatives and the Senate and then be signed by the President before it becomes law. Should the United States Covered Bond Act of 2010 become law, it would lay the foundation for a special-law-based US covered bond market.

Hopes of establishing a legal framework for US covered bonds suffered a setback in June 2010 when legislation for the bonds was excluded from the omnibus financial regulatory reform bill. There is bi-partisan support for the creation of a legal structure, though there is some disagreement, for example, about how strict the statutory regime should be. The timing of the adoption and implementation of a statutory framework for US covered bonds, including primary and secondary legislation, is uncertain. There may be more hearings, the current bill may be further revised, and a statutory framework for US covered bonds may be introduced either as a standalone act or as part of a GSE reform act.

The proposed United States Covered Bond Act of 2010

If the United States Covered Bond Act of 2010 were to be implemented in its current form, it would govern and apply to securities that are senior recourse debt obligations of eligible issuers with an initial term of not less than one year; secured by a perfected security interest in a cover pool (owned (in) directly by the eligible issuer), issued under a covered bond programme that has been approved by the covered bond regulator, and identified in a register that is maintained by this regulator.

The bill – as it stood in July 2010 – is meant to provide a funding alternative for a wide range of assets, much wider than in other covered bond laws, without imposing a uniform issuance template. The proposed United States Covered Bond Act of 2010 addresses some of the uncertainties restricting the acceptance of US covered bonds, and covers the following points:

> Issuers: Eligible issuers are IDI or their subsidiaries, bank holding companies, savings and loan holding companies, as well as nonbank financial companies. Pooled issues by entities sponsored by eligible issuers are allowed. This may provide an opportunity for smaller-sized US banks to enter the covered bond market. The covered bond regulator may approve existing covered bond programmes.

> Collateral: A cover pool is defined as a dynamic pool of assets and consists of eligible assets from a single eligible asset class, substitute assets and ancillary assets. Eligible asset classes initially include residential mortgages, home equity loans, commercial mortgages, public-sector debt, student loans, credit or charge card loans, auto loans or leases, and small business loans. Issuers must clearly mark cover assets in their books and records. Loans must not be delinquent for more than 60 consecutive days.

> Supervision: An issuer's primary federal regulator may be the covered bond regulator. The covered bond regulators must jointly set up a covered bond regulatory oversight programme (in consultation with the FDIC). In the event that they fail to set up this programme within one year after the date of the enactment of the United States Covered Bond Act of 2010, the US Treasury must set it up within 180 days. A covered bond regulator needs to approve programmes (upon consultation with the FDIC) and maintain a publicly available registry of approved programmes and the bonds drawn under those programmes.

> Over-collateralisation ('OC'): The covered bond regulators define minimum OC levels for covered bonds secured by each of the eligible asset classes on the basis of their credit, collection and interest rate risks, but not liquidity risk. A minimum OC level may be linked to the haircut applied to the same or similar asset class; for example, under the Federal Reserve System or Federal Home Loan Bank System.

> Testing and monitoring: To test compliance with the OC requirement, issuers need to perform a monthly Asset Coverage Test ('ACT'). Issuers must appoint an independent asset monitor that verifies and reports at least semi-annually to the covered bond regulator and investors whether the ACT is satisfied. Bonds issued under an approved programme remain special-law-based even if the ACT is not met. An uncured failure of the ACT within a predetermined time constitutes a default on covered bonds.

> Registration, disclosure and reporting: Issuers must disclose the outcome of the ACT to the covered bond regulator and investors. At least monthly, issuers need to deliver a list of the eligible and substitute assets in the cover pool to the independent asset monitor. The registration, disclosure as well as reporting standards vary across issuers and depend on the applicable laws and regulations.

> Default and insolvency: There are two scenarios: default on covered bonds prior to and following the issuer entering liquidation, bankruptcy, conservatorship, or receivership ('issuer default'). An issuer default would not necessarily lead to an acceleration of the outstanding covered bonds.

- Default on covered bonds before issuer default: The cover pool and covered bonds are automatically transferred to a newly created separate estate.
- Following issuer default (with the FDIC): The FDIC can transfer the cover pool and covered bonds to another eligible issuer within a 180-day period. Until the transfer is made by or repudiation by or failure of the FDIC, the FDIC as the conservator or receiver for an issuer meets its obligations under the covered bonds. If the transfer is not made within 180 days, or in case of repudiation by or failure of the FDIC, the cover pool and covered bonds are automatically transferred to a newly created separate estate.
- Following issuer default (without the FDIC): The cover pool and covered bonds are automatically transferred to a newly created separate estate.

A transferee will become liable for the covered bonds and obligations of the issuer secured by the cover pool. After the creation of the separate estate, the issuer must transfer all books, records and other materials relating to the separate estate to the covered bond regulator, or its designee, and may be required to continue servicing the cover pool for 120 days. If the cover pool and covered bonds are transferred to the separate estate, the investors retain a claim against the issuer for any deficiency with respect to covered bonds. The covered bond regulator acts as or appoints the trustee of the separate estate and appoints servicers/administrators for the assets held by the separate estate. A servicer/administrator actively manages the cover pool, raises funds on a secured or unsecured basis and disposes of assets. The covered bond regulator supervises and may replace/remove and require reports from a servicer/administrator. The issuer, conservator, receiver, liquidating agent or bankruptcy trustee retains a residual interest representing a right to any surplus from the cover pool. The covered bond regulator closes the separate estate after it has been fully administered.

As noted earlier, it is likely that the content of the proposed United States Covered Bond Act of 2010 will be further amended as it makes its way through the legislative process.

The FDIC's final Covered Bond Policy Statement

The sole focus of the final Covered Bond Policy Statement is to seek a way around the temporary automatic stay of execution rule enforced in October 2006 under Section 11(e)(13)(C) of the FDIA. Under the FDIA, the FDIC can request a stay of up to 45 days (as conservator) or 90 days (as receiver). Such a stay adds costs to the US covered bond structure. For covered bonds structured in accordance with the final Covered Bond Policy Statement the stay can be reduced to a period of 10 days. A shorter stay period and thus expedited access to the collateral pledged for qualifying covered bonds may support their use, because it makes them a more cost-effective funding alternative. To be accorded the shorter stay, covered bonds have to meet the following requirements.

> Features: They must be a non-deposit, recourse debt obligation of an IDI with a term greater than one year, but no more than 30 years, that is secured directly or indirectly by perfected security interests under applicable state and federal law on assets held and owned by the IDI.

> Collateral: The collateral can be eligible mortgages, triple-A rated mortgage-backed securities secured by eligible mortgages, and substitute collateral. Eligible mortgages are performing first-lien mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and with documented income. They must comply with the existing supervisory guidance on the

underwriting of residential mortgages. The final Covered Bond Policy Statement does not suggest a loan-to-value ('LTV') limit. The share of eligible mortgage-backed securities must not exceed 10% of the collateral for any issue/series. Substitute collateral, such as US Treasury and agency securities, and cash, can only be used as necessary to prudently manage the cover pool.

> Issuance limit: Covered bonds must be issued with the consent of the IDI's primary federal regulator and only if, after the issue, the IDI's total obligation under the bonds is not over 4% of total liabilities and only so long as the collateral backing the bond obligation is eligible. This limit reflects the FDIC's concerns about the encumbrance of assets of an IDI resulting in structural subordination of depositors, and reducing the FDIC's ability to fully recover potential depositor losses.

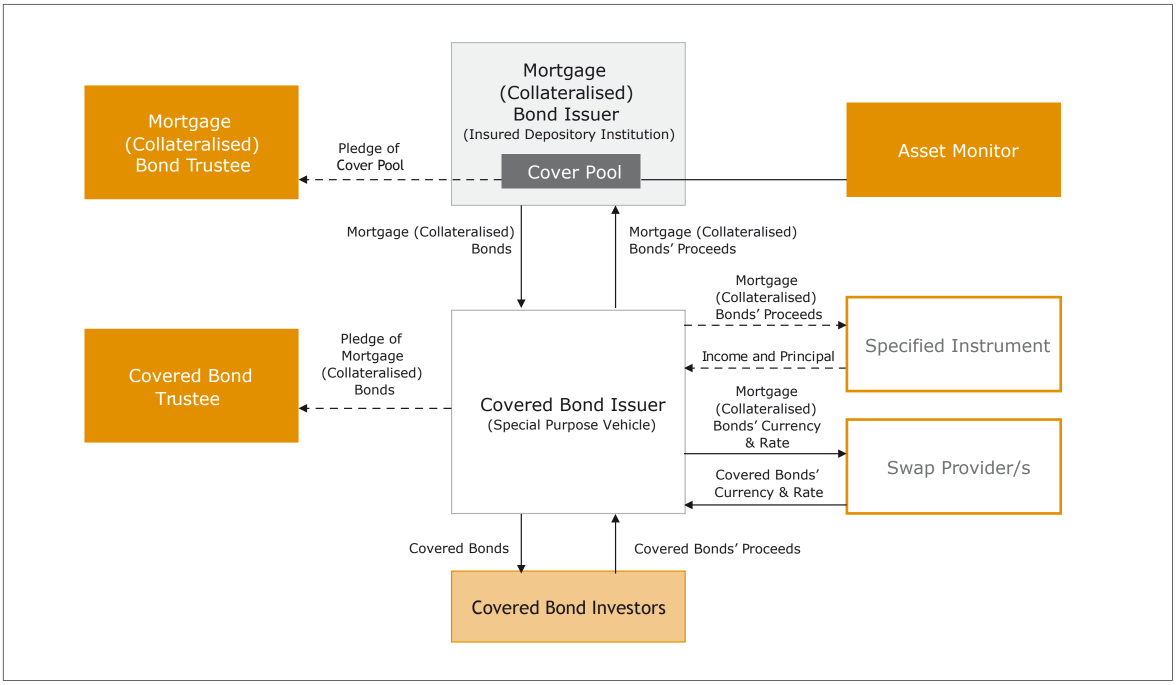
> Disclosure: Issuers of qualifying covered bonds must disclose LTV ratios for the loans included in the cover pool.

The final Covered Bond Policy Statement must not be construed as waiving, limiting or otherwise affecting the FDIC's rights and powers. Neither does it impose new obligations on the FDIC as conservator or receiver, or affect the FDIC's main responsibility to protect the interests of the insured depositors; nor is it designed to protect the interests of the investors in qualifying covered bonds from the risk of IDI insolvency. The FDIC can revise the final Covered Bond Policy Statement as the covered bond market in the US develops. It can also repeal the final Covered Bond Policy Statement following 30 days notice in the Federal Register. In this event, bonds issued before repeal, but in compliance with the final Covered Bond Policy Statement, will be grandfathered.

The US Treasury's Best Practices for Residential Covered Bonds

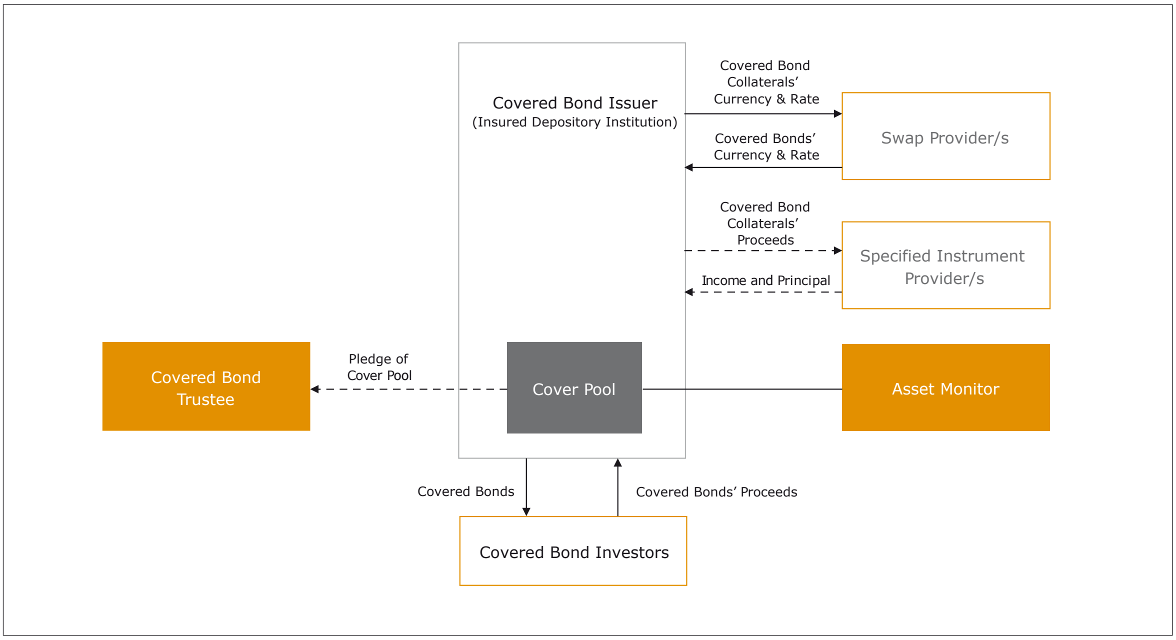
The Best Practices Guide specifies that only well-capitalised entities should issue covered bonds. It outlines two issuance structures: a) the 'SPV Structure' (the covered bond issuer is a bankruptcy-remote SPV), and b) the 'Direct Issuance Structure' (the covered bond issuer is an IDI or a wholly-owned subsidiary of an IDI). The first refers to the structure currently used by Bank of America and JPMorgan Chase Bank, as we discuss later.

> Chart 1: Simplified US covered bond structure currently used by US banks ('SPV Structure')



Source: Best Practices Guide, BofA Merrill Lynch Global Research

> Chart 2: Potential Direct Issuance Structure



Source: Best Practices Guide, BofA Merrill Lynch Global Research

According to the Best Practices Guide, obligations under the bonds must be secured by a first priority perfected security interest on the collateral for the benefit of the bondholders. Multiple covered bond issuances of an issuer can be backed by a common cover pool. Covered bonds must be launched with the consent of the primary federal regulator of an IDI and only if, after issuance, the IDI's total obligation under the bonds is not over 4% of total liabilities.

> No uniform structure: The US Treasury does not impose a uniform template for the issuance of covered bonds. It is left to the IDI's discretion to develop other issuance structures consistent with the Best Practices Guide. In the future, structures may thus deviate from the current structure.

> Joint-funding opportunities: US banks lacking the necessary volume to issue a covered bond can have access to this market since the US Treasury has not ruled out joint funding opportunities, as multiple IDI can use a joint SPV to pool collateral. In this case, each IDI would be responsible for meeting the principles set out in the Best Practices Guide and the final Covered Bond Policy Statement.

> Dynamic cover pool: Irrespective of the used issuance structure, the IDI must own and hold the collateral included in the cover pool. The cover pool must remain on the IDI's balance sheet. The IDI has to clearly identify the collateral assigned to a cover pool in its books and records and must actively manage the cover pool to comply with certain requirements.

> Other features: Fixed-rate or floating-rate covered bonds registered or non-registered with the SEC can be launched in any currency, according to the Best Practices Guide. The maturity for covered bonds has to be greater than one year, but no more than 30 years.

The Best Practices Guide not only defines qualifying covered bonds, but also repeats and expands on the standards for those bonds prescribed by the FDIC under the final Covered Bond Policy Statement. It also introduces new standards relating to key areas, including collateral, asset-liability matching, disclosure, supervision and insolvency procedures.

> Collateral: A cover pool may include performing loans secured by first-lien mortgages over one-to-four family residential properties, underwritten at the fully-indexed rate and with documented income. The loans must be in line with the existing supervisory guidance on the underwriting of residential mortgages and must not be burdened by other liens. Negative amortisation loans and loans over 60 days in arrears are not eligible for a cover pool. Non-performing and prepaid mortgages must be replaced. At the time a loan is to be included in a cover pool, the LTV must not exceed 80%. Quarterly, LTV must be updated by adjusting the original property valuation with the nationally recognised, regional housing price index or other comparable measurement. There is a concentration limit on the cover pool in terms of regions: a single Metro Statistical Area cannot account for over 20% of the cover pool. Substitute collateral, such as US Treasury and agency securities, and cash, can only be used as necessary to prudently manage the cover pool. In the future, the eligibility criteria can be adjusted with the growth of the US covered bond market.

> Derivatives: At launch of a series, an IDI must enter into swaps or similar agreements for each series to hedge interest and currency risks and risks arising from timing discrepancies between the dates on which proceeds from the collateral are received and the date on which interest and principal is payable on the covered bond series. Swap providers have to temporarily cover limited amounts of interest in the event of IDI insolvency. Swap agreements need to be with financially sound counterparties and their identity must be disclosed to investors.

> Specified investment: At launch of a series, an IDI needs to enter into a specified investment for this series with a financially sound specified instrument provider. In the event of IDI insolvency, proceeds from the collateral must be invested in the specified investment. Upon a payment default by the IDI or if the FDIC as the conservator or receiver for the IDI repudiates the bonds, scheduled payments are paid out of the specified investment as long as the specified investment provider/s receive/s proceeds from the collateral in an amount at least equal to the due amount under the covered bonds. If the proceeds are insufficient to meet the payments under the covered bonds, the bonds would become immediately due and payable ('payment acceleration').

> Asset liability matching: An IDI has to conduct a monthly ACT. At all times, an IDI must ensure a minimum OC of at least 5% of the outstanding principal balance of the covered bonds. Loans can be funded through covered bonds up to an 80% limit of their outstanding balance. If an IDI fails the ACT, no further series can be launched while such a breach exists. If an IDI fails the ACT, and the breach is not remedied by the following monthly calculation date, a trustee can terminate the programme. In this case, principal and accrued interest must be paid to covered bond investors.

> Disclosure: The outcomes of the ACT and of any reviews by the asset monitor must be made available to investors. If over 10% or 20% of the collateral is substituted in any month or quarter, respectively, an IDI must disclose updated information in relation to the collateral to investors. An IDI and SPV must disclose information relating to their financial profile and other material information. At the time an investment decision is made, and monthly after issuance, descriptive information on the cover pool must be disclosed to investors no later than 30 days after the end of every month.

> Supervision: An IDI's controls and risk management processes are supervised by the respective primary federal regulator. This regulator is charged with reviewing covered bond programmes using its standard method of evaluating the IDI's business activities as part of its ongoing supervisory efforts. The review may include an analysis of the steps taken by an IDI to conform to the principles imposed under the final Covered Bond Policy Statement and the Best Practices Guide.

> Monitoring: An IDI must designate an independent asset monitor and an independent trustee. The trustee has to act on behalf of, and represent the interests of, the covered bondholders and enforce their rights in the collateral in the event of IDI insolvency. The asset monitor needs to frequently determine compliance with the ACT.

> Insolvency procedures: The FDIC as the receiver or conservator of an IDI can affirm the IDI's covered bonds and continue to meet payments under the bonds when due, or repudiate those bonds. If the FDIC repudiates transactions, the bonds become due and payable ('payment acceleration'). In this event the FDIC can either pay off the bonds, or provide access to the collateral to the first priority perfected security interest holder to enforce its security interest and exercise self-help remedies including liquidation of the collateral to pay off the bonds. An amount equal to actual direct compensatory damages must be paid in full up to the value of the collateral. Under the final Covered Bond Policy Statement, actual direct compensatory damages are defined as the par value of the covered bonds plus interest accrued up to the date of appointment of the FDIC as the receiver or conservator. If the value of the collateral exceeds the actual direct compensatory damages, the excess amount must be returned to the FDIC as the conservator or receiver for the IDI. Thus, the cash flow to the bondholders is limited to the actual direct compensatory damages. If insufficient collateral is pledged to cover the actual direct compensatory damages, the investors would have an

unsecured claim in the receivership for any amounts remaining outstanding after the collateral has been depleted. In the event of default, the investors with a common cover pool share losses pro rata. The investors may experience a loss, if the funds derived from the collateral are insufficient to meet their claims and the shortfall is not covered by their unsecured claim in the receivership.

The Best Practices Guide must not be construed to be dedicated covered bond legislation. Neither does it provide or imply any government guarantee, or attempt to address the requirements imposed on institutions under other applicable US legislation and regulations, such as the UCC, the FDIA, and the Securities Act. The US Treasury expects the structure and collateral and other key terms of qualifying covered bonds to evolve with the growth of this market in the US.

II. EXISTING TAILOR-MADE PROGRAMMES

Two-tier approach

To date, only the SPV Structure is used. This structure operates a two-tier approach: the covered bonds are not launched by an IDI, but by an SPV. They are backed by a related series of mortgage (collateralised) bonds issued by an IDI. The mortgage (collateralised) bonds are, in turn, backed by a cover pool that remains on the IDI's balance sheet.

> Sponsor bank (ie, Bank of America or JPMorgan Chase Bank): A sponsor bank issues US$-denominated floating-rate mortgage (collateralised) bonds. Such bonds are issued in series. Each series is a direct, unconditional, and senior secured obligation of the sponsor bank ranking pari passu, pro rata, and without priority among themselves. A mortgage (collateralised) bond is backed by a pool of qualifying collateral ('cover pool') that remains on the sponsor bank's balance sheet. The cover pool is dynamic – ie, the sponsor bank can add/remove collateral at all times from the cover pool subject to its continued compliance with the ACT and the approval from rating agencies. To secure its obligations under the mortgage (collateralised) bonds, the sponsor bank grants a first priority perfected security interest in the cover pool to a MBIT for the benefit of the mortgage (collateralised) bond investors.

> Special purpose vehicle: The SPV (for example, in the form of a Delaware statutory trust) needs to be a 'separate' entity that is neither controlled by nor affiliated to the sponsor bank. Only a 'separate' entity is not consolidated for bankruptcy purposes in respect of the sponsor bank's assets. The sole purpose of an SPV is to issue a series of covered bonds and to use the proceeds to purchase a related mortgage (collateralised) bond series. The SPV grants a first priority perfected security interest in the covered bond collateral to a CBIT for the benefit of the covered bond investors. Each series of mortgage (collateralised) bonds is held by the CBIT on behalf of the SPV as collateral for the related covered bond series. The covered bonds are limited recourse obligations of the SPV ranking pro rata and without priority among themselves. The covered bond investors have no further claim against the SPV or the sponsor bank if the proceeds from the enforcement of the first priority perfected security interest in the covered bond collateral are insufficient to meet their claims. To date, the two statutory trusts organised under the laws of the State of Delaware with covered bonds outstanding are BA Covered Bond Issuer and WM Covered Bond Program.

> Mortgage Bond Indenture Trustee: The MBIT holds a first priority perfected security interest in the cover pool for the benefit of the mortgage (collateralised) bondholder/s.

> Covered Bond Indenture Trustee: The CBIT holds a first priority perfected security interest in the covered bond collateral for the benefit of the secured creditors. Upon a mortgage (collateralised) bond acceleration and prior to an SPV Event of Default, the CBIT performs the Proceeds Compliance Test.

> Asset monitor: Under an Asset Monitor Agreement, the asset monitor has to verify the arithmetic accuracy of the ACT calculation yearly. If the sponsor bank was downgraded to or below BBB- (S&P), Baa3 (Moody's) or BBB- (Fitch) the asset monitor has to test the ACT calculation monthly until the required credit ratings have been reinstated.

Eligibility of collateral for the cover pool

The tailor-made programmes provide the sponsor banks with considerable flexibility with regard to the composition of the cover pool as the eligibility criteria are relatively broad; the eligibility criteria can also be changed in the future subject to approval of the rating agency then rating the outstanding covered bonds. To date, according to the respective terms of the Mortgage Bond Indenture, the collateral has to meet the following eligibility criteria to be included in the cover pool.

> BA Covered Bond Issuer: First-lien or second-lien residential mortgages originated or acquired by the sponsor bank. Loans in arrears for over 60 days must be excluded from the ACT calculation.

> WM Covered Bond Program: First-lien or second-lien residential mortgages or home equity lines of credit or a combination thereof originated or acquired by the sponsor bank.

Of each loan up to 75% of the mortgaged property's value can be taken into account in the ACT calculation. A mortgaged property's value is the value given to the property by the sponsor bank adjusted by changes of the Office of Federal Housing Enterprise Oversight House Price Index ('OFHEO HPI'). A decrease in the OFHEO HPI is fully reflected in the reassessment of a mortgaged property's value, but only 85% of an OFHEO HPI increase can be taken into account.

Under the individual programme terms, substitute collateral is eligible to be included in the cover pool. Substitute collateral includes: a) cash, b) debt launched or guaranteed by 0% risk-weighted public sector entities, c) exposures to 10% or 20% risk-weighted entities, and d) triple-A rated, US$-denominated RMBS. RMBS must not account for over 10% of the total principal amount of the outstanding covered bonds. Substitute collateral is limited to a maximum of 10% of the cover pool.

Asset-liability matching

An SPV enters into swap agreements with qualifying swap providers in order to address risks arising from interest and currency mismatches between the mortgage (collateralised) bond series and the related covered bond series, and risks related to timing discrepancies between the dates on which proceeds from the mortgage (collateralised) bond series are received by an SPV and the date on which interest and principal is payable on the covered bond series. The swap providers must make payments to the SPV if and to the extent they receive payments from it. If an SPV fails to pay an amount due to the swap providers, for example, if the FDIC as the receiver or conservator for a sponsor bank does not authorise continued interest payments on the mortgage (collateralised) bonds issued by this sponsor bank, the swap providers must cover limited amounts of interest.

A mismatch between the coupon on the mortgage (collateralised) bonds and the yield on its collateral is unhedged. Any covered bond series must match the principal amount and core issuance terms of the related mortgage (collateralised) bond series. Depending on the final terms of a series, a bond is repaid in full on its maturity date or, in the event that the SPV fails to redeem the bond in full on the maturity date, its repayment can be deferred. According to the individual programme terms, a deferral can be up to 60 days. A deferral of payments does not constitute an SPV Event of Default. The individual programme terms provide for an ACT and a Proceeds Compliance Test ('PCT').

> Asset Coverage Test: A sponsor bank performs the ACT and ensures that the adjusted aggregate loan amount is at least equal to the aggregate unpaid principal amount of all mortgage (collateralised) bonds outstanding. The adjusted aggregate loan amount is multiplied by an asset percentage ('AP'). The AP is at least 96% for BA Covered Bond Issuer and 93% for WM Covered Bond Program and refers to a minimum OC of 4.2% and 7.5%, respectively. The ACT has to be carried out monthly. It must also be carried out when collateral is removed from the cover pool or prior to the issuance of a new covered bond series. If the ACT is failed, a sponsor bank must add further collateral to the cover pool to ensure that the ACT is passed again at the next determination date. Consecutive failure of the ACT results in a Sponsor Bank Event of Default.

> Proceeds Compliance Test: Upon the occurrence of a Sponsor Bank Event of Default and declaration of acceleration of the mortgage (collateralised) bonds by the MBIT but prior to an SPV Event of Default, the CBIT performs a monthly PCT. The CBIT assesses whether the sum of the total amounts deposited in, or credited to, the specified instrument for each covered bond series less any accrued interest, and the total unpaid principal amounts of each mortgage (collateralised) bond series is at least equal to the total principal amount of all covered bonds outstanding. A failure of the PCT constitutes an SPV Event of Default.

Asset monitor and banking supervision

Bank of America and JPMorgan Chase Bank are supervised by the OCC. The OCC charters, regulates and supervises banks. The Bank of New York Mellon was appointed independent asset monitor to assess the arithmetic accuracy of ACT calculations of Bank of America and JPMorgan Chase Bank.

Upon a Sponsor Bank Event of Default

In the event a sponsor bank becomes insolvent, is in an unsound condition, engages in certain violations of law or regulations, or if other similar circumstances occur, the specific bureau of the US Treasury can appoint the FDIC as conservator or receiver for the sponsor bank. Upon the occurrence of a Sponsor Bank Event of Default, the sponsor bank can no longer remove collateral from the cover pool. At the same time, the MBIT can declare the principal of all outstanding mortgage (collateralised) bond series, together with accrued and unpaid interest thereon through the date of acceleration, to be immediately due and payable ('Mortgage Bond Acceleration'). If one series defaults, all series default ('cross default').

Upon the occurrence of a Sponsor Bank Event of Default and Mortgage Bond Acceleration, the MBIT enforces its first priority perfected security interest in the cover pool against the FDIC as the receiver or conservator for the sponsor bank on behalf of the SPV. The cover pool backing the outstanding mortgage (collateralised) bond series is not segregated from the insolvency estate of the sponsor bank. Upon the occurrence of a Sponsor Bank Event of Default all outstanding mortgage (collateralised) bond series are secured pari passu and without priority as regards the collateral in the cover pool and each covered bond series shares pro rata any collections on, and proceeds of, the collateral in the cover pool based on their entitlements to proceeds from the related mortgage (collateralised) bond series. Upon a Mortgage Bond Acceleration but before an SPV Event of Default, the CBIT performs the monthly PCT.

Under the FDIA, the FDIC as the receiver or conservator for a sponsor bank can: a) affirm the covered bonds and continue to meet the payments under the mortgage (collateralised) bonds when due and/or seek to transfer any of the sponsor bank's assets and liabilities to a new obligor; or b) repudiate the covered bonds. If the FDIC repudiates the transactions, the mortgage (collateralised) bonds become immediately due and payable. If at any time after appointment the conservator or receiver for the sponsor bank remains in default for a predetermined period ('stay period'), or if the FDIC as the conservator or receiver for the sponsor bank repudiates the transactions, but does not pay the actual direct compensatory damages to the MBIT as the first priority perfected security interest holder within the stay, the MBIT may exercise self-help remedies and enforce its security interest over the collateral in the cover pool. The exercise of such self-help remedies is subject to approval by the FDIC.

Under the FDIA, the FDIC can request a stay of up to 45 days (as conservator) or 90 days (as receiver). For covered bonds structured in accordance with the final Covered Bond Policy Statement the stay can be reduced to a period of 10 days. The FDIC also retains the discretion to provide access to the collateral before the expiry of the 90-day (as receiver) or 45-day (as conservator) period on a case-by-case basis. Within the stay period the FDIC must either a) pay off the mortgage (collateralised) bonds; or b) provide access to the collateral to the first priority perfected security interest holder to enforce its security interest and exercise self-help remedies to pay off the mortgage (collateralised) bonds.

An amount equal to actual direct compensatory damages needs to be paid in full up to the value of the collateral in the cover pool. Actual direct compensatory damages are not defined under the FDIA, but are defined under the final Covered Bond Policy Statement as the par value of the mortgage (collateralised) bonds, together with unpaid interest accrued up to the date of appointment of the FDIC as conservator or receiver for the sponsor bank.

Upon a Sponsor Bank Event of Default, the CBIT on behalf of the SPV has to deposit the cash from liquidation of or the proceeds from the collateral into a specified instrument – ie, a guaranteed investment contract account, forward contract, or deposit account with a qualifying bank – for each covered bond series. Reserves on each specified instrument have to be swapped to provide the funds necessary to meet payments due under the respective covered bond series. Any funds standing to the credit of each specified instrument must not be commingled with a sponsor bank's other funds and assets. As long as the reserves on the respective specified instrument are sufficient to meet payments due under the related covered bond series, the covered bonds do not accelerate.

If the value of the collateral exceeds the actual direct compensatory damages, the excess amount needs to be returned to the FDIC as the conservator or receiver for the sponsor bank. If insufficient collateral is pledged to cover the actual direct compensatory damages, the mortgage (collateralised) bondholders will have an unsecured claim in the receivership for any amounts remaining outstanding after the collateral has been depleted. In other words, if the cover pool is insufficient to fully back any recognised claim of the MBIT (and thus the SPV) under the mortgage (collateralised) bonds, the MBIT (and thus the SPV) will be an unsecured general creditor of the sponsor bank as regards the portion of such claim that is unsecured.

Upon an SPV Event of Default

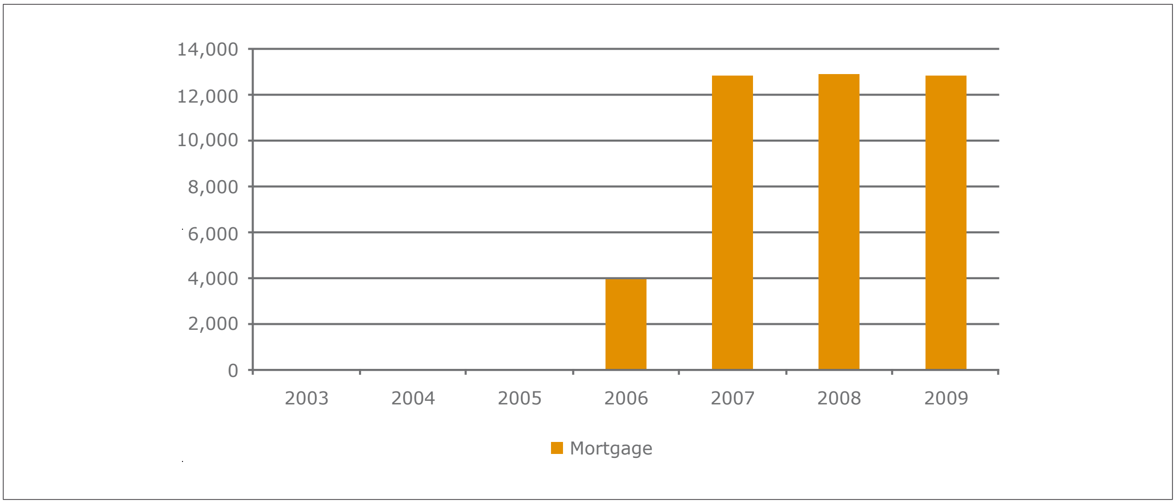
Following the occurrence of an SPV Event of Default, the CBIT can declare all covered bond series then outstanding to be immediately due and payable against the SPV at their early redemption amount plus accrued interest ('Covered Bond Acceleration'). Upon the occurrence of an SPV Event of Default and Covered Bond Acceleration, the CBIT can enforce its first priority perfected security interest over the covered bond collateral, liquidate it and exchange the proceeds with the covered bond swap providers to prepay the accelerating covered bond series. The CBIT acts on behalf of the secured creditors, including the covered bondholders. No covered bondholder can proceed directly against an SPV unless the CBIT fails to take such action. If the proceeds from the enforcement of the first priority perfected security interest in the covered bond collateral are not sufficient to meet the claims of the covered bond creditors in full, no other collateral will be available for the payment of the deficiency. The rights of the holders of such covered bond series will be extinguished.

III. RISK WEIGHTING & ECB ELIGIBILITY

Since none of the current sponsor banks is a credit institution that has its registered office in a EU member state and is subject by legislation to special public supervision designed to protect the covered bondholders, US (qualifying) covered bonds are not UCITS 22(4)-compliant and do not benefit from the higher investment limits. The bonds cannot be CRD-compliant without meeting the UCITS 22(4)-requirements; hence, they cannot benefit from special treatment in terms of risk weight.

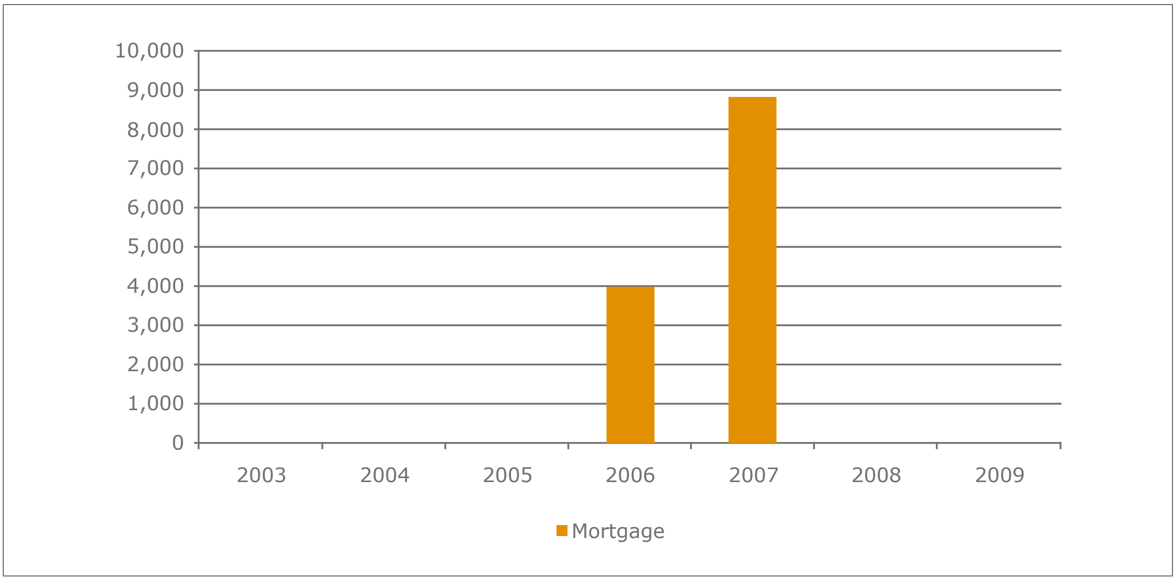
The Eurosystem accepts certain assets as collateral for its credit operations. The covered bank bond definition of the ECB follows the covered bond definition as set out in UCITS 22(4). US (qualifying) covered bonds fall outside the UCITS definition. At present, (Jumbo) US (qualifying) covered bonds are part of Liquidity Category III.

> Figure 1: Covered Bonds Outstanding 2003-2009, €m



Source: EMF/ECBC

> Figure 2: Covered Bonds Outstanding 2003-2009, €m



Source: EMF/ECBC

CHAPTER 4 - RATING AGENCIES & METHODOLOGY

4.1 FITCH COVERED BONDS RATING METHODOLOGY

By Hélène M. Heberlein and Michael Hoelter
Fitch Ratings

INTRODUCTION

Fitch covered bonds ratings mainly address their probability of default, but also incorporate an element of loss given default. Fitch's covered bonds rating methodology involves the following steps:

1. Analysis of the payment discontinuity risk, to determine how far the covered bonds probability of default can differ from that of the financial institution acting as main debtor of recourse (which is, in general, the covered bond issuer itself). The relationship is expressed through the Fitch Discontinuity Factor while the institution's probability of default is evidenced through its Issuer Default Rating (IDR).
2. Static analysis of the collateral and projected cash-flows, to calculate whether, post issuer default and considering over-collateralisation between the cover assets and all outstanding covered bonds, cash-flows generated by the cover pool are able to ensure repayment of investors under Fitch' stress scenarios corresponding to the covered bonds' maximum achievable rating on a probability-of-default basis.
3. Recovery analysis: the assigned covered bonds rating can be notched up above its rating on a probability-of-default basis by a maximum of 2 or 3 notches depending on whether the probability-of-default rating is in the investment or non investment grade range, provided that over-collateralisation taken into consideration is sufficient to produce enough recoveries under Fitch's stress scenarios.

Fitch introduced its covered bond rating criteria in July 2006, and the first Discontinuity Factor was assigned in February 2007. The treatment of liquidity risk in covered bonds programmes was reviewed in 2009, both from a qualitative and a quantitative point of view. Since July 2009, the agency has been publishing, for each individual programme, the level of over-collateralisation it calculates to be in line with the assigned rating. This so-called supporting over-collateralisation will be affected, among others, by the current profile of cover assets vs. covered bonds. It cannot be assumed that the over-collateralisation supporting a given rating will remain stable across time. In May 2010, the agency published a criteria report explaining its static analysis of cover pools consisting of commercial real estate mortgage loans. The full applicable criteria reports can be found on the agency's website, www.fitchratings.com, and are titled: 'Covered Bonds Rating Criteria', dated 18 December 2009; 'Assessment of Liquidity Risks in Covered Bonds', dated 2 March 2010; 'Criteria for the analysis of covered bonds secured by commercial real estate loans' dated 5 May 2010.

1. DISCONTINUITY RISK

Fitch Discontinuity Factors express the risk of an interruption of payments caused by the transition from the issuer to its cover pool as the source of payment on the covered bonds. The Discontinuity Factor takes systemic and cover pool as well as issuer-specific aspects into account.

The fact that covered bond holders have full recourse against a financial institution justifies using the IDR of this institution as a rating floor from a probability-of-default perspective. At one extreme, the covered bonds' probability of default will be equal to that of the institution, and in this case the Discontinuity Factor would be 100%. At the other extreme, with a Discontinuity Factor of 0%, the probability of default of the covered bonds could be completely independent of the issuer's creditworthiness, although this would be hard to achieve in practice: the institution benefiting from the covered bond funding is bound to influence the composition of the cover pool and take decisions about asset and liability management that will be dictated by its strategic choices.

Fitch Discontinuity Factors represent a weighted average of the assessment for each of the four subsections as follows:

> **Asset Segregation (45%):** Fitch investigates the strength of the asset segregation mechanism, notably whether it also places over-collateralisation beyond the reach of other creditors until all covered bonds have been repaid in full. Identified risks relate, for example, to the potential claw back of assets set aside for covered bonds investors, commingling with the issuer's other cash flows, borrowers' set-off rights or the bankruptcy remoteness of any foreign assets included in the cover pool.

> **Liquidity Gap (35%):** in most cases, incoming cash flows from the cover pool do not exactly match payments on the privileged liabilities in a given period. The liquidity gap component of Fitch Discontinuity Factors compares the time needed to monetise regular cover assets in a stress situation to the length of time granted by the programme's protection mechanism. The agency classifies the cover assets in different categories depending on their tradability. Apart from pass-through programmes, where there is no need for asset liquidation post issuer default, temporary liquidity gaps arising in the aftermath of an issuer default can be mitigated by extendible maturity of the covered bonds, pre-maturity tests and mandatory liquidity requirement or the voluntary posting of liquid assets. Programmes without any specific protection mechanism are viewed particularly negatively.

> **Alternative Management (15%):** the agency studies the legal or contractual provisions for replacing an insolvent institution in its capacity as manager of the covered bonds and servicer of the cover assets. It is crucial that upon insolvency of the issuing bank a substitute manager of the cover pool is appointed as soon as possible and that he has all powers and means to take the necessary actions, such as liquidation of the pool, if necessary to repay the covered bond holders. In addition, the Fitch analysts carry out operational reviews to identify the obstacles any such alternative manager might face when taking over the cover pool and the covered bond administration, which, ultimately, could also prevent timely payments to covered bond holders.

> **Covered Bonds Oversight (5%):** finally, the attitude of the domestic banking authorities towards the instrument plays a role in Fitch's Discontinuity Factors. Indeed, the agency recognises that regulators may exercise a positive influence on covered bonds if they monitor their risk profile through specific guidelines, especially if the covered bond market accounts for a substantial part of domestic banks' funding. This particular section addresses the preventive action of supervisory authorities rather than the likelihood of support of a given institution, which Fitch financial institutions analysts already factor in as part of the IDR assignment. Contractual covered bonds programmes get no benefit from oversight.

The combination of the likelihood of default associated with the relevant IDR and the Discontinuity Factor for a given programme indicates the maximum rating that can be assigned to the covered bonds on the basis of their probability of default, provided over-collateralisation between the cover assets and the covered bonds is sufficient to withstand Fitch stresses commensurate with this targeted rating. The table below show these achievable ratings for a few Discontinuity Factors.

Maximum Achievable Covered Bonds Rating on a Probability of Default Basis

	Discontinuity Factors										
Issuer Default Rating	**100%**	**70%**	**60%**	**50%**	**40%**	**30%**	**20%**	**15%**	**10%**	**5%**	**0%**
AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
AA+	AA+	AA+	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
AA	AA	AA+	AA+	AA+	AA+	AAA	AAA	AAA	AAA	AAA	AAA
AA-	AA-	AA	AA	AA+	AA+	AA+	AAA	AAA	AAA	AAA	AAA
A+	A+	AA-	AA-	AA-	AA	AA	AA+	AA+	AAA	AAA	AAA
A	A	A+	AA-	AA-	AA	AA	AA+	AA+	AAA	AAA	AAA
A-	A-	A	A+	A+	AA-	AA-	AA	AA+	AA+	AAA	AAA
BBB+	BBB+	A-	A	A+	A+	AA-	AA	AA	AA+	AAA	AAA
BBB	BBB	BBB+	BBB+	A-	A	A+	AA-	AA-	AA	AA+	AAA
BBB-	BBB-	BBB	BBB	BBB	BBB	BBB+	A	A+	AA-	AA	AAA
BB+	BB+	BBB-	BBB-	BBB-	BBB	BBB	BBB+	A-	A	AA-	AAA
BB	BB	BB+	BB+	BBB-	BBB-	BBB	BBB	BBB+	A-	AA-	AAA
BB-	BB-	BB	BB	BB+	BB+	BBB-	BBB	BBB	BBB+	A	AAA
B+	B+	BB-	BB	BB	BB+	BB+	BBB-	BBB	BBB	A-	AAA
B	B	B+	BB-	BB-	BB	BB+	BBB-	BBB-	BBB	BBB+	AAA
B-	B-	B	B+	BB-	BB-	BB	BB+	BBB-	BBB-	BBB+	AAA
CCC+/ CCC	CCC+/ CCC	B-	B	B+	BB-	BB-	BB	BB+	BBB-	BBB	AAA

Source: Fitch

2. STATIC ASSET ANALYSIS AND CASH-FLOW MODELLING

In order to reach a conclusion about the covered bonds' probability of default, Fitch simulates a wind-down scenario under the management of a third party. Fitch tests whether over-collateralisation accounted for by the agency is sufficient to withstand the stress scenario corresponding to the rating indicated in the above matrix, such that cash flows generated by the cover assets are sufficient to meet payments to privileged creditors on their due date. The stress scenario includes assumptions about the behaviour of the cover pool assets in terms of delinquencies, defaults, losses and prepayments. It also factors in the cost of bridging maturity mismatches, and incorporates Fitch's standard interest and currency stresses to the extent there are open positions between the cover pool and the related covered bonds, after taking into account privileged swaps. Finally, the assumed costs of a third-party manager are deducted from the stressed asset cash flows.

Unless the covered bonds are redeemable on a pass-through basis, the natural amortisation of the cover pool compared to the scheduled payments under the covered bonds may result, at times, in an excess of cash, and at times, in a shortfall of cash. Fitch's cash flows model simulates the re-investment of any excess cash at below Euribor rates. Conversely, shortfalls of cash can be compensated by monetising the cover assets at a given sale price or cost of borrowing.

Fitch's stressed refinancing cost assumptions are derived from observable sale prices where available. For mortgage assets, Fitch generally assumes that the most likely buyers will be other covered bond issuers, who will take into account their own cost of funding when placing an offer. In this instance, Fitch uses average covered bonds secondary market spreads as a starting point to calculate the corresponding refinancing costs. An additional margin that is dependent on the asset class and respective regional market is added to reflect the profit that a potential buyer would like to gain from the trade.

Fitch also applies price caps on the first sale after the default of the issuer. This is because the market will be aware of the pressure to refinance/sell assets that the administrator of the pool is facing and therefore potential buyers will try to take advantage from this situation.

Fitch will not always give full credit to over-collateralisation available at the last reporting date: in the absence of any contractual commitment or public statement, the agency considers the lowest over-collateralisation observed in the preceding 12 months if the issuer is rated 'F2' or above. Below this rating threshold, it considers only the legal minimum over-collateralisation.

If the over-collateralisation taken into account is insufficient to withstand credit risk, maturity, interest rate and currency mismatches, the cash flow model will fail, indicating that the tested rating scenario is too severe, and hence a less stressful scenario will be tested until the model passes. Through a reiterative process, the covered bonds' probability-of-default rating is set at the level corresponding to the highest rating scenario that, if applied to the cash flows, can be compensated through over-collateralisation without leading to a covered bond default.

3. RECOVERIES GIVEN DEFAULT

Fitch's covered bond ratings do not fully reflect expected loss: indeed, the benefit given to recoveries from the cover pool in the event of a default under the covered bonds is limited to a two-notch uplift from the rating corresponding to the covered bonds' probability of default if it is in the investment-grade range, and to three notches if it is in the speculative grade. In its recovery analysis, Fitch disregards any potential recourse to the bankruptcy estate of the issuer. Covered bond investors often have an additional unsecured claim, ranking pari passu with the senior unsecured creditors of a bankrupt institution, to the extent that the proceeds from the cover pool liquidation are insufficient to repay their debt in full. However, it may be impracticable for them to enforce their right if the two bankruptcy procedures do not start at the same time; moreover, the outcome is subject to several uncertain parameters, such as the quality of the non-cover-pool assets, and the capital structure prevailing at the time of the issuing institution's bankruptcy.

When giving credit to recoveries from the cover pool in a stress scenario, Fitch expressly incorporates payments owed to privileged swap counterparties. To the extent they rank equally with covered bond investors, they would share any recovery proceeds should the incoming cash flows from the cover pool and from privileged swaps be insufficient to meet the secured liabilities in timely fashion. Therefore, Fitch obtains the recovery percentage by dividing the net present value of stressed future cash flows, including payments expected from swap counterparties, by the net present value of the residual liabilities, including payments owed to swap counterparties. This recovery percentage then translates into a given number of notches as per the table below.

Recovery Ratings	Recovery Prospects	Recovery Range (%)	Maximum Notching	
			Investment Grade	Speculative Grade
RR1	Outstanding	91 - 100	2	3
RR2	Superior	71 - 90	1	2
RR3	Good	51 - 70	1	1
RR4	Average	31 - 50	–	–
RR5	Below Average	10 - 30	-1	-1
RR6	Poor	0 - 10	-1/-2	-2/-3

Source: Fitch

In some jurisdictions, however, notching up for recovery may only be justifiable if stressed recovery on covered bonds assumed to be in default reach 100%. This is because there might be some form of time subordination among outstanding issues of covered bonds such as when there is no cross-default between different covered bonds and therefore an administrator may liquidate most of the assets in the pool in order to repay earlier maturing issues at the detriment of later maturing issues.

CONCLUSION

The IDR, Discontinuity Factor, and over-collateralisation compared to the cover pool's credit risk and maturity, interest rate and currency mismatches are driving the covered bond ratings assigned by Fitch. Whereas the IDR sets the floor for the covered bonds rating on a probability-of-default basis, the Discontinuity Factor indicates how far the covered bonds probability of default rating can differ from the IDR. Finally, over-collateralisation protects against credit risks in the cover pool, and mismatches between the cover pool and the covered bonds. It furthermore drives the level of recoveries on covered bonds assumed to be in default.

Among the 110 covered bonds programmes publicly rated by the agency at end of May 2010, 98 were rated 'AAA', the majority of which corresponding to a 'AA+' or 'AA' rating on a probability of default basis, and incorporating one or two notches for recovery given default.

The average Discontinuity Factor for all 84 mortgage covered bonds was 21.8%, meaning that, all else being equal, the covered bonds could be rated 'AAA' (assuming a two notch uplift for recovery given default) as long as the IDR is 'BBB+' or above. The average Discontinuity Factor for all 26 public sector covered bonds was 10.8%, meaning that, all else being equal, the covered bonds could be rated 'AAA' (assuming a two notch uplift for recovery given default) as long as the IDR is 'BBB' or above.

The mean 'AAA' supporting over-collateralisation was 18.3% for mortgage programmes, and 10.6% for public sector programmes.

Covered Bonds SMART

In March 2008, Fitch launched a monitoring tool for covered bonds programmes rated by the agency. It is the first single, comprehensive source of periodic information on key covered bonds credit characteristics. It gives an overview of the IDR, the Discontinuity Factors and the covered bonds ratings. It shows the amount of outstanding covered bonds and corresponding cover pools, highlighting available nominal over-collateralisation as of each reporting date, as well as the percentage of over-collateralisation (or asset percentage) supporting the assigned rating.

Covered Bonds SMART also features graphs comparing the redemption profile of the cover assets to the covered bonds'. It also displays indicators of maturity, interest rate and currency mismatches between the cover pool and the covered bonds. Furthermore, it enables users to follow the composition of cover pools, such as geographical distribution for public sector assets, or loan-to-value ratios for mortgage loans. Covered Bonds SMART is a subscription service accessible from the surveillance menu of www.fitchratings.com.

4.2 MOODY'S COVERED BOND RATING METHOD

By Juan Pablo Soriano, Nicholas Lindstrom and Jane Soldera
Moody's

SUMMARY

Moody's rating for a covered bond is determined after applying a two-step process:

> Moody's EL Model: determines a rating based on a largely quantitative calculation of expected loss taking into account both the issuer's credit strength and the value of the cover pool following issuer default; and

> Timely Payment Indicator (TPI): may cap the rating arrived at using Moody's EL Model by applying the framework of rating caps based on the issuer's rating and the TPI assigned to the programme. The TPI assigned will reflect the probability of timely payments continuing on the covered bonds following "Issuer Default" (ie: removal of support from the issuer group).

MOODY'S EL MODEL – OVERVIEW

A Moody's covered bond rating is primarily determined by its expected loss under Moody's EL Model. This calculates the probability of Issuer Default and the subsequent losses (if any) to the covered bonds. Following Issuer Default the value of the cover pool, and therefore any losses, will be determined assuming a stressed environment. The key factors affecting the value of the cover pool include:

> The credit quality of the collateral in the cover pool;

> Refinancing risk in the event that funds need to be raised to finance the cover pool following Issuer Default; and

> Any interest rate and currency risks to which the cover pool is exposed.

For a covered bond Moody's EL Model calculates the probability of Issuer Default (based on the issuer's senior unsecured rating), and the subsequent loss (if any) on the cover pool, on a month-by-month basis from issue to final maturity. The results are then summed and discounted back to present value to give the overall expected loss on the covered bond.

MOODY'S EL MODEL - ROLE OF THE ISSUER

During the life of the covered bond, Moody's EL Model calculates the probability of Issuer Default based on the senior unsecured rating of the issuer. If the issuer is performing, there should be no loss to covered bondholders. Moody's EL Model also takes into account various issuer and issuer group-related benefits in addition to the senior unsecured rating of the issuer. For instance, the issuer will normally actively manage the cover pool to the benefit of the covered bondholders: this may include replacing defaulted assets with performing assets or replacing high LTV loans with lower LTV loans, particularly where required by law. For this reason Moody's sees the role of the issuer as more important than that of a simple guarantor.

MOODY'S EL MODEL - VALUE OF THE COVER POOL

(I) CREDIT QUALITY OF THE COVER POOL

The credit quality of the cover pool is determined by calculating the amount of losses on cover pool assets that Moody's assumes will accrue after Issuer Default as a result of asset defaults or impairments.

It is measured by the “Collateral Score” (which approximates to Aaa enhancement – so the lower the Collateral Score the better quality the pool). Factors which will determine the Collateral Score vary, but for mortgage loans they will normally include the presence and quality of affordability underwriting, the range and distribution of loan-to-value ratios, and the quality of property valuations. Factors most relevant for public sector loans will include the credit strength of the public sector borrowers and concentration levels. Of course the quality of the cover pool may vary over time as issuers typically have discretion to add and remove assets, but Moody’s recalculates the Collateral Score for most programmes on a quarterly basis to monitor this.

(II) REFINANCING THE COVER POOL

Following Issuer Default, the timely payment of principal under the covered bonds may rely on funds being raised against the cover pool. This is because the expected maturity of the assets in the cover pool is generally longer than that of the covered bonds and therefore Moody’s EL Model assumes that funds must be raised against the cover pool, most likely at a discount to the notional value of the cover pool.

The refinancing environment for the assets at this time is likely to be stressed and this is taken into account in the level of discount built into the overall enhancement modelled for a given rating level. This enhancement is based on three factors:

(a) the level of discount (referred to as refinancing margin);

(b) the portion of the cover pool exposed to refinancing risk; and

(c) the average life of the refinancing risk.

Typically Moody’s assumes the life of the refinancing risk, which equates to the average remaining life of the cover pool at the time of Issuer Default, as being a minimum of five years. The portion of the cover pool exposed to refinancing risk is normally considered to be a minimum of 50%. The refinancing margins are set by reference to each jurisdiction and then adjusted for individual programmes; they are, on average, around 3.4% for mortgage-backed programmes and 1.8% for public sector-backed programmes (as at the time of writing).

(II) INTEREST RATE AND CURRENCY RISKS IN THE COVER POOL

Following an Issuer Default, investors in covered bonds may be exposed to interest rate and currency mismatches due to different durations and payment promises made on the cover pool assets and the covered bonds. Under Moody’s EL Model these mismatches are sized by taking into account:

(a) the size of the interest rate (or currency) movement over the relevant period, for example looking at the impact of increasing and decreasing interest rates and taking the path that leads to the harshest expected loss on the bonds;

(b) the portion of the assets with interest rate (or currency) mismatches; and

(c) in the case of interest rate risk, the average life of the mismatch based on the assets in the cover pool (typically assumed to be a minimum of five years at point of Issuer Default).

Moody’s EL Model takes into account whether there is hedging in place at the point of Issuer Default and the probability of the hedging terminating at this time or subsequently. Generally, the lower the probability of a hedge terminating the lower the risk of an interest rate or currency mismatch arising, however in no case has Moody's assumed that swaps used to hedge interest rate and currency risk completely remove these risks from a covered bond.

MOODY'S TIMELY PAYMENT INDICATORS ("TPIS")

A "Timely Payment Indicator" or "TPI" is Moody's assessment of the likelihood that timely payment would continue to be made to covered bondholders following Issuer Default. TPIs range from "Very High" to "Very Improbable". Following Issuer Default the Issuer can no longer be relied on to make timely payments on the bonds and bondholders must therefore rely on external support, liquidity and the legal/contractual framework of the bonds to provide for timely payment. These are the factors Moody's considers when assigning TPIs.

TPIs operate to cap the rating of a covered bond to a certain number of notches above the issuer's rating. Moody's publishes a TPI Table setting out maximum covered bond ratings for different issuer rating/TPI combinations – see Moody's rating methodology report referred to at the end of this chapter. As indicated at the beginning of this chapter, the rating cap under the TPI Table will always prevail if it is lower than the rating which is possible under Moody's EL Model.

In assessing TPIs Moody's considers that following Issuer Default the single most important risk to timely payment for most covered bonds is the existence of refinancing risk (described above). This risk is highly volatile, which is why covered bonds which are subject to material refinancing risk cannot support Moody's highest ratings unless they are also backed by a highly-rated issuer.

Other factors relevant when Moody's assesses TPI levels include continuity of servicing and cash management, risk of termination of swaps, risk of acceleration of the covered bonds, enhancement levels, the issuer's ability to change the programme (in particular to add new assets and enter into hew hedging arrangements) and sovereign risk.

Moody's largely determines TPI on a jurisdiction-by-jurisdiction basis as many of the above factors are common across jurisdictions. A good example of this is where covered bonds are systemically important in a jurisdiction and would be likely to receive support from the government or local market participants in the aftermath of an Issuer Default - this can be an important mitigant to refinancing risk. Within a jurisdiction TPIs may then be adjusted at the programme level to reflect particular features of a programme.

References:

> Moody's EMEA Covered Bond Monitoring Overview: Q4 2009; 21 July 2010 (updated quarterly)
> Moody's Rating Approach to Covered Bonds; 4 March 2010
> Assessing Swaps as Hedges in the Covered Bond Market; 17 September 2008
> European Covered Bond Legal Frameworks: Moody's Legal Checklist; 9 December 2005

4.3 STANDARD & POOR'S

By Karen Naylor, Karlo Fuchs, Sabrina Miehs and Nicolas Malaterre
Standard & Poor's

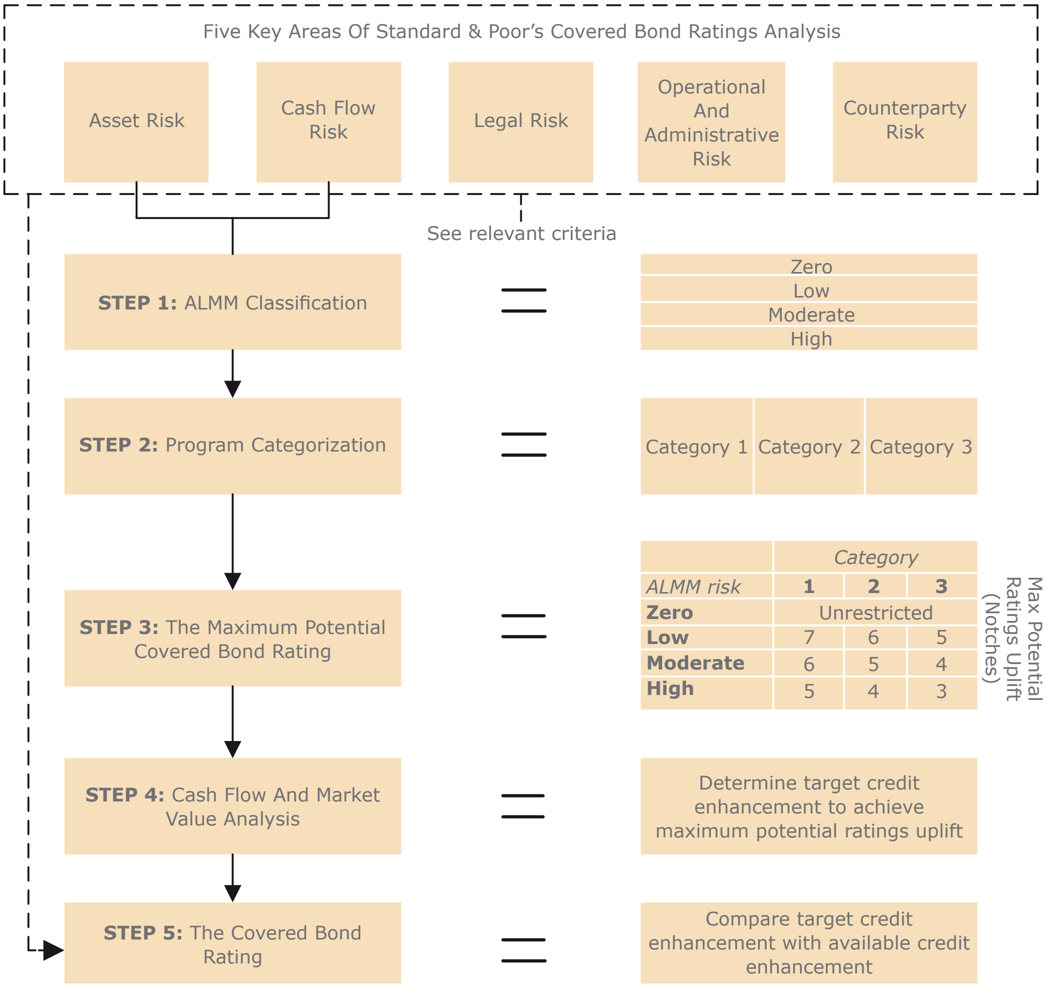
Standard & Poor's Ratings Services rates covered bonds issued globally based on its criteria published in late 2009 ("Revised Methodology And Assumptions For Assessing Asset-Liability Mismatch Risk In Covered Bonds" published on Dec. 16, 2009 and available on RatingsDirect and www.standardandpoors.com/coveredbonds).

S&P's criteria reflects its belief that covered bonds that exhibit mismatches between the underlying assets and the covered bond liabilities should be linked to the issuer credit rating on the issuing or sponsor bank. Only if a covered bond can be isolated from that risk can S&P rate the covered bonds on a de-linked basis from the issuer.

When the program is exposed to asset-liability mismatch (ALMM) risk, the maximum potential rating uplift the covered bond rating can achieve above the issuer credit rating is seven notches. Therefore, this approach results in the assignment of 'AAA' ratings only to covered bonds of highly rated issuers, provided that S&P believes the program has sufficient credit enhancement to cover all relevant risks, in particular market value risk arising from the asset-liability mismatch.

To arrive at a covered bond rating, S&P considers five main factors in its covered bond rating analysis, which are depicted in the following chart and described below.

Summary Of Revised Criteria For Assessing Asset-Liability Mismatch Risk In Covered Bonds



ASSET AND CASH FLOW ANALYSIS

Asset analysis

The underlying cover pools typically contain residential mortgage loans, public sector bonds and loans, or some other form of high credit-quality collateral. Using jurisdiction- and asset-specific assumptions, S&P analyses these pools to form a view on the expected stressed performance. Ongoing monitoring of the issuer as well as markets allows S&P to incorporate relevant market developments into its covered bond rating assumptions. The credit analysis also incorporates issuer specific aspects such as the impact of its underwriting policies or its collateral management.

Cash flow analysis and market value risk

Established covered bond programs typically issue debt with a broad range of maturities. The supporting cover pool assets generally have a significantly longer dated maturity profile than the covered bonds. Hence, there is an inherent maturity mismatch of assets and liabilities. The timing and weighting of the degree of this mismatch is important in S&P's analysis. Generally, the expected cash flow from the cover pool can partially mitigate some of the ALMM risk. In most circumstances, however, there remains a need for the underlying cover pool assets to be sold or otherwise liquidated to repay each series of covered bonds at its maturity. This raises the prospect of market value risk if the value of the assets sold doesn't match the covered bond liability. The market value risk assumptions S&P makes are a function of its view of the relative liquidity in the market for the assets.

To assess the effect of asset-liability mismatches, the rating analysis thus focuses on the covered bond program's ability to pay its obligations based on the cover pool. S&P has devised a five-step process to evaluate the maximum potential ratings uplift for a covered bond program based on a combined assessment of its ALMM risk exposure, its country "categorisation" and the available credit enhancement.

Step 1: Classification of the asset-liability mismatch

S&P first calculates its view of a program's ALMM exposure and classifies this exposure based on its magnitude. In this step S&P includes stresses to the cash flows to cover asset credit risks and any other credit risk to which the covered bonds may be exposed. Any structural features (such as bond extensions or liquidity facilities) that may affect the asset-liability mismatch are also factored into the rating analysis.

S&P then considers the timing of the mismatch in the asset-liability analysis and treats near-term mismatches as being more significant than those occurring in the medium or long term. The ALMM percentage used to classify the program is the maximum cumulative mismatch expressed as a percentage of a program's outstanding liabilities. Based on these stresses and assumptions S&P classifies each program as a "low", "moderate" or "high" ALMM risk. The classification in turn determines the number of maximum notches of potential rating uplift from the issuer's rating.

Step 2: Program categorisation

Secondly, S&P segments covered bond programs predominantly by country based on the range of external funding options available to the program and S&P's view on the likelihood of obtaining this funding. The programs fall into one of three categories, each of which has a range of maximum potential ratings uplift. The broader the range of funding options and the more well-established and systemically important S&P believes the covered bond product is in a particular country, the higher is the potential uplift.

Step 3: The maximum potential covered bond rating

In this step S&P evaluates the maximum degree to which a program's rating may potentially exceed the issuing bank's rating. S&P combines its assessments of a program's ALMM exposure (from step 1) and its ability to cover its funding need (as defined by its program categorization from step 2) in the matrix in the summary chart. The maximum potential rating on a covered bond is calculated as the bank's issuer credit rating increased by the appropriate number of notches derived from the matrix. This potential uplift assumes that the program's available credit enhancement equals the target credit enhancement (see step 4). Covered bonds may be either issued directly by a bank or via a special-purpose entity. In the case of direct issuance by a bank, S&P would expect the bank to have either a public or confidential S&P rating. For programs using a special-purpose entity, S&P applies the criteria of its "Group Methodology", published April 22, 2009.

Step 4: Cash flow and market value analysis

S&P then sizes the target credit enhancement level that, in its view, corresponds to the maximum potential ratings uplift. In this step it analyses the program cash flows and applies market value stress to the cash flows in the situations where asset-liability mismatches occur and there is a funding need. If S&P's analysis indicates that a program can liquidate enough assets to meet such mismatches, while leaving sufficient collateral to service the remaining debt, it can achieve its maximum potential covered bond rating. S&P models market value risk in terms of a "spread shock," by which it calculates the net present value of the cash flows of the assets to be sold using a stressed discount rate. The degree of market value stresses applied depends predominantly on the type of assets in the cover pool, and the location of those assets and their tenor. S&P also incorporates its asset default stresses and any interest and currency stresses to the extent not appropriately hedged.

To analyze whether the credit enhancement provided is commensurate with the maximum achievable rating, S&P reviews the following risks: Asset default risk, interest rate and currency risks, and market value risks arising from asset-liability mismatches.

Step 5: The covered bond program rating

Lastly, S&P determines a rating on the program that reflects the cover pool's actual level of credit enhancement. In this step, S&P assesses whether the available credit enhancement in a program is equal to or higher than the target credit enhancement for the maximum potential rating given in step 3. If this is the case, the program can achieve the maximum potential rating. If it is not the case, S&P assigns the first notch of uplift if the available credit enhancement covers all credit risks related to the default of the cover pool assets. The remaining credit enhancement is compared to the additional notches of potential ratings uplift to determine the uplift achievable.

The assignment of outlooks

Under S&P's criteria, it assigns an outlook to all covered bond ratings. These provide a view of a program's potential for a rating change and its direction over the intermediate term (see "General Criteria: Use Of CreditWatch And Outlooks," published Sept. 14, 2009). The covered bond outlooks take into account S&P's views on the outlook on the issuer, the level of ratings uplift achieved, the likelihood of changes in ALMM risk, as well as potential rating changes due to the performance of the collateral.

Legal, Operational And Administrative, And Counterparty Risks

In addition to the analysis of the asset and cash flows outlined above, S&P also reviews any legal risks, operational and administrative risks, and any counterparty exposures to determine whether these are commensurate with the rating being assigned as per step 5 above.

Legal risks

S&P typically reviews the following legal aspects when assigning a rating to a covered bond program:

> The nature of the segregation of the assets and cash flows if the issuing bank fails, (i.e., becomes insolvent);

> Whether there is any acceleration of payments to noteholders if the issuing bank fails—whether payments of interest and principal will continue in accordance with the original terms of the covered bonds;

> Whether there is any payment moratorium or forced restructuring;

> Whether there are any limits to overcollateralisation levels, i.e., if a program may overcollateralise its covered bonds above the minimum limit defined under the legislation or the program documents, and whether this additional overcollateralisation is available to the covered bond holders notwithstanding the issuing bank's failure;

> The treatment of any hedging agreements if the issuing bank fails;

> Whether the program can access funding after the issuing bank's failure; and

> The management of the cover pool both before and after the issuing bank fails.

Operational and administrative risks

S&P also reviews the issuer's origination, underwriting, and servicing operations to assess whether to factor any additional risks into its rating process.

Counterparty risks

To the extent a program benefits from any interest rate or currency hedges to address any interest rate or currency mismatches S&P reviews the underlying agreements to assess whether they conform with its relevant counterparty criteria.

Assigning And Monitoring The Rating

The outcome of S&P's rating analysis is a rating on the covered bond program and the bonds that the program issues. S&P is committed to providing a written rationale of its rating decision and any changes to the rating as a result of the ongoing surveillance S&P does on that program.

CHAPTER 5 - COVERED BOND STATISTICS

5.1 INTRODUCTION

By Johannes Rudolph, HSBC Trinkaus and
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I. REVIEW OF COVERED BOND STATISTICS

The ECBC Statistics and Data Working Group collects and provides information on the outstanding volume and annual gross supply of covered bonds at year-end. Its aim is to provide complete covered bond market statistics. The statistics cover 24 jurisdictions as at the end of 2009.[1] The collation of statistics is possible thanks to the cooperation of the Working Group members and covered bond issuers. Although there is plenty of covered bond data available, it is often difficult to evaluate its coverage and completeness.[2] For some countries, national specifics need to be considered.

> **Austria:** Reliable statistics are no longer available since the Österreichische Nationalbank stopped publishing Pfandbrief-related data in 2004. Due to inconsistent disclosure of cover pool data and covered bond information, there is uncertainty around annual gross supply and the bonds' classification as mortgage or public covered bonds.

> **Canada:** The general-law-based covered bonds issued by Canadian Imperial Bank of Commerce and Bank of Montreal backed by mortgages insured against borrower default by Canada Mortgage and Housing Corporation are classed as mortgage covered bonds.

> **Czech Republic:** The Czech Republic's annual gross supply statistics include only new covered bond issues. Covered bonds that have been launched and cancelled during the same year are not included in the annual gross supply statistics.

> **Denmark:** Denmark's covered bond statistics have been revised. They are no longer distorted by a year-end effect. The reported total outstanding amount is now more in line with the actual total outstanding amount. However, the revision has led to a downward correction of the statistics.

> **France:** Compagnie de Financement Foncier's cover pool includes public sector debt, mortgage loans and senior tranches of securitisations, and that of Crédit Foncier et Communal d'Alsace et Lorraine – Société de Crédit Foncier includes mortgage loans and public sector debt. The covered bonds of both issuers are grouped into one category.

> **Germany:** Germany's covered bond statistics are based on Deutsche Bundesbank statistics and exclude secured bonds issued in accordance with the DG Bank Transformation Act of 1998, the DSL Bank Transformation Act of 1999 and the Law Governing Landwirtschaftliche Rentenbank.

> **Hungary:** Hungary's annual gross supply statistics include new covered bond issues and taps. Covered bonds that have been launched and cancelled during the same year are not considered in the annual gross supply statistics.

1 These were Austria, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Luxembourg, Norway, Poland, Portugal, Slovakia, Spain, Sweden, Switzerland, Ukraine, the Netherlands, the UK and the US.

2 In accordance with applicable reporting standards, some issuers disclose outstanding covered bonds at their market value, but not at their par value. The International Financial Reporting Standards (IFRS) do not require issuers to disclose their covered bonds and the corresponding collateral.

- > **Iceland:** Iceland's covered bond statistics are no longer included in the statistics because of the unavailability of reliable data. One issuer cancelled its covered bond programme and another is in the winding-up process.
- > **Italy:** Italy's covered bond statistics include covered bonds governed by Law No. 130 of 30 April 1999 ('Law 130') and Cassa Depositi e Prestiti's covered bonds.
- > **Latvia:** Latvia's annual gross supply statistics include only new covered bond issues. Covered bonds that have been launched and cancelled during the same year are not taken into account in the annual gross supply statistics.
- > **Slovakia:** Slovakia adopted the euro on 1 January 2009. Its 2009 covered bond statistics do not distinguish between domestic currency and euro-denominated covered bonds.
- > **Spain:** Spain's covered bond statistics include only cédulas with an official listing in Spain's AIAF (Asociaciòn de Intermediarios de Activos Financieros). Cédulas without an official listing in the AIAF are not included in the statistics.
- > **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).

The statistics distinguish between covered bonds backed by public sector debt, mortgage loans, shipping loans and a mix thereof. In contrast to the non-Jumbos, Jumbos typically have a minimum size of €1bn, a fixed coupon payable once a year in arrears and bullet redemption. In addition, they are supported by the commitment of at least five market makers to quote continuous two-way prices during normal trading hours as long as there is sufficient liquidity in the respective Jumbo.

In addition, covered bonds are divided into those distributed via private or public placement, those denominated in euro, those in domestic currency (if not the euro), and those in a currency other than the euro and the domestic currency. The statistics regard covered bonds listed with an exchange as publicly placed. The exchange rate used to convert non-euro-denominated covered bonds is the end-of-year rate published by the European Central Bank (ECB). A distinction is also made between fixed-rate and floating-rate covered bonds and covered bonds with another coupon structure. The maturity of bonds refers to the weighted average time to maturity of the outstanding covered bonds from one country.

The statistics are divided into five categories: 1) covered bonds backed by mortgage loans, public sector debt, shipping loans or a mix thereof; 2) non-Jumbos or Jumbos; 3) privately placed or publicly placed covered bonds; 4) those denominated in euro, those in domestic currency (if not the euro), or those in a currency other than the euro and the domestic currency; and 5) fixed-rate and floating-rate covered bonds, or covered bonds with another coupon structure.

The statistics are skewed by country specifics (see above), exchange rate fluctuations and banks' refunding, repurchase, cancellation and call activities. Owing to the inconsistent disclosure of cover pool data and information on outstanding covered bonds, and on covered bond issuance or the unavailability of information, there may be uncertainty around a number of bonds' classification or, in some cases, bonds cannot be classified at all. Consequently, the total or sum of each category at year-end may differ.

II. COVERED BOND MARKET DEVELOPMENTS

At the end of 2009, the total outstanding volume of covered bonds was €2,390bn compared with €2,279bn at the end of 2008, representing 5% and 13% growth, respectively. In 2009, the Jumbo segment accounted for 52% of the total outstanding volume of covered bonds and 49% of annual gross supply. The total outstanding volume of euro-denominated Jumbos was €875bn at the end of 2009 compared with €859bn at the end of 2008, representing 2% growth after 1% growth in 2008. We believe the expansion of the covered bond market has not yet run its course.

The market is still growing, especially outside Europe. South Korea entered the covered bond market in 2009. Ukraine exited the market in 2010, after the last outstanding covered bond was repaid in March. Markets inside and outside Europe are currently conducting a feasibility study into the merits of the product as a funding instrument for lenders. In jurisdictions, such as Australia, Belgium, Canada, Cyprus, Japan, Mexico, New Zealand, Romania, South Korea, and the US, working groups are lobbying for dedicated covered bond legislation. The legislative procedures are at different stages in each country.

In their search for an optimal funding mix to allow a degree of diversification in terms of investors and products while avoiding concentration and spread risks, banks have already turned, or may turn, their attention towards covered bonds. In 2009, 34 entities joined the covered bond market and 10 left, due mainly to mergers or the repayment of last outstanding covered bonds. Of the first-time issuers in 2009, 12 were from Norway and four from France, Germany, Spain and the UK (each). At the end of 2009, 295 issuers were competing for investor attention.

As at the end of July 2010, the number of issuers had increased further to 301.[3] Of this total, 262 had issued mortgage covered bonds, 117 public covered bonds, six had launched covered bonds backed by shipping loans and four had issued covered bonds backed by a pool of mixed collateral. Several banks had more than one programme. Until the end of July 2010, four issuers exited the market after the last outstanding covered bond was repaid, eight joined the market and more than five had finalised a covered bond programme. With 68 Spanish, 58 German, 26 Austrian, 23 UK, 19 Norwegian and 15 French issuers, these countries represented nearly 70% of issuers in the overall covered bond market at the end of July 2010.

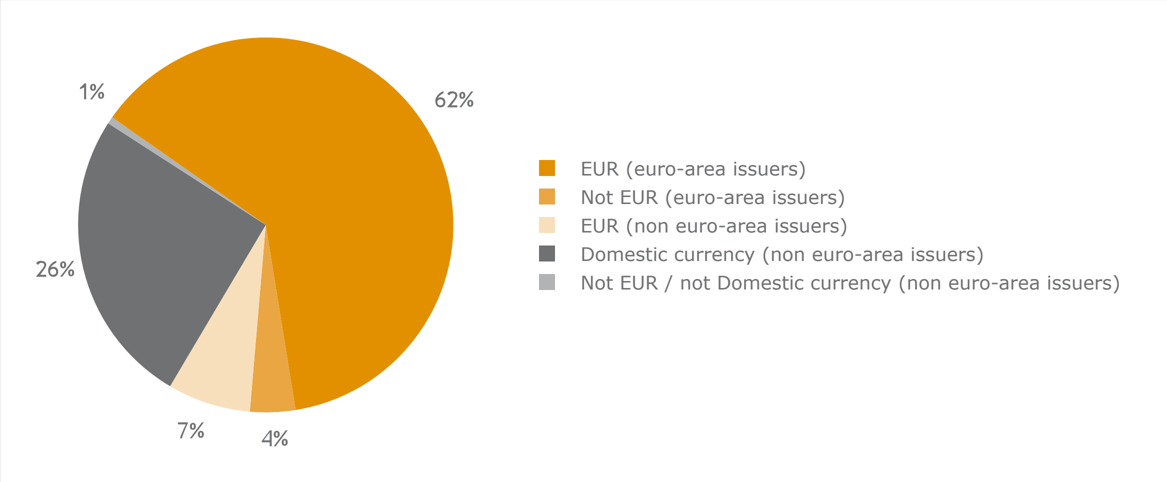
In 2009, gross supply of covered bonds reached €529bn compared with €651bn in 2008. Around 24% (€565bn) of the total outstanding volume of covered bonds at the end of 2009 was placed privately. Euro-area entities issued €268bn of covered bonds, of which €262bn were euro-denominated. In May 2009, the ECB announced direct purchases of euro-denominated covered bonds issued by euro-area entities. Between 6 July 2009 and 31 December 2009, the Eurosystem purchased eligible covered bonds for a total of €28bn. Between 6 July 2009 and 30 June 2010, it bought eligible covered bonds for a total of €61bn. According to the ECB, of this total, around €17bn (27%) represented purchases in the primary market.

With a total outstanding volume of €719bn at the end of 2009, Germany remains by far the largest covered bond market, followed by Spain (€353bn), Denmark (€327bn), France (€289bn), the UK (€205bn) and Sweden (€134bn). These six captured 85% of the overall covered bond market. In 2009, the total outstanding volume of Norwegian covered bonds experienced triple-digit growth. In Austria, Canada,

3 This figure excludes the two Icelandic covered bond issuers and includes four institutions that repaid their last outstanding covered bond in 2010.

Denmark, Finland, Greece, Italy, the Netherlands, Portugal, Sweden and Switzerland, growth in covered bonds was in double digits. In Germany, Latvia, Luxembourg and Ukraine growth in covered bonds declined by 11%, 6%, 11% and 64%, respectively.

> CHART 1: THE IMPORTANCE OF DOMESTIC CURRENCY-DENOMINATED COVERED BONDS



Source: European Covered Bond Council

Many issuers use domestic currency-denominated covered bonds. At the end of 2009, €2,107bn (88%) of the total outstanding volume of covered bonds was denominated in the issuer's domestic currency and €1,671bn (70%) was denominated in euro. The total outstanding volume of euro-denominated covered bonds of euro-area entities was €1,497bn. Only €92bn (6%) of the total outstanding volume of covered bonds of euro-area entities was non-euro denominated. In 2009, Canadian issuers used domestic currency-denominated covered bonds and Swiss issuers launched non domestic currency-denominated covered bonds for the first time. Compared with their peers, Finnish, Greek, Portuguese and Ukrainian issuers have not yet launched covered bonds denominated in a currency other than the domestic currency.

Apart from the euro, important currencies are DKK, GBP, SEK, USD, CHF and NOK. Until 2007, most UK covered bonds were euro-denominated. This changed dramatically in 2008. In 2009, the portion of £-denominated UK covered bonds was over 60% (6% in 2007) of the total outstanding volume of UK covered bonds. There was a similar development in Norway. In 2007 and 2008, more than 50% of Norwegian covered bonds were euro-denominated. In 2009, the portion of domestic currency-denominated covered bonds had increased significantly and reached 71% of the total outstanding volume of Norwegian covered bonds.

Mortgage covered bonds dominated the market in 2009, accounting for 81% of gross supply and 67% of the total outstanding volume of covered bonds. All jurisdictions (apart from Luxembourg) included in the 2009 statistics were mortgage covered bond markets. Some 11 countries were also public covered bond markets. Denmark and Germany were the only ship mortgage covered bond markets and France was the only market with covered bonds backed by a pool of mixed collateral.[4] Even though some cov-

4 This excludes secured bonds launched by German issuers in accordance with the DG Bank Transformation Act of 1998 and the DSL Bank Transformation Act of 1999.

ered bond laws allow for a mixed cover pool, only a few banks run a pool of mixed collateral. Last year's gross supply of covered bonds secured by a pool of mixed collateral was €16bn.

At the end of 2009, of the total outstanding volume of covered bonds, 21% were floating rate. Floating-rate covered bonds were in vogue in 2008, accounting for 45% of gross supply. In 2009, the portion of floating-rate covered bonds was less than 25% of gross supply and gross supply of fixed-rate covered bonds was over three times that of floating-rate covered bonds. Going forward, it seems that the floating-rate covered bond market may not necessarily stand up to the fixed-rate covered bond market.

The market distinguishes between special-law-based and general-law-based covered bonds. The first are governed by a special covered bond law. At the end of 2009, general-law-based covered bonds existed in countries, such as Canada, France, Germany, Iceland, South Korea, Switzerland, the Netherlands, the UK and the US. Since the beginning of the financial crisis, the share of general-law-based euro-denominated Jumbo covered bonds within the overall euro-denominated Jumbo covered bond market has declined notably and has returned to a level seen in 2004. At the end of 1H10, their total outstanding volume was about €85bn – i.e., less than 10% of the overall euro-denominated Jumbo covered bond market – compared with €155bn in 2009.

5.2 STATISTICS

5.2.1 TOTAL

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector	869714	858645	869924	884038	858947	774670	691430
Outstanding CBs backed by Mortgage	584148	643687	745455	923289	1069825	1407311	1600465
Outstanding CBs backed by Ships	10087	9542	10586	11341	12167	16327	15151
Outstanding CBs backed by Mixed Assets	34530	41350	50040	61930	80097	80631	82572
Total Outstanding	**1498533**	**1553224**	**1676006**	**1880598**	**2021035**	**2278938**	**2389618**
Outstanding Jumbo	682671	745862	838717	966788	1048538	1150386	1234192
Outstanding non-Jumbo	805112	796612	837289	913810	972497	1128552	1155426
Sum	1487783	1542474	1676006	1880598	2021035	2278938	2389617
Total Outstanding Public Placement	1000452	987572	1137239	1218626	1476274	1698874	1769705
Total Outstanding Private Placement	391136	446011	450067	477974	515748	543883	565183
Sum	1391587	1433583	1587306	1696601	1992022	2242758	2334887
Outstanding denominated in EURO	1212927	1252336	1336544	1326319	1556014	1650815	1670832
Outstanding denominated in domestic currency	230395	242569	277273	342495	362347	511989	610036
Outstanding denominated in other currencies	44461	47568	62178	57181	102674	116134	108033
Sum	1487783	1542473	1675995	1725995	2021035	2278937	2388901
Outstanding fixed coupon	1241913	1261062	1378893	1500402	1724780	1735814	1751250
Outstanding floating coupon	155423	177148	177237	201488	251701	498935	512796
Outstanding other	24578	25313	27225	20098	31688	31921	23270
Sum	1421913	1463524	1583355	1721989	2008169	2266670	2287316
Maturity of Bonds							

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector	182482	162269	179523	173361	151091	128728	83814
New Issues of CBs backed by Mortgage	205204	198078	273240	304384	285732	507082	426943
New Issues of CBs backed by Ships	2421	1785	3579	3334	3143	6289	2221
New Issues of CBs by Mixed Assets	9600	11150	13150	17263	23682	8549	15824
Total Issuance	**399707**	**373282**	**469492**	**498342**	**463647**	**650648**	**528801**
Issuance Jumbo	109327	112300	136847	194903	233116	214572	256537
Issuance non-Jumbo	277949	249832	315690	303438	230531	436077	272264
Sum	387276	362132	452537	498342	463647	650649	528801
Total Issuance Public Placement	316385	294286	377394	384473	360482	511157	405336
Total Issuance Private Placement	80362	78996	88433	113869	103166	134177	110963
Sum	396747	373282	465827	498342	463647	645334	516299
Issuance denominated in EURO	283572	267724	284413	343990	332710	382806	302589
Issuance denominated in domestic currency	98710	96391	152467	125409	101148	251213	214294
Issuance denominated in other currencies	14593	9167	28946	28942	29789	16306	11830
Sum	396876	373282	465826	498341	463647	650326	528713
Issuance fixed coupon	319503	309181	375653	392247	365929	350876	404176
Issuance floating coupon	50741	44735	67057	54233	83263	292744	119787
Issuance other	10403	10765	14047	5828	5596	6704	4705
Sum	380647	364682	456757	452308	454787	650324	528668
Maturity of bonds							

Note: Data is provisional
Source: EMF/ECBC

5.2.2 TOTAL 2009 STATISTICS BY TYPE OF ASSETS

COVERED BONDS OUTSTANDING 2009 in EUR million					
	Public Sector	Mortgage	Ships	Mixed Assets	TOTAL
Austria (e)	19,617	5,317	0	0	24,934
Canada	0	7,525	0	0	7,525
Czech Republic	0	8,186	0	0	8,186
Denmark	134	319,434	7,197	0	326,765
Finland	0	7,625	0	0	7,625
France	71,905	134,757	0	82,572	289,234
Germany	486,406	225,100	7,954	0	719,460
Greece	0	6,500	0	0	6,500
Hungary	0	7,116	0	0	7,116
Ireland	50,951	29,725	0	0	80,676
Italy	9,063	14,000	0	0	23,063
Latvia	0	85	0	0	85
Luxembourg	31,645	0	0	0	31,645
Netherlands	0	28,367	0	0	28,367
Norway	951	51,340	0	0	52,291
Poland	139	578	0	0	717
Portugal	1,150	20,270	0	0	21,420
Slovakia	0	3,608	0	0	3,608
Spain	16,030	336,750	0	0	352,780
Sweden	0	133,903	0	0	133,903
Switzerland	0	46,283	0	0	46,283
Ukraine	0	4	0	0	4
United Kingdom	3,439	201,096	0	0	204,535
United States	0	12,896	0	0	12,896
Total	**691,430**	**1,600,465**	**15,151**	**82,572**	**2,389,617**

Source: EMF/ECBC

COVERED BONDS Issuance 2009 in EUR million					
	Public Sector	Mortgage	Ships	Mixed Assets	TOTAL
Austria (e)	2,501	1,442	0	0	3,943
Canada	0	951	0	0	951
Czech Republic	0	738	0	0	738
Denmark	0	125,484	935	0	126,419
Finland	0	2,125	0	0	2,125
France	13,915	29,373	0	15,824	59,112
Germany	52,251	56,852	1,286	0	110,389
Greece	0	1,500	0	0	1,500
Hungary	0	3,209	0	0	3,209
Ireland	3,174	14,801	0	0	17,975
Italy	3,000	7,500	0	0	10,500
Latvia	0	0	0	0	0
Luxembourg	3,083	0	0	0	3,083
Netherlands	0	7,725	0	0	7,725
Norway	951	28,916	0	0	29,867
Poland	0	88	0	0	88
Portugal	1,000	6,000	0	0	7,000
Slovakia	0	707	0	0	707
Spain	500	43,580	0	0	44,080
Sweden	0	53,106	0	0	53,106
Switzerland	0	12,414	0	0	12,414
Ukraine	0	0	0	0	0
United Kingdom	3,439	30,431	0	0	33,870
United States	0	0	0	0	0
Total	**83,814**	**426,943**	**2,221**	**15,824**	**528,801**

Source: EMF/ECBC

5.2.3 AUSTRIA (ESTIMATE)

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector	6750	6750	13038	15615	15200	17326	19617
Outstanding CBs backed by Mortgage	4000	4000	4000	3880	4125	4973	5317
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding	**10750**	**10750**	**17038**	**19495**	**19325**	**22299**	**24934**
Outstanding Jumbo			6000	6000	7000	8000	8000
Outstanding non-Jumbo			11038	13495	12325	14298	16934
Sum			17038	19495	19325	22298	24934
Total Outstanding Public Placement				10235	10987	12931	12161
Total Outstanding Private Placement				9260	8338	9367	12773
Sum				19495	19325	22298	24934
Outstanding denominated in EURO			15691	17703	17304	19664	24002
Outstanding denominated in domestic currency							
Outstanding denominated in other currencies			1347	1792	2021	2634	932
Sum			17038	19495	19325	22298	24934
Outstanding fixed coupon			13497	17207	18111	19523	16593
Outstanding floating coupon			3324	2062	1029	3444	6309
Outstanding other			217	226	185	0	2032
Sum			17038	19495	19325	22967	24934
Maturity of Bonds							

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector	1802		3591	3110	3131	9361	2501
New Issues of CBs backed by Mortgage	1029		214	2176	1959	1321	1442
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance	**2831**		**3805**	**5286**	**5090**	**10682**	**3943**
Issuance Jumbo				1000	1000	1000	1000
Issuance non-Jumbo				4286	4090	9682	2943
Sum				5286	5090	10682	3943
Total Issuance Public Placement				1677	1531	3361	2599
Total Issuance Private Placement				3609	3559	7321	1344
Sum				5286	5090	10682	3943
Issuance denominated in EURO				4899	4861	10362	3943
Issuance denominated in domestic currency							
Issuance denominated in other currencies				387	229	320	0
Sum				5286	5090	10682	3943
Issuance fixed coupon				3807	4577	8255	3252
Issuance floating coupon				1478	490	2262	435
Issuance other				0	23	165	256
Sum				5286	5090	10682	3943
Maturity of bonds							

Note: Data is tentative

5.2.4 CANADA

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector							
Outstanding CBs backed by Mortgage					2000	6574	7525
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding					**2000**	**6574**	**7525**
Outstanding Jumbo					2000	6250	6250
Outstanding non-Jumbo						324	1275
Sum					2000	6574	7525
Total Outstanding Public Placement					2000	6250	7201
Total Outstanding Private Placement					0	324	324
Sum					2000	6574	7525
Outstanding denominated in EURO					2000	6574	6574
Outstanding denominated in domestic currency							496
Outstanding denominated in other currencies							455
Sum					2000	6574	7525
Outstanding fixed coupon					2000	6250	6999
Outstanding floating coupon						324	526
Outstanding other							
Sum					2000	6574	7525
Maturity of Bonds					5	4	3

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector							
New Issues of CBs backed by Mortgage					2000	4574	951
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance					**2000**	**4574**	**951**
Issuance Jumbo					2000	4250	0
Issuance non-Jumbo						324	951
Sum					2000	4574	951
Total Issuance Public Placement					2000	4250	951
Total Issuance Private Placement						324	0
Sum					2000	4574	951
Issuance denominated in EURO					2000	4250	0
Issuance denominated in domestic currency							496
Issuance denominated in other currencies							455
Sum					2000	4250	951
Issuance fixed coupon					2000	4250	749
Issuance floating coupon							202
Issuance other							0
Sum					2000	4250	951
Maturity of bonds					5	4	4

5.2.5 CZECH REPUBLIC

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector							
Outstanding CBs backed by Mortgage	1638	1956	4452	5543	8245	8098	8186
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding	**1638**	**1956**	**4452**	**5543**	**8245**	**8098**	**8186**
Outstanding Jumbo							
Outstanding non-Jumbo	1638	1956	4452	5543	8245	8098	8186
Sum	1638	1956	4452	5543	8245	8098	8186
Total Outstanding Public Placement	1537	1721	3710	4682	6639	6508	5444
Total Outstanding Private Placement	100	235	742	861	1607	1590	2742
Sum	1638	1956	4452	5543	8245	8098	8186
Outstanding denominated in EURO				42	39	35	118
Outstanding denominated in domestic currency	1638	1956	4452	5501	8206	8064	8068
Outstanding denominated in other currencies							
Sum	1638	1956	4452	5543	8245	8098	8186
Outstanding fixed coupon	1572	1796	3619	4615	5894	5758	3759
Outstanding floating coupon	66	160	833	928	1681	1271	3903
Outstanding other					670	1070	523
Sum	1638	1956	4452	5543	8245	8098	8186
Maturity of Bonds	3	4	8	7			

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector							
New Issues of CBs backed by Mortgage	666	744	2558	956	3514	939	738
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance	**666**	**744**	**2558**	**956**	**3514**	**939**	**738**
Issuance Jumbo							
Issuance non-Jumbo	666	744	2558	956	3514	939	738
Sum	666	744	2558	956	3514	939	738
Total Issuance Public Placement	565	610	2068	875	3359	939	187
Total Issuance Private Placement	100	135	490	81	155	0	551
Sum	666	744	2558	956	3514	939	738
Issuance denominated in EURO				42	0	0	89
Issuance denominated in domestic currency	666	744	2558	914	3514	939	650
Issuance denominated in other currencies							
Sum	666	744	2558	956	3514	939	738
Issuance fixed coupon	666	650	1897	903	1328	55	76
Issuance floating coupon		94	661	53	1705	790	662
Issuance other					482	95	0
Sum	666	744	2558	956	3514	939	738
Maturity of bonds	5.0	4.5	12.3	5.5			

5.2.6 DENMARK

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector					174	154	134
Outstanding CBs backed by Mortgage	204695	216133	246411	260367	244696	255140	319434
Outstanding CBs backed by Ships	6915	6330	6915	6672	7754	7045	7197
Outstanding CBs backed by Mixed Assets							
Total Outstanding	**211610**	**222463**	**253326**	**267039**	**252624**	**262339**	**326765**
Outstanding Jumbo	122126	136804	159665	180563	194244	190051	247272
Outstanding non-Jumbo	89484	85659	93661	86476	58380	72288	79493
Sum	211610	222463	253326	267039	252624	262339	326765
Total Outstanding Public Placement	211610	222463	253315	267039	252624	260998	322332
Total Outstanding Private Placement						1341	4433
Sum	211610	222463	253315	267039	252624	262339	326765
Outstanding denominated in EURO	17457	18315	18432	18743	19547	22520	37965
Outstanding denominated in domestic currency	194153	204148	234883	248296	233077	238478	287127
Outstanding denominated in other currencies						1341	1673
Sum	211610	222463	253315	267039	252624	262339	326765
Outstanding fixed coupon	193578	202936	209656	208623	179127	184790	255028
Outstanding floating coupon	5735	7877	32729	48232	73497	77549	71737
Outstanding other	12297	11650	10930	10184	0	0	0
Sum	211610	222463	253315	267039	252624	262339	326765
Maturity of Bonds	15	13	13	13	11	8	6

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector						15	0
New Issues of CBs backed by Mortgage	99727	95009	149708	114014	70955	103230	125484
New Issues of CBs backed by Ships	318	139	1837	960	2515	235	935
New Issues of CBs by Mixed Assets							
Total Issuance	**100045**	**95148**	**151545**	**114974**	**73470**	**103480**	**126419**
Issuance Jumbo					61239	75100	100157
Issuance non-Jumbo	100045	95148	151545	114974	12231	28380	26262
Sum	100045	95148	151545	114974	73470	103480	126419
Total Issuance Public Placement	100045	95148	151545	114974	73470	102139	125014
Total Issuance Private Placement						1341	1405
Sum	100045	95148	151545	114974	73470	103480	126419
Issuance denominated in EURO	8455	5556	8850	8844	14415	13186	22255
Issuance denominated in domestic currency	91590	89591	142695	106130	59055	90294	101183
Issuance denominated in other currencies							2981
Sum	100045	95148	151545	114974	73470	103480	126419
Issuance fixed coupon	97916	91267	123590	93771	50757	89888	122851
Issuance floating coupon	2128	3881	27955	21203	22713	13592	3568
Issuance other	1	0	0	0	0	0	0
Sum	100045	95148	151545	114974	73470	103480	126419
Maturity of bonds	12.0	10.0	13.0	12.0	11.0	10.0	1.8

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

Since most of the Danish Mortgage Covered Bonds are tapped issued over a period of typically 3 years, Jumbo issues and outstandings are defined as covered bond with more than 1 bn. euro in the year, where the bond reach 1 bn. euro. The whole outstanding amount will be reported as Jumbo the year the bond exceed 1 bn. euro. This definition coveres both covered bonds denominated in Danish crowns and in euro. Most of the Danish Covered bonds denominated in euro are issued via VP Lux in Luxembourg. Theses bonds issued via VP Lux are included in the Danish data.

5.2.7 FINLAND

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector							
Outstanding CBs backed by Mortgage		250	1500	3000	4500	5750	7625
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding		**250**	**1500**	**3000**	**4500**	**5750**	**7625**
Outstanding Jumbo			1000	2000	3000	4000	5250
Outstanding non-Jumbo		250	500	1000	1500	1750	2375
Sum		250	1500	3000	4500	5750	7625
Total Outstanding Public Placement		250	1500	3000	4500	5750	7625
Total Outstanding Private Placement							
Sum		250	1500	3000	4500	5750	7625
Outstanding denominated in EURO		250	1500	3000	4500	5750	7625
Outstanding denominated in domestic currency							
Outstanding denominated in other currencies							
Sum		250	1500	3000	4500	5750	7625
Outstanding fixed coupon		0	1000	2250	3750	4750	6500
Outstanding floating coupon		250	500	750	750	1000	1125
Outstanding other							
Sum		250	1500	3000	4500	5750	7625
Maturity of Bonds							
Issuance (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector							
New Issues of CBs backed by Mortgage		250	1250	1500	1500	1250	2125
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance		**250**	**1250**	**1500**	**1500**	**1250**	**2125**
Issuance Jumbo			1000	1000	1000	1000	1250
Issuance non-Jumbo		250	250	500	500	250	875
Sum		250	1250	1500	1500	1250	2125
Total Issuance Public Placement		250	1250	1500	1500	1250	2125
Total Issuance Private Placement							
Sum		250	1250	1500	1500	1250	2125
Issuance denominated in EURO		250	1250	1500	1500	1250	2125
Issuance denominated in domestic currency							
Issuance denominated in other currencies							
Sum		250	1250	1500	1500	1250	2125
Issuance fixed coupon			1000	1250	1500	1000	2000
Issuance floating coupon		250	250	250	0	250	125
Issuance other							
Sum		250	1250	1500	1500	1250	2125
Maturity of bonds							

5.2.8 FRANCE

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector	31340	37600	42600	49660	56403	64756	71905
Outstanding CBs backed by Mortgage	21079	26816	32133	43012	63555	119092	134757
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets	34530	41350	50040	61930	80097	80631	82572
Total Outstanding	**86949**	**105766**	**124773**	**154602**	**200055**	**264479**	**289234**
Outstanding Jumbo	64757	75307	80132	102577	102550	147318	165536
Outstanding non-Jumbo	22192	30459	44641	52025	97505	117161	123698
Sum	86949	105766	124773	154602	200055	264479	289234
Total Outstanding Public Placement	21079	26083	61465		194593	231908	216964
Total Outstanding Private Placement		733	20668		5461	32572	71656
Sum	21079	26816	82133		200054	264479	288619
Outstanding denominated in EURO	77109	94104	109236		165779	226922	256798
Outstanding denominated in domestic currency							
Outstanding denominated in other currencies	9840	11662	15537		34276	37558	32436
Sum	86949	105766	124773		200055	264480	289234
Outstanding fixed coupon	21079	26333	30465		174388	204729	162534
Outstanding floating coupon					10502	48633	42600
Outstanding other		483	1668		15165	11117	1528
Sum	21079	26816	32133		200055	264479	206662
Maturity of Bonds	6	6	6	6			

Issuance (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Total Covered Bonds Issuance						0	700
New Issues of CBs backed by Public Sector	6500	8600	9070	12134	15271	11354	13915
New Issues of CBs backed by Mortgage	6181	5737	6397	12637	21670	59734	29373
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets	9600	11150	13150	17263	23682	8549	15824
Total Issuance	**22281**	**25487**	**28617**	**42034**	**60623**	**79637**	**59112**
Issuance Jumbo	10562	8640	7210	29471	33200	21130	32700
Issuance non-Jumbo	2119	5697	8257	12563	27423	58507	26412
Sum	12681	14337	15467	42034	60623	79637	59112
Total Issuance Public Placement	17492	16611	16963	32437	52393	62507	43608
Total Issuance Private Placement	4660	8877	11654	9597	8230	17130	15504
Sum	22152	25487	28617	42034	60623	79637	59112
Issuance denominated in EURO	19774	21369	20637	34172	50700	73930	56155
Issuance denominated in domestic currency							
Issuance denominated in other currencies	2507	4119	7980	7862	9923	5708	2957
Sum	22281	25488	28617	42034	60623	79637	59112
Issuance fixed coupon	6052	12279	14904		57009	37158	50398
Issuance floating coupon		1004	526		2614	42224	8519
Issuance other		3605	4117		1000	255	150
Sum	6052	16887	19547		60623	79637	59067
Maturity of bonds	7.7	8.9	9.2	8.8			

5.2.9 GERMANY

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector	797492	760264	734713	720835	677656	578974	486406
Outstanding CBs backed by Mortgage	256027	246636	237547	223306	206489	217367	225100
Outstanding CBs backed by Ships	3172	3212	3670	4669	4413	9282	7954
Outstanding CBs backed by Mixed Assets							
Total Outstanding	**1056691**	**1010112**	**975930**	**948810**	**888558**	**805623**	**719460**
Outstanding Jumbo	413700	391400	372600	345640	312358	279176	233500
Outstanding non-Jumbo	642991	618712	603330	603170	576200	526447	485960
Sum	1056691	1010112	975930	948810	888558	805623	719460
Total Outstanding Public Placement	672091	576463	567910	512621	427073	362461	317755
Total Outstanding Private Placement	384600	433649	408020	436189	461485	443162	401705
Sum	1056691	1010112	975930	948810	888558	805623	719460
Outstanding denominated in EURO	1030959	985370	952485	922878	863594	778623	690510
Outstanding denominated in domestic currency							
Outstanding denominated in other currencies	25732	24742	23445	25932	24964	27000	28950
Sum	1056691	1010112	975930	948810	888558	805623	719460
Outstanding fixed coupon	901004	838345	845386	823130	789338	689124	619364
Outstanding floating coupon	144270	160693	120681	121754	90552	107522	90136
Outstanding other	11417	11075	9863	3926	8668	8976	9959
Sum	1056691	1010112	975930	948810	888558	805623	719460
Maturity of Bonds	4.6	4.8	5.0	5.4	5.6	5.3	5.7

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector	151690	131506	137235	129452	107913	89522	52251
New Issues of CBs backed by Mortgage	57621	40773	33722	35336	26834	57345	56852
New Issues of CBs backed by Ships	2103	1646	1742	2374	628	6054	1286
New Issues of CBs by Mixed Assets							
Total Issuance	**211414**	**173925**	**172699**	**167162**	**135375**	**152921**	**110389**
Issuance Jumbo	49725	44075	47950	42660	33105	27415	19275
Issuance non-Jumbo	161689	129850	124749	124502	102270	125506	91114
Sum	211414	173925	172699	167162	135375	152921	110389
Total Issuance Public Placement	138958	109423	106895	76935	57973	67337	43507
Total Issuance Private Placement	72456	64502	65804	90227	77402	85584	66882
Sum	211414	173925	172699	167162	135375	152921	110389
Issuance denominated in EURO	203206	172085	163931	159340	131807	149137	107488
Issuance denominated in domestic currency							
Issuance denominated in other currencies	8208	1840	8768	7822	3568	3784	2901
Sum	211414	173925	172699	167162	135375	152921	110389
Issuance fixed coupon	155531	130723	138259	143869	113085	111309	89605
Issuance floating coupon	45685	36559	27077	18859	20099	40156	20091
Issuance other	10198	6643	7363	4434	2191	1456	693
Sum	211414	173925	172699	167162	135375	152921	110389
Maturity of bonds	6.4	6.3	7.1	7.4	7.2	4.8	6.7

5.2.10 GREECE

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector							
Outstanding CBs backed by Mortgage						5000	6500
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding						**5000**	**6500**
Outstanding Jumbo							1500
Outstanding non-Jumbo						5000	5000
Sum						5000	6500
Total Outstanding Public Placement						5000	6500
Total Outstanding Private Placement							
Sum						5000	6500
Outstanding denominated in EURO						5000	6500
Outstanding denominated in domestic currency							
Outstanding denominated in other currencies							
Sum						5000	6500
Outstanding fixed coupon							1500
Outstanding floating coupon						5000	5000
Outstanding other							
Sum						5000	6500
Maturity of Bonds							

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector							
New Issues of CBs backed by Mortgage						5000	1500
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance						**5000**	**1500**
Issuance Jumbo							1500
Issuance non-Jumbo						5000	
Sum						5000	1500
Total Issuance Public Placement						5000	1500
Total Issuance Private Placement							
Sum						5000	1500
Issuance denominated in EURO						5000	1500
Issuance denominated in domestic currency							
Issuance denominated in other currencies							
Sum						5000	1500
Issuance fixed coupon							1500
Issuance floating coupon						5000	
Issuance other							
Sum						5000	1500
Maturity of bonds							

5.2.11 HUNGARY

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector							
Outstanding CBs backed by Mortgage	3568	4962	5072	5924	5987	7105	7116
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding	**3622**	**4962**	**5072**	**5924**	**5987**	**7105**	**7116**
Outstanding Jumbo						1000	1000
Outstanding non-Jumbo	3622	4962	5072	5924	5987	6105	6116
Sum	3622	4962	5072	5924	5987	7105	7116
Total Outstanding Public Placement	2178	2993	3182	4188	4131	4955	
Total Outstanding Private Placement	1444	1970	1890	1736	1856	2150	
Sum	3622	4962	5072	5924	5987	7105	
Outstanding denominated in EURO		350	540	1547	1784	2879	3726
Outstanding denominated in domestic currency	3622	4612	4532	4377	4203	4226	3390
Outstanding denominated in other currencies							
Sum	3622	4962	5072	5924	5987	7105	7116
Outstanding fixed coupon	3236	4556	4587	5214	5080	4086	
Outstanding floating coupon	297	316	398	635	907	3019	
Outstanding other	89	90	87	75	0	0	
Sum	3622	4962	5072	5924	5987	7105	
Maturity of Bonds	5.0	5.0	4.0	4.0	n.a.	4.0	

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector							
New Issues of CBs backed by Mortgage	2961	2381	808	1418	331	3331	3209
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance	**2961**	**2381**	**808**	**1418**	**331**	**3331**	**3209**
Issuance Jumbo						1000	0
Issuance non-Jumbo	2961	2381	808	1418	331	2331	3209
Sum	2961	2381	808	1418	331	3331	3209
Total Issuance Public Placement	2135	1815	618	1412	158	3091	3205
Total Issuance Private Placement	826	566	190	6	173	240	4
Sum	2961	2381	808	1418	331	3331	3209
Issuance denominated in EURO		350	190	1007	291	1407	1102
Issuance denominated in domestic currency	2961	2031	618	411	40	1924	2107
Issuance denominated in other currencies							
Sum	2961	2381	808	1418	331	3331	3209
Issuance fixed coupon	2779	2377	718	1168	116	2275	3200
Issuance floating coupon	177	0	90	250	215	1056	9
Issuance other	4	4	0	0	0	0	0
Sum	2961	2381	808	1418	331	3331	3209
Maturity of bonds	5.0	5.0	2.8	3.0	n.a.	4.1	

5.2.12 IRELAND

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector	12362	27204	40965	49914	51204	52613	50951
Outstanding CBs backed by Mortgage		2000	4140	11900	13575	23075	29725
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding	**12362**	**29204**	**45105**	**61814**	**64779**	**75688**	**80676**
Outstanding Jumbo	11490	25418	32607	39417	41440	41916	42113
Outstanding non-Jumbo	872	3787	12499	22397	23339	33772	38563
Sum	12362	29204	45105	61814	64779	75688	80676
Total Outstanding Public Placement	11999	27278	35190	43557	43833	46224	45305
Total Outstanding Private Placement	363	1926	9916	18257	20947	29464	35371
Sum	12362	29204	45105	61814	64779	75688	80676
Outstanding denominated in EURO	10881	26696	37452	52800	52328	60056	67626
Outstanding denominated in domestic currency							
Outstanding denominated in other currencies	1481	2508	7654	9014	12451	15632	13050
Sum	12362	29204	45105	61814	64779	75688	80676
Outstanding fixed coupon	12027	28460	40717	55825	56087	48817	44717
Outstanding floating coupon	335	631	2095	3028	5299	23294	36909
Outstanding other	0	114	2294	2954	3386	3577	50
Sum	12362	29204	45105	61807	64772	75688	81676
Maturity of Bonds	6.6	6.9	7.7	7.9	6.2	7.1	6.8

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance	12362	17047	15576	17475	11208	22171	17975
New Issues of CBs backed by Public Sector	12362	15047	13576	9722	9533	12665	3174
New Issues of CBs backed by Mortgage		2000	2000	7753	1675	9506	14801
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance	**12362**	**17047**	**15576**	**17475**	**11208**	**22171**	**17975**
Issuance Jumbo	11490	14000	6907	12259	3883	7250	10250
Issuance non-Jumbo	872	3047	8669	5216	7325	14921	7725
Sum	12362	17047	15576	17475	11208	22171	17975
Total Issuance Public Placement	11999	15285	8667	12508	5314	8250	10250
Total Issuance Private Placement	363	1761	7050	4967	5894	13921	7725
Sum	12362	17047	15716	17475	11208	22171	17975
Issuance denominated in EURO	10881	15816	10733	15035	6612	18741	17975
Issuance denominated in domestic currency							
Issuance denominated in other currencies	1481	1231	4984	2440	4596	3430	0
Sum	12362	17047	15716	17475	11208	22171	17975
Issuance fixed coupon	12027	16467	12103	15537	8183	4600	4175
Issuance floating coupon	335	466	1445	1101	2351	17240	13750
Issuance other		114	2167	837	674	331	50
Sum	12362	17047	15716	17475	11208	22171	17975
Maturity of bonds	6.6	7.4	9.6	8.3	9.6	7.7	5.7

5.2.13 ITALY

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector			4000	8063	8063	8063	9063
Outstanding CBs backed by Mortgage						6500	14000
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding			**4000**	**8063**	**8063**	**14563**	**23063**
Outstanding Jumbo			4000	8000	8000	9000	14500
Outstanding non-Jumbo				63	63	5563	8563
Sum			4000	8063	8063	14563	23063
Total Outstanding Public Placement			4000	8000	8000	14500	23000
Total Outstanding Private Placement				63	63	63	63
Sum			4000	8063	8063	14563	23063
Outstanding denominated in EURO			4000	8000	8000	14500	23000
Outstanding denominated in domestic currency							
Outstanding denominated in other currencies				63	63	63	63
Sum			4000	8063	8063	14563	23063
Outstanding fixed coupon			4000	8063	8063	10063	15563
Outstanding floating coupon						500	500
Outstanding other						4000	7000
Sum			4000	8063	8063	14563	23063
Maturity of Bonds			6.0	5.0			

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector			4000	4063			3000
New Issues of CBs backed by Mortgage						6500	7500
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance			**4000**	**4063**	**0**	**6500**	**10500**
Issuance Jumbo			4000	4000		1000	7500
Issuance non-Jumbo				63		5500	3000
Sum			4000	4063		6500	10500
Total Issuance Public Placement			4000	4000		6500	10500
Total Issuance Private Placement				63			
Sum			4000	4063		6500	10500
Issuance denominated in EURO			4000	4000		6500	10500
Issuance denominated in domestic currency							
Issuance denominated in other currencies				63			
Sum			4000	4063		6500	10500
Issuance fixed coupon			4000	4000		2000	7500
Issuance floating coupon				0		500	
Issuance other				63		4000	3000
Sum			4000	4063		6500	10500
Maturity of bonds			6.0	4.0			

Figures for the years 2005 and 2006 relates to public sector covered bonds issued by Cassa Depositi e Prestiti.

5.2.14 LATVIA

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector							
Outstanding CBs backed by Mortgage	35	54	60	63	90	90	85
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding	**35**	**54**	**60**	**63**	**90**	**90**	**85**
Outstanding Jumbo							
Outstanding non-Jumbo	35	54	60	63	90	90	85
Sum	35	54	60	63	90	90	85
Total Outstanding Public Placement	35	54	60	63	90	90	85
Total Outstanding Private Placement							
Sum	35	54	60	63	90	90	85
Outstanding denominated in EURO				20	56	69	64
Outstanding denominated in domestic currency	35	36	38	34	28	17	17
Outstanding denominated in other currencies	0	18	21	8	6	4	4
Sum	35	54	60	63	90	90	85
Outstanding fixed coupon	26	27	26	21	15	26	26
Outstanding floating coupon	9	27	34	41	75	64	59
Outstanding other							
Sum	35	54	60	63	90	90	85
Maturity of Bonds	5.4	5.0	4.5	3.3			

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector							
New Issues of CBs backed by Mortgage	11	22	4	20	19	25	
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance	**11**	**22**	**4**	**20**	**19**	**25**	**0**
Issuance Jumbo							
Issuance non-Jumbo	11	22	4	20	19	25	
Sum	11	22	4	20	19	25	0
Total Issuance Public Placement	11	22	4	20	19	25	
Total Issuance Private Placement							
Sum	11	22	4	20	19	25	0
Issuance denominated in EURO				20	19	25	
Issuance denominated in domestic currency	11	3	4				
Issuance denominated in other currencies		18					
Sum	11	22	4	20	19	25	0
Issuance fixed coupon	9	3	0	0	0	25	
Issuance floating coupon	2	18	4	20	19		
Issuance other							
Sum	11	22	4	20	19	25	0
Maturity of bonds	5.9	8.1	4.6	5.1			

5.2.15 LUXEMBOURG

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector	16870	19627	24968	28360	33741	35467	31645
Outstanding CBs backed by Mortgage				150	150	150	0
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding	**16870**	**19627**	**24968**	**28510**	**33891**	**35617**	**31645**
Outstanding Jumbo	5000	4000	2000	2000	2250	2250	2250
Outstanding non-Jumbo	11870	15627	22968	26510	31641	33367	29395
Sum	16870	19627	24968	28510	33891	35617	31645
Total Outstanding Public Placement	12384	12358	16577	18833	21993	21295	18398
Total Outstanding Private Placement	4486	7270	8391	9677	11898	14322	13247
Sum	16870	19627	24968	28510	33891	35617	31645
Outstanding denominated in EURO	9473	11032	10909	12319	16172	18147	16592
Outstanding denominated in domestic currency							
Outstanding denominated in other currencies	7397	8595	14059	16191	17719	17470	15053
Sum	16870	19627	24968	28510	33891	35617	31645
Outstanding fixed coupon	11631	12236	15427	19077	22573	22267	21126
Outstanding floating coupon	4465	5489	7376	7217	9210	11270	9355
Outstanding other	774	1902	2165	2216	2108	2080	1164
Sum	16870	19627	24968	28510	33891	35617	31645
Maturity of Bonds	4.0						

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector	4528	5516	9611	9730	10052	3967	3083
New Issues of CBs backed by Mortgage				150	0	0	0
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance	**4528**	**5516**	**9611**	**9880**	**10052**	**3967**	**3083**
Issuance Jumbo	750	0	0	0	250	0	0
Issuance non-Jumbo	3778	5516	9611	9880	9802	3967	3083
Sum	4528	5516	9611	9880	10052	3967	3083
Total Issuance Public Placement	3197	2870	6749	6798	4819	878	500
Total Issuance Private Placement	1331	2646	2862	3082	5233	3089	2583
Sum	4528	5516	9611	9880	10052	3967	3083
Issuance denominated in EURO	2131	3589	2468	3628	5773	2639	2661
Issuance denominated in domestic currency							
Issuance denominated in other currencies	2397	1927	7143	6252	4279	1328	422
Sum	4528	5516	9611	9880	10052	3967	3083
Issuance fixed coupon	2828	3516	7511	8092	5425	1423	1526
Issuance floating coupon	1500	1600	1700	1601	4448	2471	1530
Issuance other	200	400	400	187	178	73	27
Sum	4528	5516	9611	9880	10051	3967	3083
Maturity of bonds	4.0						

5.2.16 NETHERLANDS

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector							
Outstanding CBs backed by Mortgage			2000	7500	15727	20977	28367
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding			**2000**	**7500**	**15727**	**20977**	**28367**
Outstanding Jumbo			2000	5500	11000	14000	20250
Outstanding non-Jumbo			0	2000	4727	6977	8117
Sum			2000	7500	15727	20977	28367
Total Outstanding Public Placement			2000	6650	13817	18970	25306
Total Outstanding Private Placement			0	850	1910	2007	3061
Sum			2000	7500	15727	20977	28367
Outstanding denominated in EURO			2000	6400	14319	19157	26525
Outstanding denominated in domestic currency							
Outstanding denominated in other currencies				1100	1408	1819	1842
Sum			2000	7500	15727	20976	28367
Outstanding fixed coupon			2000	7200	13725	17807	25370
Outstanding floating coupon					1647	3120	2947
Outstanding other				300	355	50	50
Sum			2000	7500	15727	20977	28367
Maturity of Bonds							

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector							
New Issues of CBs backed by Mortgage			2000	5500	8227	5608	7725
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance			**2000**	**5500**	**8227**	**5608**	**7725**
Issuance Jumbo			2000	3500	5500	3000	6250
Issuance non-Jumbo			0	2000	2727	2608	1475
Sum			2000	5500	8227	5608	7725
Total Issuance Public Placement			2000	4650	7167	5118	6415
Total Issuance Private Placement				850	1060	491	1310
Sum			2000	5500	8227	5609	7725
Issuance denominated in EURO			2000	4400	7919	5191	7725
Issuance denominated in domestic currency							
Issuance denominated in other currencies				1100	308	418	0
Sum			2000	5500	8227	5609	7725
Issuance fixed coupon			2000	5200	6525	4033	7535
Issuance floating coupon					1647	1575	190
Issuance other				300	55	0	0
Sum			2000	5500	8227	5608	7725
Maturity of bonds							

5.2.17 NORWAY

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector							951
Outstanding CBs backed by Mortgage					6371	21924	51340
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding					**6371**	**21924**	**52291**
Outstanding Jumbo					4500	12046	34347
Outstanding non-Jumbo					1871	9877	17943
Sum					6371	21924	52291
Total Outstanding Public Placement					6371	17742	37045
Total Outstanding Private Placement					0	4182	15246
Sum					6371	21924	52291
Outstanding denominated in EURO					4500	12847	14522
Outstanding denominated in domestic currency					1433	8351	36956
Outstanding denominated in other currencies					438	725	813
Sum					6371	21924	52291
Outstanding fixed coupon					5718	14750	16870
Outstanding floating coupon					653	7174	35420
Outstanding other							
Sum					6371	21924	52291
Maturity of Bonds					3.7	4.1	4.6

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector							951
New Issues of CBs backed by Mortgage					6458	15660	28916
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance					**6458**	**15660**	**29867**
Issuance Jumbo					4500	7546	18317
Issuance non-Jumbo					1958	8114	11550
Sum					6458	15660	29867
Total Issuance Public Placement					6458	12630	19400
Total Issuance Private Placement						3030	10467
Sum					6458	15660	29867
Issuance denominated in EURO					4500	8346	2044
Issuance denominated in domestic currency					1521	7042	27756
Issuance denominated in other currencies					438	272	67
Sum					6458	15660	29867
Issuance fixed coupon					5754	9020	2260
Issuance floating coupon					704	6640	27607
Issuance other							
Sum					6458	15660	29867
Maturity of bonds					3.7	5.0	5.9

5.2.18 POLAND

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector					131	137	139
Outstanding CBs backed by Mortgage	160	220	558	453	676	561	578
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding	**160**	**220**	**558**	**453**	**807**	**698**	**717**
Outstanding Jumbo							
Outstanding non-Jumbo	160	220	558	453	807	698	717
Sum	160	220	558	453	807	698	717
Total Outstanding Public Placement	91	91	265	339	725	627	
Total Outstanding Private Placement	69	129	293	114	82	71	
Sum	160	220	558	453	807	698	
Outstanding denominated in EURO	37	62	62	62	56	56	
Outstanding denominated in domestic currency	111	115	440	357	726	617	
Outstanding denominated in other currencies	11	43	56	34	25	25	
Sum	159	220	558	453	807	698	
Outstanding fixed coupon	4	4	4	4	1	1	
Outstanding floating coupon	156	216	554	450	806	697	
Outstanding other							
Sum	160	220	558	453	807	698	
Maturity of Bonds	6.0	5.0	5.0	5.0			5.0

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector					131	24	
New Issues of CBs backed by Mortgage	123	63	224	52	206	197	88
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance	**123**	**63**	**224**	**52**	**337**	**222**	**88**
Issuance Jumbo							
Issuance non-Jumbo	123	63	224	52	337	222	88
Sum	123	63	224	52	337	222	88
Total Issuance Public Placement	91	0	174	52	337	222	
Total Issuance Private Placement	32	63	50	0	0	0	
Sum	123	63	224	52	337	222	
Issuance denominated in EURO	23	25	0	0	0	0	
Issuance denominated in domestic currency	100	7	211	52	337	222	
Issuance denominated in other currencies		31	12	0	0	0	
Sum	123	63	223	52	337	222	
Issuance fixed coupon							
Issuance floating coupon	123	63	224	52	337	222	
Issuance other							
Sum	123	63	224	52	337	222	
Maturity of bonds	5.0	5.0	5.0	5.0			

5.2.19 PORTUGAL

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector						150	1150
Outstanding CBs backed by Mortgage				2000	7850	15270	20270
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding				**2000**	**7850**	**15420**	**21420**
Outstanding Jumbo				2000	6500	12150	17150
Outstanding non-Jumbo					1350	3270	4270
Sum				2000	7850	15420	21420
Total Outstanding Public Placement				2000	7850	15420	21420
Total Outstanding Private Placement							
Sum				2000	7850	15420	21420
Outstanding denominated in EURO				2000	7850	15420	21420
Outstanding denominated in domestic currency							
Outstanding denominated in other currencies							
Sum				2000	7850	15420	21420
Outstanding fixed coupon				2000	6500	12150	18150
Outstanding floating coupon					1350	3100	2925
Outstanding other						170	345
Sum				2000	7850	15420	21420
Maturity of Bonds				10.0			

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector						150	1000
New Issues of CBs backed by Mortgage				2000	5850	7420	6000
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance				**2000**	**5850**	**7570**	**7000**
Issuance Jumbo				2000	4500	5650	6000
Issuance non-Jumbo					1350	1920	1000
Sum				2000	5850	7570	7000
Total Issuance Public Placement				2000	5850	7570	7000
Total Issuance Private Placement							
Sum				2000	5850	7570	7000
Issuance denominated in EURO				2000	5850	7570	7000
Issuance denominated in domestic currency							
Issuance denominated in other currencies							
Sum				2000	5850	7570	7000
Issuance fixed coupon				2000	4500	5650	6000
Issuance floating coupon					1350	1750	825
Issuance other						170	175
Sum				2000	5850	7570	7000
Maturity of bonds				10.0			

5.2.20 SLOVAKIA

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector							
Outstanding CBs backed by Mortgage	510	1052	1583	2214	2738	3576	3608
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding	**510**	**1052**	**1583**	**2214**	**2738**	**3576**	**3608**
Outstanding Jumbo							
Outstanding non-Jumbo	510	1052	1583	2214	2738	3576	3608
Sum	510	1052	1583	2214	2738	3576	3608
Total Outstanding Public Placement	436	953	1435	1731	2111	2676	2900
Total Outstanding Private Placement	73	100	148	482	627	900	708
Sum	510	1052	1583	2214	2738	3576	3608
Outstanding denominated in EURO				280	510	1189	3516
Outstanding denominated in domestic currency	510	1052	1583	1934	2161	2296	
Outstanding denominated in other currencies					68	92	92
Sum	510	1052	1583	2214	2738	3576	3608
Outstanding fixed coupon	510	1052	1223	1405	1666	1992	1845
Outstanding floating coupon			360	809	1073	1584	1762
Outstanding other							
Sum	510	1052	1583	2214	2738	3576	3608
Maturity of Bonds							

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector							
New Issues of CBs backed by Mortgage	355	549	584	676	803	1414	707
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance	**355**	**549**	**584**	**676**	**803**	**1414**	**707**
Issuance Jumbo							
Issuance non-Jumbo	355	549	584	676	803	1414	707
Sum	355	549	584	676	803	1414	707
Total Issuance Public Placement	289	516	482	296	380	565	224
Total Issuance Private Placement	66	33	101	380	423	849	483
Sum	355	549	584	676	803	1414	707
Issuance denominated in EURO				280	230	679	707
Issuance denominated in domestic currency	355	549	584	396	505	711	
Issuance denominated in other currencies					68	24	0
Sum	355	549	584	676	803	1414	707
Issuance fixed coupon	355	549	223	227	539	902	529
Issuance floating coupon			360	449	264	512	178
Issuance other							
Sum	355	549	584	676	803	1414	707
Maturity of bonds							

5.2.21 SPAIN

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector	4900	7200	9640	11590	16375	17030	16030
Outstanding CBs backed by Mortgage	57111	94707	150213	214768	266959	315055	336750
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding	**62011**	**101907**	**159853**	**226358**	**283334**	**332085**	**352780**
Outstanding Jumbo	60598	98683	155463	220058	268723	309503	312686
Outstanding non-Jumbo	1413	3224	4390	6300	14611	22582	40094
Sum	62011	101907	159853	226358	283334	332085	352780
Total Outstanding Public Placement	62011	101907	159853	226358	283334	332085	352780
Total Outstanding Private Placement							
Sum	62011	101907	159853	226358	283334	332085	352780
Outstanding denominated in EURO	62011	101907	159853	226358	283334	332085	352780
Outstanding denominated in domestic currency							
Outstanding denominated in other currencies							
Sum	62011	101907	159853	226358	283334	332085	352780
Outstanding fixed coupon	61921	100417	153588	212878	238273	261480	291235
Outstanding floating coupon	90	1490	6265	13480	45061	70606	61545
Outstanding other							
Sum	62011	101907	159853	226358	283334	332085	352780
Maturity of Bonds	7.5	7.6	8.0	8.3	7.5	6.3	5.4

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector	5600	1600	2440	5150	5060	1670	500
New Issues of CBs backed by Mortgage	28502	37835	57780	69890	51801	54187	43580
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance	**34102**	**39435**	**60220**	**75040**	**56861**	**55857**	**44080**
Issuance Jumbo	31800	36335	58780	69230	50955	42510	31108
Issuance non-Jumbo	2302	3100	1440	5810	5906	13347	12972
Sum	34102	39435	60220	75040	56861	55857	44080
Total Issuance Public Placement	34102	39435	60220	75040	56861	55857	44080
Total Issuance Private Placement							
Sum	34102	39435	60220	75040	56861	55857	44080
Issuance denominated in EURO	34102	39435	60220	75040	56861	55857	44080
Issuance denominated in domestic currency							
Issuance denominated in other currencies							
Sum	34102	39435	60220	75040	56861	55857	44080
Issuance fixed coupon	33312	38635	55545	66125	35870	21957	37480
Issuance floating coupon	790	800	4675	8915	20991	33900	6600
Issuance other							
Sum	34102	39435	60220	75040	56861	55857	44080
Maturity of bonds	5.4	6.6	10.4	10.5	9.3	3.4	5.4

Source: AIAF

5.2.22 SWEDEN

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector							
Outstanding CBs backed by Mortgage				55267	92254	117628	133903
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding	**0**	**0**	**0**	**55267**	**92254**	**117628**	**133903**
Outstanding Jumbo				5283	11114	40100	45941
Outstanding non-Jumbo				49984	81140	77528	87962
Sum	0	0	0	55267	92254	117628	133903
Total Outstanding Public Placement				54781	90780	115259	130049
Total Outstanding Private Placement				486	1474	2369	3855
Sum	0	0	0	55267	92254	117628	133903
Outstanding denominated in EURO				5283	13171	21126	25787
Outstanding denominated in domestic currency				49474	77436	93374	103809
Outstanding denominated in other currencies				510	1648	3128	4308
Sum	0	0	0	55267	92254	117628	133903
Outstanding fixed coupon				55029	88944	112648	126116
Outstanding floating coupon				21	3046	4259	7169
Outstanding other				217	265	721	619
Sum	0	0	0	55267	92254	117628	133903
Maturity of Bonds				2.8	2.6	2.2	2.7

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector							
New Issues of CBs backed by Mortgage				17569	36638	43488	53106
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance	**0**	**0**	**0**	**17569**	**36638**	**43488**	**53106**
Issuance Jumbo				5283	5875	16721	14480
Issuance non-Jumbo				12286	30762	26767	38626
Sum	0	0	0	17569	36638	43488	53106
Total Issuance Public Placement				17482	36084	42631	50402
Total Issuance Private Placement				87	554	856	2704
Sum	0	0	0	17569	36638	43488	53106
Issuance denominated in EURO				5283	7085	10975	6705
Issuance denominated in domestic currency				11794	28417	31490	44354
Issuance denominated in other currencies				492	1135	1023	2047
Sum	0	0	0	17569	36638	43488	53106
Issuance fixed coupon				17560	35779	39135	47375
Issuance floating coupon				2	752	4353	5376
Issuance other				7	107	0	354
Sum	0	0	0	17569	36638	43488	53106
Maturity of bonds				4.1	3.1	2.4	4.1

5.2.23 SWITZERLAND

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector							
Outstanding CBs backed by Mortgage	30326	29941	29010	29395	29013	36180	46283
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding	**30326**	**29941**	**29010**	**29395**	**29013**	**36180**	**46283**
Outstanding Jumbo							3000
Outstanding non-Jumbo	30326	29941	29010	29395	29013	36180	43283
Sum	30326	29941	29010	29395	29013	36180	46283
Total Outstanding Public Placement							
Total Outstanding Private Placement							
Sum							
Outstanding denominated in EURO							3000
Outstanding denominated in domestic currency	30326	29941	29010	29395	29013	36180	43283
Outstanding denominated in other currencies							
Sum	30326	29941	29010	29395	29013	36180	46283
Outstanding fixed coupon	30326	29941	29010	29395	29013	36180	46283
Outstanding floating coupon							
Outstanding other							
Sum	30326	29941	29010	29395	29013	36180	46283
Maturity of Bonds							

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector							
New Issues of CBs backed by Mortgage	3027	2755	4171	4967	4559	5316	12414
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance	**3027**	**2755**	**4171**	**4967**	**4559**	**5316**	**12414**
Issuance Jumbo							3000
Issuance non-Jumbo	3027	2755	4171	4967	4559	5316	9414
Sum	3027	2755	4171	4967	4559	5316	12414
Total Issuance Public Placement	2500	2342	3940	4047	4076		
Total Issuance Private Placement	527	413	231	920	483		
Sum	3027	2755	4171	4967	4559		
Issuance denominated in EURO							3000
Issuance denominated in domestic currency	3027	2755	4171	4967	4559	5316	9414
Issuance denominated in other currencies							
Sum	3027	2755	4171	4967	4559	5316	12414
Issuance fixed coupon	3027	2755	4171	4967	4559	5316	12414
Issuance floating coupon							
Issuance other							
Sum	3027	2755	4171	4967	4559	5316	12414
Maturity of bonds							

5.2.24 UKRAINE

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector							
Outstanding CBs backed by Mortgage						11	4
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding						**11**	**4**
Outstanding Jumbo							
Outstanding non-Jumbo						11	4
Sum						11	4
Total Outstanding Public Placement						11	4
Total Outstanding Private Placement							
Sum						11	4
Outstanding denominated in EURO							
Outstanding denominated in domestic currency						11	4
Outstanding denominated in other currencies							
Sum						11	4
Outstanding fixed coupon						11	4
Outstanding floating coupon							
Outstanding other							
Sum						11	4
Maturity of Bonds							

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector							
New Issues of CBs backed by Mortgage						7	
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance						**7**	**0**
Issuance Jumbo							
Issuance non-Jumbo						7	
Sum						7	
Total Issuance Public Placement						7	
Total Issuance Private Placement							
Sum						7	
Issuance denominated in EURO							
Issuance denominated in domestic currency						7	
Issuance denominated in other currencies							
Sum						7	
Issuance fixed coupon						7	
Issuance floating coupon							
Issuance other							
Sum						7	
Maturity of bonds							

Note: The €6.83m covered bonds issued in 2008 were subsequently withdrawn in February 2009.

5.2.25 UNITED KINGDOM

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector							3439
Outstanding CBs backed by Mortgage	5000	14959	26778	50548	81964	204278	201096
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding	**5000**	**14959**	**26778**	**50548**	**81964**	**204278**	**204535**
Outstanding Jumbo	5000	14250	23250	43750	61000	60689	60750
Outstanding non-Jumbo	0	709	3528	6798	20964	143589	143785
Sum	5000	14959	26778	50548	81964	204278	204535
Total Outstanding Public Placement	5000	14959	26778	50548	81964	204278	204535
Total Outstanding Private Placement							
Sum	5000	14959	26778	50548	81964	204278	204535
Outstanding denominated in EURO	5000	14250	24384	44884	69672	76697	70683
Outstanding denominated in domestic currency	0	709	2335	3127	4704	118937	125491
Outstanding denominated in other currencies	0	0	60	2536	7588	8644	8361
Sum	5000	14959	26778	50548	81964	204278	204535
Outstanding fixed coupon	5000	14959	24689	48467	76515	78613	71668
Outstanding floating coupon			2089	2081	4563	125505	132867
Outstanding other					886	160	0
Sum	5000	14959	26778	50548	81964	204278	204535
Maturity of Bonds							

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector							3439
New Issues of CBs backed by Mortgage	5000	9959	11819	23770	31874	121030	30431
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance	**5000**	**9959**	**11819**	**23770**	**31874**	**121030**	**33870**
Issuance Jumbo	5000	9250	9000	20500	17250	0	3750
Issuance non-Jumbo	0	709	2819	3270	14624	121030	30120
Sum	5000	9959	11819	23770	31874	121030	33870
Total Issuance Public Placement	5000	9959	11819	23770	31874	121030	33870
Total Issuance Private Placement							
Sum	5000	9959	11819	23770	31874	121030	33870
Issuance denominated in EURO	5000	9250	10134	20500	24788	7763	5535
Issuance denominated in domestic currency		709	1626	745	1841	113267	28335
Issuance denominated in other currencies			60	2525	5245	0	0
Sum	5000	9959	11819	23770	31874	121030	33870
Issuance fixed coupon	5000	9959	9730	23770	28424	2618	3750
Issuance floating coupon			2089	0	2564	118253	30120
Issuance other					886	159	0
Sum	5000	9959	11819	23770	31874	121030	33870
Maturity of bonds							

5.2.26 UNITED STATES

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Outstanding							
Outstanding CBs backed by Public Sector							
Outstanding CBs backed by Mortgage				4000	12859	12937	12896
Outstanding CBs backed by Ships							
Outstanding CBs backed by Mixed Assets							
Total Outstanding				**4000**	**12859**	**12937**	**12896**
Outstanding Jumbo				4000	12859	12937	12896
Outstanding non-Jumbo							
Sum				4000	12859	12937	12896
Total Outstanding Public Placement				4000	12859	12937	12896
Total Outstanding Private Placement							
Sum				4000	12859	12937	12896
Outstanding denominated in EURO				4000	11500	11500	11500
Outstanding denominated in domestic currency					1359	1437	1396
Outstanding denominated in other currencies							
Sum				4000	12859	12937	12896
Outstanding fixed coupon							
Outstanding floating coupon							
Outstanding other							
Sum							
Maturity of Bonds							

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009
Total Covered Bonds Issuance							
New Issues of CBs backed by Public Sector							
New Issues of CBs backed by Mortgage				4000	8859		
New Issues of CBs backed by Ships							
New Issues of CBs by Mixed Assets							
Total Issuance				**4000**	**8859**	**0**	**0**
Issuance Jumbo				4000	8859		
Issuance non-Jumbo							
Sum				4000	8859		
Total Issuance Public Placement				4000	8859		
Total Issuance Private Placement							
Sum				4000	8859		
Issuance denominated in EURO				4000	7500		
Issuance denominated in domestic currency					1359		
Issuance denominated in other currencies							
Sum				4000	8859		
Issuance fixed coupon							
Issuance floating coupon							
Issuance other							
Sum							
Maturity of bonds							

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The Covered Bond Voice of the European Mortgage Federation

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