ECBC

EUROPEAN COVERED BOND **FACT BOOK**

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2008 ECBC EUROPEAN COVERED BOND **FACT BOOK**

ECBC
European Covered Bond Council
The Covered Bond Voice of the European Mortgage Federation

EUROPEAN MORTGAGE FEDERATION

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FOREWORD

At the time of going to press, we are still in the middle of one of the most significant financial crises of modern times. This crisis has, since the summer of 2007, impacted liquidity and refinancing operations in the banking sector, and obscures visibility going forward.

Against this background, European covered bond markets have been amongst the least affected asset classes within European capital markets. Of course, covered bonds did not escape unscathed from the crisis, witnessing, for example, a widening of spreads, though this was significantly more limited than for other bank funding tools such as unsecured borrowing or securitisation. However, covered bonds as an asset class have held up remarkably well, evidently benefiting from the underlying protection against risk built into the product: clear asset eligibility criteria, highly conservative valuation rules and the two fold protection of bondholder's rights.

Covered bonds have underlined their importance and stabilising role in mortgage financing in Europe to such an extent that the U.S. authorities are now undertaking to facilitate the adoption of covered bonds, seeking to introduce a set of guidelines designed to replicate the high quality of this European instrument in the U.S. market.

Indeed, issuance of covered bonds exceeded €500 billion for the first time in 2007, and total outstanding covered bonds rose by nearly 10% to over €2.1 trillion. The covered bond family continued to expand in 2007 with the introduction or amendment of legislation in numerous jurisdictions, as well as several countries issuing covered bonds for the first time.

The European Covered Bond Council (ECBC) was created in late 2004, and its role is to highlight the position of covered bonds at European level and operate as a think-tank as well as a lobbying and networking platform for covered bond market participants. With over 90 members including covered bond issuers, investment banks, research analysts, rating agencies and trading platforms, the ECBC represents more than 95% of all existing covered bonds issued. Since the beginning of the crisis, the ECBC has reinforced its role, as evidenced by the 'essential features of covered bonds' published in early 2008, as well as having been active in representing the covered bond industry to authorities and regulators at both national and European level, stressing the role of covered bonds in providing on-balance sheet financing which also encourages prudent lending. As with other asset classes, covered bonds saw a decline in both liquidity and inter-bank market-making. With the creation of the ECBC '8-to-8' Market-Makers and Issuers Committee, the ECBC played a direct operational role in facilitating orderly conditions for the markets to adapt to the changing environment. ECBC members are currently working hard to restore more optimal liquidity conditions.

Following on from the outstanding success of the 2006 and 2007 editions, the ECBC is pleased to present herewith the 2008 edition of the European Covered Bond Fact Book, intended to be a benchmark and comprehensive source of information on this asset class. The Fact Book presents five articles on key issues in Chapter I: assessing the state of play in secondary markets; analysing the role of covered bonds as a funding tool; the investor's perspective; investigating general law framework (structured) covered bonds; and looking at pooling models. The second chapter explains more about covered bonds and their main features and includes articles comparing covered bonds with RMBS as well as how the Capital Requirements Directive relates to covered bonds. In the third chapter, detailed explanations are presented on the legislation and markets for covered bonds for 29 countries, adding seven new countries compared to the last edition of the Fact Book. Chapter IV gives the rating agencies the opportunity to present their covered bond methodologies as well as providing a brief comparison of their different approaches. In Chapter V, a description of trends in the covered market as well as a complete set of covered bond statistics are presented.

Special thanks must be given to Mr Wolfgang Kälberer, the Chairman of the ECBC Fact Book working group for guiding so expertly the Fact Book towards completion, as well as the members of the "Fact Book" and "Statistics & Data" working groups, whose enthusiasm and dedication resulted in the 2008 edition of the ECBC European Covered Bond Fact Book.

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CHAPTER I - KEY THEMES OF THE YEAR

1.1 MARKET-MAKING: ADAPTING TO THE NEW PARADIGM

By Richard Kemmish, Credit Suisse

1 / A CORNERSTONE OF THE MARKET'S DEVELOPMENT

Trading in the covered bond market has long been defined by a system of formal agreements that determine the minimum performance standards for the houses acting as market makers. Since their invention in 1995 (the first bond to be governed by them was issued by Frankfurter Hypothekenbank in May of that year) these agreements have slowly evolved as the covered bond market has grown and diversified.

Increasingly the tight bid/ask spreads and high levels of liquidity that these agreements underpinned became a selling point for the entire covered bond market. They were often referred to in roadshow presentations and investor conferences as one of the reasons why the covered bond market was a suitable surrogate for (and therefore should be benchmarked to) the government and agency bond markets.

As new jurisdictions joined the market they were quickly won over to the benefits of the market making conventions and frequently used a direct copy of the existing rules as an easy way to demonstrate their commitment to liquidity and their desire to emulate the best practices of the existing covered bond issuers.

Over time the strict rules, in particular those which governed which bonds were and which bonds were not, eligible for formal market making started to take on an identity and life of their own. The concept of the Jumbo covered bond – as a brand representing high liquidity was born.

2 / THE THEORY

Market making may be central to the market and (at least until last summer) have been widely regarded as a key to the covered bond market's good health, but as it came under scrutiny it became increasingly obvious that different parties had differing views on exactly what it was. This is hardly surprising, there were different rules for different issuers, springing from different sources. First of all there were industry wide guidelines such as those published by the vdp (Verband Deutscher Pfandbriefbanken, the Association of German Pfandbrief Banks) the so called 'minimum standards', secondly there were multi-lateral agreements on market making signed by issuers and market makers (for example, in the French market), thirdly there are bi-lateral contracts (at closing of a transaction the issuer and their dealers sign a formal agreement) and finally, some issuers simply work on the basis of an understanding that their dealers will make markets according to the 'norms' in the covered bond market.

Although market making rules came from various sources, they were all broadly similar in their content, give or take some minor details. For example, the vdp Minimum Standards specify that for qualifying pfandbrief, market makers had to be prepared to trade:

- 'during usual trading hours…'
- 'for lots of up to EUR 15mn..'
- 'bid/.ask ..prices simultaneously'
- with a maximum spread as per the below table

Residual maturity	Maximum spread
Up to 4 year	5 cents
4 to 6 years	6 cents
6 to 8 years	8 cents
8 to 15 years	10 cents
15 – 20 years	15 cents
20 – 25 years	25 cents

Source: vdp

These aspects of the market making rules were well understood. What there was confusion over was exactly who they applied to? Initially the rules were designed for trading between market makers - the trading between a bank and their investor was very much up to the bank. But the existence of a liquid inter-bank market was designed to give the traders confidence that they would be able to unwind even large positions easily with the street. It became apparent however that many issuers - and some of the very large investors - felt that the market making agreements should be available to all market participants. Before last summer this lack of common understanding was something of a moot point.

3 / REACTING TO MARKET TURMOIL

The trading arrangements, even with their multiple sources and the occasional misunderstanding about the detail, were widely regarded as one of the reasons for the market's reputation for liquidity and low volatility. Many issuers used these arrangements as a justification for the positioning of covered bonds as a 'rates product' rather than a 'credit product'. The distinction between these two product types is one of the many features of the market that was accepted but has only really come under scrutiny since the turmoil of summer 2007.

Partly because of the safe haven reputation which covered bonds (as a 'rates product') enjoyed, it at first appeared relatively immune from the events of last summer. As the credit markets deteriorated in July and August, covered bond spreads were largely unaffected and market liquidity at first held up well.

The mechanism by which the credit market turmoil eventually infected covered bonds has been much debated. Some commentators have argued that covered bonds were more of a credit product than they had been represented (the rating agencies disagree: as demonstrated by the remarkable rating robustness of the product since summer). Others have laid the blame firmly at the door of the market making arrangements.

Two things went wrong. Firstly, the availability of continuous executable prices for bonds on screens, which is a boon in normal market conditions, was a liability when markets turned volatile. In particular those banks who have long made a commitment to this market, and as a consequence have literally hundreds of market making commitments to honour, were put in the difficult position of being forced buyers when the market started to deteriorate. As an inevitable consequence they withdrew from continuous executable pricing on systems such as MTS. Secondly, the fixed bid/ask spreads in covered bonds started to become far smaller than the bid/ask spreads in any comparable markets, most significantly in the swaps and agency markets. When the spread on the hedge is greater than the spread on the underlying asset it is more profitable to sell the bond than it is to hedge it. Inevitably the trader buying the bond was looking at the same screens and they were forced to sell the bonds too. The so called 'hot potato' trading developed where one bond passed from trader to trader at ever wider spreads, with each trader minimising their loss by selling the bond rather than hedging it.

Obviously this situation was untenable and one by one banks withdrew their prices from MTS and started quoting on wider spreads in 'phone trading. Inevitably transparency and liquidity were the losers and volatility was the winner of this development.

4 / 8-TO-8: THE MARKET'S ADVISER

There were attempts by trading groups to reduce the causes of this volatility, for example a proposal from the ACI to maintain market making rules on 'core' covered bonds whilst relaxing them on 'peripheral' bonds. Inevitably an attempt to differentiate the market with an arbitrary 'line in the sand' was controversial and participants in that decision were aggrieved to find that their involvement was held against them by issuers.

The ECBC took it on themselves to find a solution to the impasse. At the September meeting of the ECBC it was decided to set up a committee which would make recommendations as to the relaxing or tightening of market making rules in response to market developments. To avoid the problems that the ACI encountered it was decided that this committee should contain senior representatives of both market makers and issuers, that its size should be limited (inevitably controversial with those excluded), that its deliberations should enjoy total confidentiality and that it should focus on a rapid response to short term market disruptions. Thus the ECBC '8-to-8' Market Makers and Issuers Committee was born.

The '8-to-8' committee's constituents are representatives of the issuer communities in each of the 8 largest covered bond countries – as calculated annually by the ECBC secretariat, currently, Germany, Spain, France, Ireland, the Netherlands, Portugal, Sweden and the United Kingdom - and representatives of the 8 market makers that currently have the most market making commitments outstanding.

The '8-to-8' has since convened several times and has made recommendations as to appropriate trading rules for the current market environment. These recommendations are all available on the ECBC website and are broadly circulated to all market participants. Inevitably some of these decisions have attracted controversy - a broad market consensus on these topics is impossible. But market participants and commentators alike have recognised that the '8-to-8' committee, by providing a flexible and senior response to market developments has been a positive development for the market as a whole.

Criticisms that the 8-to-8 was not fully representative of the market are of course valid. However by limiting their remit to a response to market developments, (where the large and the medium sized market makers are unlikely to disagree with each other) rather than more fundamental topics, the committee has effectively addressed these criticisms.

It did however raise the question of whether longer term reform of trading is needed and if so, how this should be achieved?

5 / THE CURRENT DEBATE

It has been argued that the large number of market making commitments entered into by some banks are, in these market conditions, far more onerous than the banks were compensated for when they underwrote the original transaction. Rigid adherence to the original agreements punishes precisely those banks that have made the greatest long term commitment to the covered bond market. The obvious counter-argument to which is that market making agreements were never intended to be 'fair weather agreements' and their signatories must continue to honour them in volatile times if they are to have any value.

The difficult commercial situation of the largest market makers is more easily accommodated when trading is 'phone' based. Their prices are no longer accessible to all on a real time basis, and they can not be 'hit' simultaneously on all of the bonds that they make markets in. At the same time, the very fact that they are the largest market makers definitively gives them more access to information about flows in the market. This competitive advantage (which doesn't exist when everyone can see the same screens) helps to offset the burden of the large number of commitments and should make it easier for traders to continue to honour their commitments.

Having said that, 'phone based trading is clearly failing the market in many respects. Chief of which is the lack of transparency, which undermines confidence for investors, makes new issue pricing less accurate and which exacerbates the risk of the entire market re-pricing to 'credit' type spreads. As a consequence of this many investors have withdrawn funds from the market and some have reclassified covered bonds into their credit portfolios – a very worrying development.

On the other hand, is there any way in which some transparency can be restored to the market whilst respecting the commercial reality for the market makers?

6 / THE ECBC'S RESPONSE

The first attempt to reconcile the needs of all of market participants came from Mr Ted Packmohr of Dresdner Bank. He proposed that the current phone trading practices could be replicated electronically, rather than 'phone one another, traders would send an electronic Request For Quotes (RFQ), with the reply and subsequent decision whether to deal or not being similarly automated. Replacing phone calls with automatic messages wouldn't upset any normal commercial activities but would at least allow some post deal reporting (with a sufficient delay to protect commercially sensitive information) and thus address the markets opacity.

The ECBC Market Related Issues Working Group developed this proposal into a discussion paper in January 2008 (available on the ECBC's website). This paper was widely circulated and received an impressive 24 formal replies from market makers, issuer representatives, systems providers and investors. These replies were presented to the ECBC's plenary meeting in Milan in March 2008 (summary also available on the ECBC website).

To (over simplistically) summarise these replies, they can be divided into two broad schools of thought:

- some respondents, typically those who emphasised the importance of the market making concept, accepted the idea that the RFQ model was the least disruptive way to introduce transparency whilst allowing existing market making conventions to survive. Their replies tended to emphasise the detail of how to make such a market work.

- Others said that the concept of market making needed more fundamental reform and that such a system would only protect a set of trading conventions that was at odds with those in other comparable markets and ultimately to the detriment of the market. These replies tended to suggest alternative systems for the market.

Recognising the impossibility of reconciling these two views, and the urgent need for some practical input to the design of such a system, the Working Group turned to several potential systems providers to drive the debate forward with some concrete proposals. Six possible solutions providers (BCG, Bloomberg, Eurex, ICAP, MTS and Tradeweb), made presentations to the market making community at a meeting in the offices of Credit Suisse, London in May 2008. At the time of going to press, ECBC secretariat and the working group is compiling feedback on these presentations.

Hopefully this initiative of the ECBC will result in one or more trading platforms being developed in the near future.

The covered bond market's reputation for liquidity and therefore the tight spreads and high market capacity that have characterised it since the Frankfurter Hypothekenbank deal in 1995, depend heavily on our ability to adapt to the new trading paradigm.

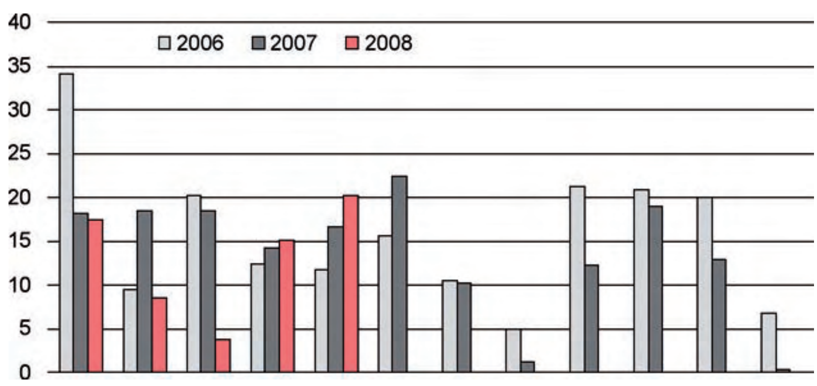
1.2 COVERED BONDS AS A FUNDING TOOL

By Ralf Burmeister, LBBW, Franz Rudolf, UniCredit, Claudia Sigl, Bayern LB and, Frank Will, RBS.

Covered bonds continue to gain in importance as increasingly banks have started to use covered bonds as one of their funding tools alongside securitisation and unsecured funding. In the current challenging market conditions, covered bonds represent one of the cheapest wholesale funding instruments for banks and most issuers view them as vital for an optimal asset-liability-management. Moreover, the introduction of Basel II and the EU Capital Requirements Directive (CRD) has significantly reduced the capital relief advantage of securitisation and created a more level playing field between both asset classes. Attracted by the advantages of the product, we have seen almost 50 new covered bond issuers over the last couple of years coming from established and new covered markets across Europe including Denmark, Finland, France, Hungary, the Netherlands, Norway, Portugal and Spain as well as new issuers out of Canada and the US. The advantages of covered bonds will attract further issuers, in our view, and we expect a number of new issuers out of new covered bond markets like Italy, Turkey, Greece, Central and Eastern Europe as well as Japan and Korea.

The strong primary activity in covered bonds during the second half of 2007 and the first half of 2008 underlines the key message of the covered bond market that covered bonds were not unaffected by the credit crisis, but were the least affected. Since the crisis started in summer 2007, the covered bond market showed that primary market activities do work even in an adverse environment. With an issue volume of EUR 124 bn between July 1, 2007 and June 9, 2008, just in the Jumbo format (without considering the issuance activity of registered or non-Jumbo-size covered bonds), the covered bond market was the most active among the asset classes available for banks as funding tools. And except for the time period of a few weeks, i.e. the last six weeks in 2007 and a few weeks in February/March 2008, issuance levels even came close to those in the previous year.

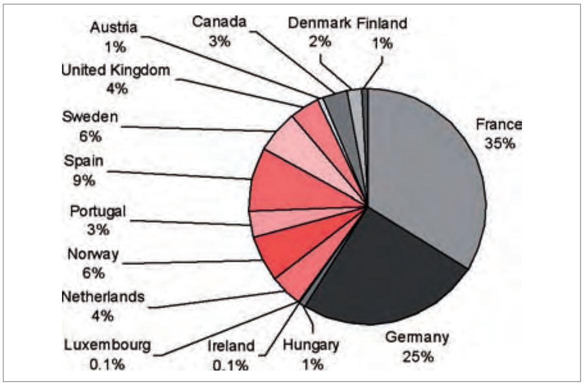
> FIGURE 1: JUMBO COVERED BOND ISSUANCE VOLUMES ON A MONTHLY BASIS



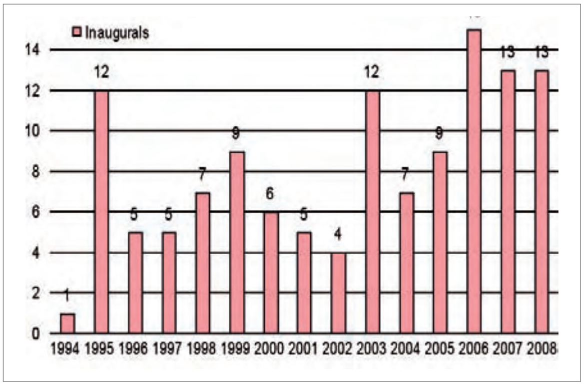
Source: UniCredit Global Research

The highest volumes of new issuance came from Germany and France. Since July 1, 2007, Germany issued EUR 31.2 bn in Jumbo covered bonds, and France even EUR 41.8 bn, representing a market share of 25% and 34%, respectively. We see two main reasons for this, one being the strong demand from domestic markets (market depth), and the second being the stable spread development of these two markets relative to other covered bond markets, which in turn is also partially a consequence of market depth. The strong demand from domestic investors is a very supportive factor for covered bond issuance. German investors in Pfandbrief issues accounted for up to 90% in the recent past. In the case of France, this share was up to 50%. This compares to other markets in Europe, where the domestic demand for new issues was significantly lower – sometimes even below 10%. The numbers underpin the fact that the ability to issue new covered bonds is highly correlated with the strength of domestic bid. This is also (partially) reflected in the respective spread levels of different markets. While the spread development of the overall iBoxx Covered Bond Index widened by 27 bp since the beginning of July 2007, and some markets significantly exceeded this range (e.g. UK covered bonds +57 bp, Spanish covered bonds +45 bp), German Pfandbriefe only lost 6 bp and French Obligation Foncières moved only 10 bp wider. But not only did the spread difference between markets increase, also the differentiation of different names within the same market became higher. In the case of France, the picture is even a bit more diversified: the issuance volume of EUR 41.8 bn since mid 2007 consists of EUR 20.7 bn Obligation Foncières, EUR 7.7 bn CRH, and EUR 13.5 bn French structured covered bonds. While Obligation Foncieres and CRH's covered bonds widened by around 10 bp, French structured covered bonds widened by around 20 bp. In our view, in case of French structured covered bonds the effects of strong domestic demand and high issuer credit profiles played a more important role than actual spread levels. Overall, stable spreads enabled issuers to access the market at reasonable funding costs even in a distressed environment. In addition, the diverse development of spreads and the difference in issuance activities are also influenced by the status of the respective real estate markets, as well as by the status of the underlying legal framework. However, these effects are more diffuse and not uniform across the covered bond universe.

> FIGURE 2: ISSUANCE SINCE JULY 2007



> FIGURE 3: INAUGURAL ISSUES



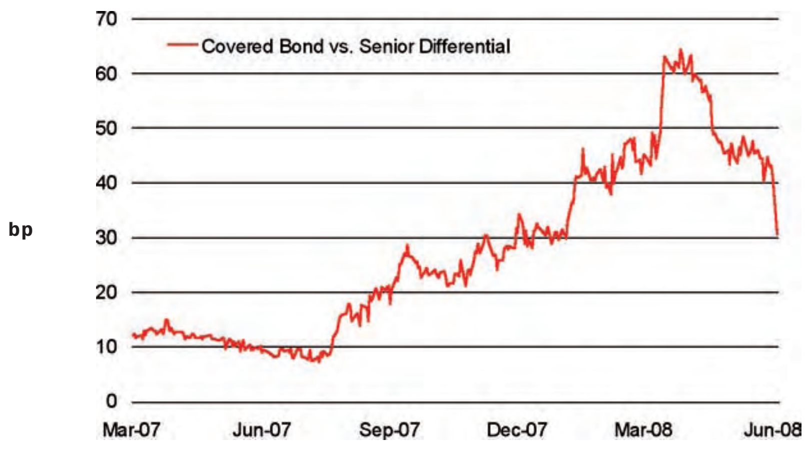
Source: UniCredit Global Research
Notes: Data as of June 9, 2008.

Given the overall difficult market conditions, it is quite remarkable that up to July 2008, about 20 inaugural issuers joined the covered bond community. We saw new issuers from Canada, Denmark, France, Germany, the Netherlands, Norway, Portugal, Spain, and Sweden successfully launching their first Jumbo covered bond. Thus, even in times of the crisis, new issuers as well as new covered bond structures were successfully launched. In our view, this demonstrates two things: (i) the increased relative attractiveness of covered bonds vs. other asset classes like unsecured paper or securitized assets, as well as (ii) the advantage of newcomers not to spoil their secondary market curve due to high new issue premiums.

The first point emerged when markets for mortgaged backed securities broke down following the subprime crisis, and also dragged down senior unsecured paper from banks. The formerly favourable play of buying, originating, and repackaging loans in order to place them via securitization to investors was severely disturbed. These markets were basically shut down for months and only recently started to recover slowly. Therefore, the on-balance sheet refinancing of loans - as it is part of the common covered bond technique - has become increasingly important for funding strategies of banks.

In respect to senior unsecured funding, the price of covered bond funding has decreased in relative terms. While the spread difference between covered funding and senior unsecured funding used to be in the range of 10 to 20 bp in the past, this picture has changed dramatically. During the crisis, levels of up to 60 bp have been reached on an overall basis. Thus, with funding via securitisation hardly being available and unsecured funding much more expensive, the role of covered bonds as an attractive funding tool increased significantly.

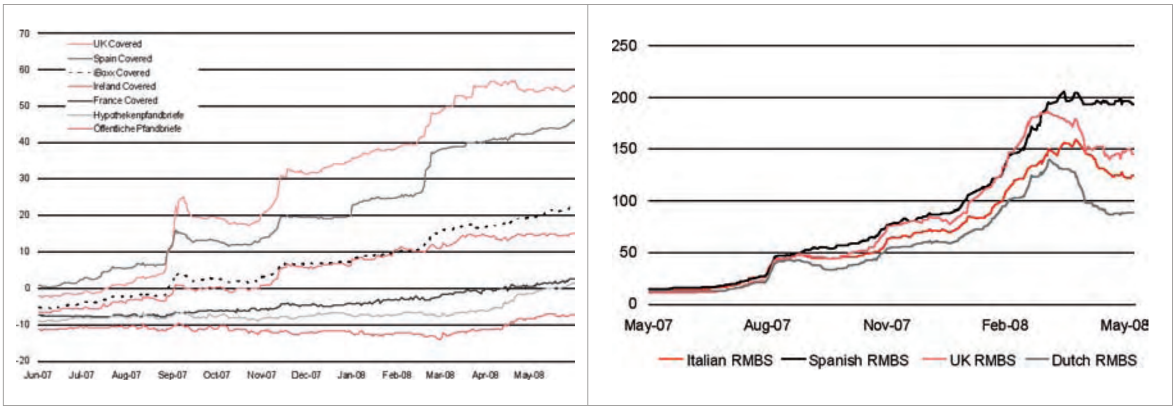
> FIGURE 4: SPREAD DIFFERENTIAL OF COVERED BONDS VS. SENIOR UNSECURED BONDS



Source: UniCredit Global Research

The second point gained in importance since investors suffered from marked-to-market write downs due to the credit crisis. Thus, "old" issuers had to decide to either tap the market, pay a relatively high new issuance premium (sometimes up to 20 bp), and trigger a price adjustment of their already outstanding covered bonds, or wait for better days to come (or issue registered covered bonds, which are not marked-to-market). This dilemma, however, was not relevant for inaugural issuers. In addition, funding through covered bonds (even at relatively high levels) compared favourably for the new issuers to their previous funding tools (i.e. unsecured paper, MBS), and helped to secure their business model. Thus, the entry barrier for these new issuers was rather low from a spread level perspective. Overall, the engagement of new names in the covered bond market created new momentum for the complete covered bond community as name diversification increased, and the status of covered bonds as a reliable funding tool was improved further.

> FIGURE 5: COMPARISON OF COVERED BOND SPREAD DEVELOPMENT VS. AAA RMBS SPREADS



Source: UniCredit Global Research

During the crisis, the liquidity of the covered bond market and here especially again the Jumbo segment, has been negatively affected. But this should not be seen as an isolated event or a covered bond specific problem as various other neighbouring markets like e.g. RMBS or even European Government bonds also had their difficulties in trading conditions as shown, for example, by a sharp increase of bid/offer spreads in these instruments. Also, one has to keep in mind the large spread widening of some Euro-government bonds which also drove out spreads of covered bonds out of the countries concerned.

Covered Bonds – from Rates to Credit...?

Another outcome of the financial crisis is the discussion, whether covered bonds should be treated as credit products instead of rates products. In general covered bonds are and have always been hybrid products as far as they can be clearly assigned neither as a straight rates product nor as a pure credit product.

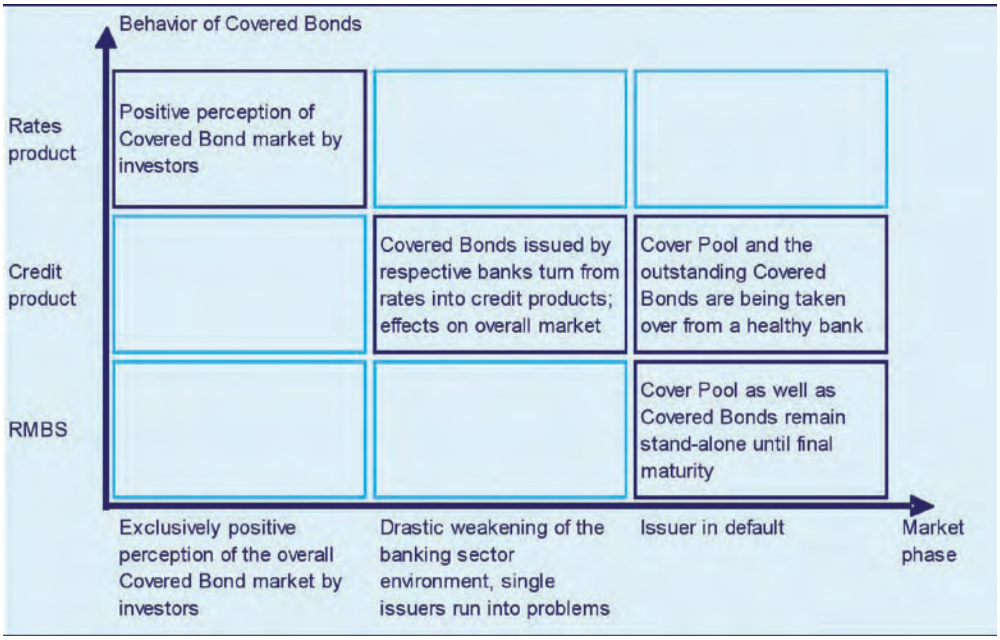
Depending on the overall market situation the perception of this product changes somewhat. In times of strong excess demand especially for Triple-A investments covered bonds are regarded exclusively as a rate product. Also the Market Making commitment, which could be seen as a characterisation of rate products, helps to create the image of covered bonds being a rate product.

In a market phase of exclusively positive perception of the overall covered bond market the behaviour of covered bond resembles straight rate products. Whereas in a phase of drastic weakening of the banking sector environment the perception of covered bonds turns from “rate” into “credit product”.

With increasing problems within the banking sector and a highly volatile swap market, the spread development of especially mortgage-backed covered bonds issued by respective credit institutions deteriorates. Consequently repercussions on covered bonds mainly through negative effects on the issuing banks are observed. This is not concentrated on individual issuers; rather there are overall effects on the whole market.

In addition the perception of covered bonds has changed since August 2007 along with the temporarily modified or suspended Market Making arrangements respectively – at least from an investor's point of view.

> FIGURE 6: PERCEPTION OF COVERED BONDS CAN CHANGE



source : LBBW Credit Research

The worst case scenario regarding the modified classification of covered bonds should be seen in a market phase of an issuer's default. If the cover pool as well as the covered bond issuing tool remain stand-alone until the final maturity of the outstanding bonds, the product will turn into an RMBS equivalent. However, we have no reason to expect this outcome in the near future.

Nevertheless, a portion of the covered bond market has been particularly affected by the shift in the last quarters, due not only to the risky situation on certain real estate markets, but also to the perception of a weakening quality of the issuer as manager a dynamic cover pool and a lack or perceived weakness of covered bond legislation.

Without further exploring into this very interesting topic, one has to admit that there have been changes i.e. reactions on the investor side in order to adapt investment strategies and/or asset allocations based on the individual view towards covered bonds within the credit universe.

How does this affect the funding activities?

We already touched on the development between secured and unsecured funding in the above section. From a fundamental point of view, we do not have the impression that covered bonds have changed dramatically in the recent quarters as legal changes have not occurred to a large extent. Also, the underlying credit quality especially in case of mortgage related covered bonds as measured by e.g. level of non-performing assets has not suffered that much in order to explain the spread reactions.

This view is also underpinned by the high degree of rating stability. Until early June 2008, only three examples of downgrades (based on Moody's data) of covered bonds were related to downgrades of the issuing institution. Therefore, it is to examine whether the market movements were rather based on a real deterioration of fundamentals – which just can be demonstrated with a time lag of several months - or maybe more driven by the fear of a large scale deterioration of fundamentals to unprecedented levels in the near future. This later worst case scenario cannot be completely ruled out, but it is fair to state that spread development was not solely based on credit fundamentals but also on liquidity to a considerable extend.

In times of being considered as a rate product, the spread between senior unsecured bank debt and secured bank debt is even tighter than in times of covered bonds being perceived as credit product. During this market phase we can observe that the senior unsecured vs. secured spread is significantly wider.

In this respect Covered bonds remain the preferred funding tool vs. senior unsecured or even subordinated debt. The economic pressure to make use of covered bonds as one funding tool amongst others for any treasury department of a bank has increased during times of severe market stress.

Box 1: Registered Covered Bonds

As one way to react to market turbulences which started in summer 2007, some investors increased their demand in registered covered bond. Vice versa, introducing registered Covered Bonds became more attractive for certain issuers. This format of issuing covered bonds offers exactly the same degree of safety as they offer the identical rights to investors like Jumbo sized covered bonds – a claim against the same cover pool, a full recourse to the same originating bank, etc. The main differences between plain vanilla covered bonds and those covered bonds issued under a registered bond programme are accounting issues and aspects of tradability. With regard to accounting under IFRS, a registered covered bond can be attributed to the category "Loans and Receivables". Therefore, no mark to market adjustments (and therefore temporary write-downs with effects on the profit and loss statement of the investor concerned) needs to be taken as long as the investor does not expect disruptions in the cash flow of the registered covered bonds. As the treatment of registered covered bonds in this aspect is identical to the accounting treatment of loans, it does not come as a surprise that there is no trading in registered covered bonds like there is in all kinds of ordinary bearer bonds. From a legal perspective, registered covered bonds can only be ceded, as they entitle the investor to certain rights. From an economic point of view, there is hardly any difference whether a Jumbo covered bond is sold or a registered covered bond from the same issuer is ceded. But it is fair to say that investors being active in the area of registered covered bond do need a setup i.e. the infrastructure to handle those cessions. There could be restrictions as to how often a registered covered bond might be passed on to other investors (it might also be handed back to the issuer), which in practice usually does not overshadow the attractiveness of this special format of covered bonds. A large portion of registered Covered Bonds is placed with buy-and-hold investors, therefore demand for prices in the secondary market is subdued anyway. Additionally, one great advantage of registered Covered Bonds besides an accounting treatment which helps to reduce portfolio volatility, is the fact that they can easily be adapted to specific requirements of the investor side, i.e. real tailor made issues in terms of e.g. maturities or any kind of structural features. Nevertheless, tradability does not seem to be any kind of obstacle for investors in registered Covered Bonds as a survey from a German bank, conducted just before the outbreak of the crisis in summer 2007 clearly shows: On a scale from 1 (low) to 10 (high), the mainly German investor base in registered Covered Bonds was quite satisfied with the liquidity of this product class as it was given roughly a 6 in terms of liquidity.

In order to shed more light on a market which is by definition a playground for private placements, the ECBC conducted a survey in May 2008 amongst issuing members. Responses were received from issuers representing an outstanding registered covered bond volume roughly EUR 110 bn from six countries: Denmark, Germany, France, Luxemburg, Norway and Portugal. As the ECBC also received feedback from issuers not yet active in that field, it was possible to identify motives for not using registered covered bonds so far: besides legal aspects in setting up the corresponding programme, potential issuers stated that their funding needs are too large in order to deal with registered bonds, other issuers stated that they can meet their funding plans comfortably without having to access this market – therefore, no uniform picture amongst those players still standing at the sideline.

Looking at active issuers, there was a clear statement why registered covered bonds are used. The three most frequently cited reasons are better funding levels, the ability to achieve a higher overall funding volume as well as a diversification of the funding base:

The importance of registered bonds for the particular covered bond bank varies significantly, but looking at an unweighted average, roughly 37% of total covered bonds funding is done by using the registered format. Out of this share, around one third is issued in structured bonds such as single or multiple callables.

When it comes to more favourable funding conditions, the issuers stated that for maturities up to seven years, the funding advantage of registered covered bonds vs. Jumbo style bonds varies between 0 and 3 basis points. The advantage increases to some 4 to 5 basis points when looking at maturities over 10 years. Interestingly, half of issuers identify funding advantages with plain vanilla registered covered bonds while the remainder replied that issuing structures does offer better funding conditions to them.

In accordance with the motives to set up a registered bond programme, roughly 50% of the banks stated that they do address a different circle of investors compared to Jumbo issuance. While the bulk of this paper is sold to German accounts, answers showed also some interest out of Switzerland and Austria.

To sum it up, registered covered bonds have been around for quite some time. However, the exceptional market circumstances in the past months have put this market segment more in the focus of market participants. According to the survey conducted by the ECBC, registered covered bonds should not be seen as a competition for Jumbo covered bonds but rather as a supplement and a useful tool within the funding mix of a bank. So the outlook given by issuers does not come as a surprise: roughly 30 percent of the respondents plan to increase the use of registered covered bonds while the majority tends to keep the current issuing volumes constant. No plans to reduce the use of registered covered bonds were revealed. With several new issuers having entered the market in 2008, it may be necessary to conduct further surveys to explore this most private sector of the covered bond market.

Box 2: Non-EUR issuance

The covered bond market has been dominated by straight fix-rated Jumbo covered bonds and traditional non-Jumbo Pfandbriefe out of Germany, both denominated in euro. The only major exceptions have been the established covered bond markets in Sweden and Denmark which are characterised by a strong domestic non-euro market. However, outside those two markets, non-euro covered bond issuance has grown considerably over the last few years with US dollar, Swiss francs, Pound Sterling, Japanese Yen being among the favourite currencies.

Advantages of non-euro issuance

Issuance in non-euro currencies has a number of advantages from a covered bond issuer perspective. By issuing in local currencies, they are able attract higher demand from the domestic investor base which holds particular true for covered bonds issuance in GBP, CHF, JPY and AUD. Another advantage for the issuers is that non-euro issuance reduces the supply in euro which should support the valuations of the outstanding € benchmarks of the particular issuer and might free up credit lines at investors. By buying such a bond, non-domestic investors on the other hand can play the interest curves of the respective country without taking any significant credit risk given the triple-A character of covered bonds.

Moreover, a multi-currency strategy can offer attractive arbitrage opportunities for covered bond issuers with a more opportunistic approach. Issuance in various currencies enables an issuer to play the basis swap movements between the currencies and to optimise its funding mix.

Last but not least, an increasing number of issuers have broadened their activities on the asset side and have acquired collateral assets outside the Eurozone (e.g. the UK, Switzerland, Denmark, Sweden, Norway, the US, Canada, Japan). These assets are often denominated in local currencies and instead of swapping those assets into euro to hedge the currency risk, the issuer can also issue covered bonds with a similar maturity and size in the local currency.

Development of Issuance and Outlook

Last year's covered bond issuance in US Dollar benchmarks reached even a new record level of almost $20bn. Two-thirds of the full-year volume were issued in the first half of the year (83% of total issuance if July is included). Since the beginning of the liquidity crisis, however, only CFF and Depfa tapped the US dollar market in benchmark size. Other currencies like Swiss Francs, Pound Sterling and Japanese Yen played only a minor role and were primarily used for non-Jumbo sized deals and private placements.

At this stage, it is difficult to forecast, but we see a good chance that non-euro currencies will regain in importance as soon as the financial markets in general and the covered bond market in particular recover. The advantages in terms of investor diversification, arbitrage opportunities through basis swap movement and currency matching of asset funding remain unchanged and will ultimately lead to a revival of issuance in non-euro currencies over the coming years, in our view.

CONCLUSION

Covered bonds are important funding tools for banks and continue to attract new issuers across the globe. One of the main drivers of this impressive growth in numbers is the funding advantage of covered bonds offer compared to unsecured bank paper and securitisation. The resilience of the primary market especially in times of market uncertainty is another reason. Despite the fact that other markets were more or less closed during the crisis, banks were still able to issue covered bonds which were priced - at least in case of the French OF issuers and the German Pfandbrief issuers - only slightly wider compared to pre-crisis levels. We therefore expect that the number of covered bond issuers will continue to grow as more and more banks would like to use covered bonds as funding tool alongside unsecured funding and securitisation.

The strength of the primary market demand can be partly explained by the dual recourse character of covered bonds which offer investors a high level of protection. However, the recent crisis has underlined that covered bonds are hybrids between rates products and credit products. Concerns about the state of the mortgage markets in the various countries as well as about the credit standing of the individual issuers have triggered a selected spread widening in the secondary market. New issue levels well above the secondary market levels contributed to the widening. However, one should not forget that other market segments like senior unsecured bank debt or securitisation have suffered much more during the crisis and that covered bonds in general benefited from a strong rating stability.

Despite a strong primary market, the liquidity of covered bonds (or better the lack thereof) has been one of the key topics over the last twelve months. Many investors were disappointed by the lack of liquidity in the covered bond market. Several attempts by the ECBC ‘8-8’ Market Makers and Issuers Committee to restore liquidity in the market were only partially successful and liquidity in particular at the longer end of the curve remains low. There are, however, a number of initiatives under way to improve the market liquidity including the expansion of electronic trading which will hopefully improve the situation in the secondary market. Moreover, we believe that the expected convergence of the spread levels in the primary and secondary market will decrease the relative attractiveness of new issues compared to ‘old’ covered bonds which will increase the number of buyers of bonds in secondary market and should ultimately help to improve the overall liquidity.

1.3 THE INVESTOR'S PERSPECTIVE

By Fritz Engelhard, Barclays Capital
and Torsten Strohrmann, DWS Investment GmbH

I. INTRODUCTION

Since mid-2007, capital markets have suffered ongoing disruptions to money market conditions in major currencies, resulting from forced bank balance sheet growth and a simultaneous rise in bank credit risk aversion among institutional investors. The resulting drought in term liquidity has led to persistent illiquidity in interest rate and currency swap markets. The combination of these issues has had serious implications for benchmark debt markets, including covered bonds.

Since mid 2007 inter-bank market-making conditions across cash €-rates products have been characterised by lower volumes, quoted at wider bid-ask spreads, and an increasing bias to unwind positions through client flows. In mid-March 2008 and more recently again in early July 2008 liquidity vanished in any cash €-rates product including government bonds, except for those government bonds who were deliverable in future contracts. For some covered bonds no bids are available at all or only at very wide spread levels, whilst offer prices are sometimes quoted 200bp tighter.

In this chapter we discuss the implications of the stressed environment from a covered bond investor's point of view. We highlight the different stages of re-pricing which were the result of reduced market liquidity and increased spread volatility. We also describe the decreasing number of options available to covered bond investors in order to manage their positions and also how portfolio managers needed to adapt their approach to the new environment.

II. CRISIS? WHAT CRISIS?

Jumbo covered bonds have an explicit contractual commitment from syndicate banks, to provide liquidity to the inter-bank market. According to the Jumbo market making agreements, a minimum of five market makers were generally committed to quote tight bid ask spreads for lots up to €15mn. Over a long period, the Jumbo model largely resulted in a quite favourable environment for covered bond investors. Before August 2007 investors had the choice among a rather large number of market makers who were all able and ready to provide competitive pricing.

Routinely the Jumbo model was also regarded as an instrument to help isolate the covered bond market from an overall deterioration of secondary market liquidity, which could also help reduce spread volatility. However, shortly after the breakout of the financial markets crisis, the Jumbo market making arrangements resulted in high spread volatility. The industry-wide de-leveraging process has caused a general downsizing of cash product inventory at investment banks. The attempts to maintain the respective Jumbo market making commitments kept the market open as one of the few channels still available for unwinding positions. This was also possible because the respective committees representing covered bond market makers and issuers amended their recommendations for the application of the respective rules several times. While in August 2007, market-making efforts were purely coordinated by the ACI Committee of Covered Bond Market Makers, a further attempt was made to improve coordination with the introduction of the ECBC 8-to-8 committee in September 2007. Figure 2 below lists the recommendations of both bodies since the breakout of the crisis in chronological order.

> FIGURE 1: RECOMMENDATIONS ON JUMBO COVERED BOND MARKET-MAKING PRACTICES

Date	Event
16 Aug 07	The ACI Committee of Covered Bond Market Makers announced that the covered bond market-making will continue with tripled bid/offer spread.
29 Aug 07	The ACI Committee of Covered Bond Market Makers announced that it unanimously agreed to recommend a re-tightening of bid/offer spreads to double regular spreads.
4 Oct 07	The newly established ECBC "8-to-8" Market Makers and Issuers Committee meets in order to develop clear "crisis guidelines" for market participants and recommends that double bid/offer spreads remain in place.
21 Nov 07	ECBC "8-to-8" Market Makers and Issuers Committee recommends the suspension of inter-bank market-making "in order to avoid undue over-acceleration in the widening of spreads."
26 Nov 07	ECBC "8-to-8" Committee recommends the resumption of inter-bank market-making with 3 times normal bid/ask spreads and min. volume of €5mn.
4 Jan 08	ECBC "8-to-8" Committee recommends the resumption of inter-bank market-making with 2 times normal bid/ask spreads and min. volume of €15mn.
11 Jan 08	ECBC "8-to-8" Committee recommends for certain transactions trading at a bid spread of Euribor +20bp or above 3 times normal bid/ask spreads and min. volume of €5mn.

Source: ACI Germany, ECBC.

The combination of one-way traffic and the artificially enhanced inter-bank market liquidity had some unpleasant consequences for investors. It resulted in swap spread widening, an increasing divergence between screen prices and executable prices, a smaller number of available counterparties, lower executable volumes and thus a significantly hampered ability to actively manage cash positions. To most investors this was a quite unpleasant surprise, as they thought that the Jumbo scheme would help protect them exactly from such developments. At the same time, the cheapening of many covered bonds was regarded as a sign of deteriorating quality, which at this point in time was generally completely unfounded. Thus, whilst from a credit quality point of view at this point in time there were hardly reasons to be worried, the liquidity crisis led to results which signalled the opposite.

Some covered bond investors were regarding the spread widening in Q3 2007 as an opportunity to enhance exposure in this asset class. This resulted in a significant spread tightening between mid September and mid October 2007 particularly in those sectors which suffered strongly in the first wave of selling. In addition, the increase of primary market activity in Q4 2007 also reflected more appetite to benefit from attractive spreads. Whilst in January 2008 market activity seemed to resume satisfyingly the situation deteriorated further in February/March.

III. PRISONER'S TACTICS

In mid-March 2008 the liquidity crisis seems to have reached a trough. Inter-bank liquidity vanished in any cash €-rates product including government bonds, except for those government bonds who were deliverable in future contracts. For some covered bonds no bids were available at all or only at very wide spread levels, whilst offers were available at much tighter levels.

At the latest, mid March was also the point in time were fundamental credit concerns started to have a more important impact on spreads compared to de-leveraging activity. Both, the performance of underlying cover pool assets and the credit profile of issuing institutions took centre stage. In order to properly gauge fair value of covered bond programmes, the cooperation with financials and securitization analysts has become much more important In addition, the programme structures of some of the less well-established programmes were subject to further scrutiny.

Whilst there was very low primary market activity in March, new issuance activity picked up again in Q2 2008. However, significant premiums of 10bp and more versus outstanding covered bonds needed to be paid in order to attract sufficient demand, thereby unveiling the spread level with a "true" bid for the respective bonds. Again, covered bond investors suffered from a re-pricing many of their covered bond holdings, which this time was less driven by de-leveraging activity but more so by primary market transactions. Another unpleasant side effect of this situation was the fact that the significant new issue premiums could hardly be realized through switches, as the bids for comparables were generally adjusted to the price level of the new bond.

As there were fewer and fewer options to actively counter a further underperformance, many investors felt like kept imprisoned in their positions. However, most investors adapted their management approach to the new environment. In order to cope with the limited secondary market liquidity and the danger of a continued re-pricing of covered bond holdings they started to focus on shorter maturities, as well as private placements and investments in registered covered bonds. The bias to prefer covered bonds with a shorter final maturity was additionally driven by the inversion of the swap curve and the significant widening of the Schatz asset swap spread. Furthermore, European mutual bond funds experienced unprecedented redemptions since mid-2007. This has caused many asset managers to maintain a rather high cash buffer. Thus, there was an additional incentive to invest in bonds with a quite short maturity. At the same time, duration was increasingly managed rather with the respective off-balance sheet products, which suffered less from the global drain in liquidity.

IV. WHERE DO WE GO FROM HERE AND LESSONS OUT OF THE LAST CRISIS?

The realities in covered bond markets will very much remain a function of global financial market conditions. These will very likely be characterized by rising macroeconomic uncertainties, ongoing regulatory intervention, persistent tensions in money markets, reduced risk appetite, lower leverage, high volatility as well as reduced transaction volumes and liquidity. Thus, conditions in covered bond markets will remain challenging. Whilst this creates interesting investment opportunities, the experience of the past 12 months should also be taken as a lesson to learn how to limit spread volatility of covered bonds in the future. In particular the incentives to provide secondary market liquidity should be considered as well as the standardization of minimum liquidity requirements. This is important as the business case of some investors in Covered Bonds often is based on a high liquidity assumption, reflected in low sourcing and search costs and availability of prices at any time.

The quality features of Covered Bonds lured new investors into the market not having had the experience from 2000-2001, where there was already a difficult time for Covered Bonds. The crisis of 2000-2001 showed significant spread widening for at that time merely Pfandbriefe and that liquidity is an issue in Covered Bonds.

A point to be taken out of 2000-2001 is that it was the right decision to buy Covered Bonds at high spread levels or at least to keep them. Even distressed names regained confidence in the market and traded even tighter than before a few months later. The situation we are in now looks similar but on a larger scale. Defaults in Covered Bonds are not likely, so the question is about timing-the-buy and having the time to hold the bonds either to maturity or until the dust has settled again.

1.4 GENERAL LAW BASED FRAMEWORKS: STRUCTURED COVERED BONDS

By Michelle Bradley, Morgan Stanley

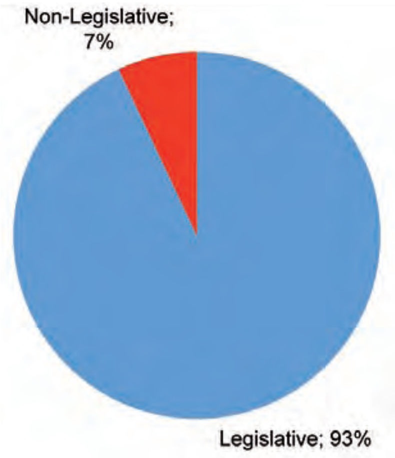
Structured Covered Bonds

The structured covered bond market has come full circle in 2008. In 2003, HBOS came to the market with a revolutionary new concept – a structured covered bond. The aim was to create a "Pfandbrief" within the confines of UK law. The idea was quickly adopted in the UK and beyond.

In 2008, five years after HBOS launched the structured covered bond, legislation was passed in the UK which created a legal framework for the issuance of covered bonds. The Dutch have also passed covered bond legislation in July 2008.

Figure 1 shows the breakdown of the covered bond market as it stands today.

> FIGURE 1: COVERED BOND MARKET BREAKDOWN



Source: Morgan Stanley

Now that the UK and the Netherlands have moved to a legislative framework the proportion of covered bonds not issued under a specific covered bond legislation is actually quite a small percentage of the market. Does this spell the end for the structured covered bond market? We discuss the future of structured covered bonds in the context of the developments in the covered bond market over the past five years and also the credit crunch of the past year.

Why Structure? Imitation Is the Greatest Form of Flattery

In order to look at the future of the structured covered bond market, it is useful to explore the motivations to create a structured covered bond in the first place.

The introduction of a structured covered bond was a seminal change for the covered bond market. However, there was another important change that preceded the introduction of structured covered bonds, and that was covered bonds backed by residential mortgages. The covered bond market had predominantly been a funding tool for public sector loans – the Pfandbrief market was split about 75% public sector versus 25% mortgages. Cedulas issuance changed all that. The combination of an existing legal framework and a booming housing market created the right climate for Spanish banks to embrace covered bonds as an alternative funding source to unsecured debt and securitisation. In a spread tightening environment with demand for yield pickup, Cedulas flew off the shelf. Cedulas heralded the concept of residential mortgage backed covered bonds.

Against this backdrop it becomes a lot clearer why the concept of covered bonds appealed to issuers beyond the traditional covered bond markets. Covered bonds could provide not only cheaper funding, but a diversified investor base and funding source. The combination of the reputation of the Pfandbrief for safety and security among an interest rate investor base and the growing demand in the market for Cedulas backed by residential mortgages created the ideal environment for a new product that took some elements from each.

The fact that HBOS went to such great lengths to re-create the features of the Pfandbrief within UK law is testament to the success of the Pfandbrief as a product. It also indicates the initial issuers of structured covered bonds wanted to maintain and preserve the status quo rather than revolutionise the covered bond market. The introduction of a legal framework in the UK and the Netherlands was simply the logical next step in that process.

Structured vs. Legislation – Two-Way Flow

But the last five years have not just been about structured covered bonds moving towards a legislative framework. Perhaps a much more interesting development, in the context of the future of the covered bond market, is issuers who are choosing structured covered bonds when a legal framework is available. Again, it is important to look at the reasons why issuers are choosing the structured route rather than legislation.

By choosing structured rather than legislation, issuers are choosing not to be confined by the terms and conditions set out in legislation. Whereas the UK issuers looked to assimilate many of the features of the Pfandbrief into their structure, the new band of issuers are starting from a very different place. Instead of looking to achieve an end product, they are looking at their own situation and balance sheet and choosing a framework that works best for their needs. By doing, so they can create a bond that enjoys some of the benefits of being a covered bond but doing so in a way that is most efficient for them.

You Get What You Pay For…

A legislative framework provides both the issuer and the investor with a lot of benefits. Legislation has the advantage of creating a standardised product. All covered bonds issued under the same legislation will have the same characteristics — i.e., there is a minimum standard to which the bonds must comply. For example, all Pfandbriefe will have a pool with maximum LTV of 60%, though individual issuers may have lower. The fact that the terms and conditions are set down in law and supervised by the regulator offers additional comfort for the investor.

However, there is a price to pay for this additional level of comfort for both the issuer and the investor. For the issuer they need to maintain a high-quality dynamic pool and usually with a level of over-collateralisation – something which adds to the cost of issuing covered bonds. Similarly for investors, structured covered bonds have tended to trade at a discount to legislation backed covered bonds.

In the credit crunch this gap has widened significantly. So although legislation does provide issuers and investors with benefits, they are not free.

Therefore, I think it is important to look at the choice between legislation and structure from an economic perspective. The new wave of French issuers like BNP-Paribas and CM-CIC have the option to issue Obligation Foncieres. There is no doubt that they will have considered this option and weighted it against the costs involved.

In issuing a structured covered bond, issuers are not undermining legislative covered bonds in any way, in my view. Rather, they are simply evaluating their options – do the benefits of issuing under legislation outweigh the flexibility of issuing structured covered bonds? For some banks the answer will be yes, for others it will be no.

This does suggest a ripple of change in the covered bonds market. The initial structured covered bond issuers have become part of the establishment by introducing legislation. Issuers who choose to structure when they can use legislation are, in a sense, rejecting the establishment. They are taking the concept of a covered bond and moulding it so that it fits into their landscape and, perhaps more importantly, is an efficient way of raising funds.

Credit Crunch – Back to Basics

The covered bond market, like others, has suffered through the credit crunch. The primary market has remained open throughout, but some issuers have found it difficult to come to market. The first Spanish issuers did not venture into the market until May 2008, UK issuers have also been notable by their absence (at the time of writing), and the ACS mortgage backed issuers have also been on the sidelines. The tie that links all these three types of covered bonds is not that they are structured, as of March 2008 all have legislation backing them, but rather that they come from jurisdictions where there are concerns over the housing market.

However, in the current environment for some investors, the idea of “structured” and “mortgage” in the same sentence is unthinkable, let alone in the same product. As we move to a less benign credit environment there will be more emphasis on the quality of the issuer, the quality of the assets and the procedure in the case of issuer insolvency. Through the pricing structure, the market has shown that it has a preference for legislative covered bonds and as such has typically been prepared to pay more for covered bonds issued under legislation.

The pricing structure of new deals done in the first five months of 2008 confirms that spreads between structured and legislative covered bonds have widened even further. That is not to say that investors do not want to buy structured covered bonds – far from it – but they are demanding a discount. The simple explanation is that we are simply moving back to a world where the concept of risk and reward has returned.

What is the Future of the Structured Covered Bond Market?

Structured covered bonds are at an important juncture. The adoption of the structure by issuers who could otherwise issue covered bonds backed by legislation is validation of the concept of a structured covered bond. By going this route they are adapting the covered bond concept to fit around their needs.

This raises the question of how the principle of a covered bond can be extended further. In our view, this can be extended to include assets other than mortgages and issuers other than banks.

The current credit environment may have implications for the development of this process. The credit crunch has resulted in the re-pricing of risk, and from an issuer's point of view, the cost of funding has increased. As spreads have widened on covered bonds, the decision to issue via legislation or structure, or whether to structure with alternative assets, has changed. This is no longer a market where there is a 20 bp difference between the cheapest and the most expensive issue. Differentiation between issuers, asset pools and form of issuance exists and is priced in. This means that those issuers who want to step away from the standardised covered bond model will have to pay up accordingly.

Some may argue that expansion in this a direction has negative implications for the covered bond market as it is. We disagree. Taking the principle of a covered bond and applying it to other issuers or assets is proof that the concept of a covered bond works. It remains to be seen whether the pricing, for issuers and investors alike, still makes sense in risk-averse, leverage-scarce world.

The author is a research analyst at Morgan Stanley & Co. International plc. *The views expressed are the author's and may differ from views of Morgan Stanley's Research Department and from the views of others within Morgan Stanley. This article is not an offer to buy or sell any security/instruments or to participate in any trading strategy. For important conflict disclosures relating to this article,*

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1.5 POOLING MODELS IN EUROPE

By Otmar Stöcker, Association of German Pfandbrief Banks

1. INTRODUCTION

Since 1995 there is a clear tendency to issue covered bonds on a large scale in Jumbo format. Although smaller private placements are still successful and were used more intensely during the last few years, especially since mid 2007, the discussion on how to pool assets in order to facilitate large issues of covered bonds were intensified all over Europe.

A special focus on this was laid in the new covered bond countries in Central and Eastern Europe, where the volume of mortgages is not big enough to enable single originators to issue large scale covered bonds, which could be attractive for international investors. Therefore, the Polish Mortgage Foundation focused on pooling models, when dealing with funding of mortgages during its "II Forum: Single European Mortgage Market" on 25 May 2007 in Krakow.

It is not well noticed that there are several pooling-models working in Europe, some of them for a long time already. The Krakow panel therefore combined experienced and new structures, legally regulated and contractual ones. The models presented and the specialists were the following (as of May 2007):

Morten Baekmand, First Vice President, Nykredit
Enrique Blázquez , Director - Securitization, Caja Madrid
Karlo Fuchs, Associate Director, European Covered Bond Ratings, S&P
Christoph Hiesberger, Member of Management Board, Pfandbriefstelle der österreichischen Landes-Hypothekenbanken
Gyula Nagy, Chief Executive Officer, UniCredit Jelzálogbank Zrt.
Henry Raymond, Chief Executive Officer, Caisse de Refinancement de l'Habitat
Joerg Schmid, Managing Director, Pfandbriefbank Schweizerischer Hypothekarinstitute
Otmar Stöcker, Moderator, Managing Director, Association of German Pfandbrief Banks
Heinrich Thiele, Senior Vice President,
International Legal Department, Landesbank Baden Württemberg

This article is mostly based on the outcome of the Krakow panel, but includes some new developments, especially regarding Denmark. This article was only possible with the support of the panelists mentioned above, who checked and amended their respective country chapters.

2. BUSINESS STRUCTURE AND LEGAL ISSUES

The issues addressed in the Krakow panel were:

- Structure of the pooling-models
- Cash flow structure
- Accounting - On whose balance sheet are the mortgage loans?
- Capital requirements - Who has to risk weight what and how?
- Costs, fees, efficiency?

Several specific legal issues were discussed:

- How are covered bonds linked to cover assets? Is a transfer of mortgages (loan claims and/or real estate collateral) necessary and if yes, how is it done? (full assignment or only pledge/charge? statutory or contractual way?)

- Insolvency segregation issue? trust? fiduciary relations?
- Banking secrecy - transfer of data
- Cross-border mortgage loans as cover assets in pooling-models?

The following country reports summarize the fundamental outcome of the explanations and discussions in Krakow.

2.1. Austria

Pfandbriefstelle is a credit institution under public law with the purpose of issuing Pfandbriefe and other bonds for its member institutions.

The Pfandbriefstelle was founded in 1939 and is a bank under public law (Pfandbriefstelle-Gesetz). As a public entity, Pfandbriefstelle has no shareholders, but members, which are all Austrian Landes-Hypothekenbanks.

The cover assets (loans to public sector and mortgage loans) are originated by the member banks. The issuance proceeds are passed on to the member banks. Cover assets remain in the balance sheet of the member banks. Pfandbriefstelle gets an issuance fee of less than one bp by its members.

According to an Austrian regulation (2. Pfandbrief-Verordnung) in the case of issuance of Pfandbriefe by Pfandbriefstelle it is not necessary to transfer the cover assets to Pfandbriefstelle. Therefore the cover assets remain in the balance sheet of the member banks, they do the risk weighting, not the Pfandbriefstelle. Member banks have to maintain a separate cover register and have to inform Pfandbriefstelle about any changes in this register.

Pfandbriefstelle has a main trustee, appointed by the Financial Market authority (FMA), members have subordinated trustees, also appointed by the FMA. The trustees have to control the cover and have access to the cover register.

In the case of insolvency of Pfandbriefstelle or one of its members the cover assets in the separate registers of the members are regarded by law as part of the assets of the Pfandbriefstelle. Therefore, a contractual transfer of assets is not necessary.

During the last years, this legally based Austrian pooling model was nearly not used, because the public guarantee of the Austrian Bundesländer for Pfandbriefstelle allowed them to get uncovered funding. This public guarantee was abolished by April 1, 2007, with a transition period until September 30, 2017. Therefore, it could be expected that the pooling model of the Pfandbriefstelle will become important in the future, if the Landes-Hypothekenbanks do not prefer to issue Pfandbriefe directly, which they are allowed to do according to specific legal provisions.

2.2. Denmark

The Danish pooling model is regulated by art. 16 b – 16 g and art 120 b in the Financial Business Act. Since July 2007, this newly regulated pooling model was not used, but there are plans to do so.

The DFSA has to approve all pooling models established according to these provisions. Only credit institutes (i.e. commercial banks and mortgage credit institutes) can participate in this model. For the purpose of simplification, the term "bank" is used in the following.

The structure is the following: Bank A originates a mortgage loan and sells it to Bank B. Bank A decides if and when to sell the loan to Bank B. The loan becomes an asset on Bank B's balance sheet after the sale and the registration in the land registry of the new creditor - and with this transfer the capital requirements of this loan are transferred to Bank B, too. This can have the positive effect that risk weighting is reduced, so for example if the funding bank uses the advanced internal rating based approach, whereas the originating bank uses the standardized approach.

When setting up the new legislation, there was a lot of discussion about the possibility to keep the assets on the balance sheet of the originator and to grant a pledge only to the funding institution; but this was not possible because of the DFSA interpretation of the CRD-limit of exposures to credit institutions.

The borrower is not informed about the actual sale of his mortgage loan, but must be informed about Bank A's right to sell it and the possible transfer of specific data concerning the borrower to a another bank (at a future date). Bank A acts as servicer of the mortgage loan on behalf of Bank B. The borrower pays interest and principal to Bank A. Regarding data protection, a special provision (art 120 b) allows the transfer of data from Bank A to Bank B for the purpose of risk management and administration of this pooling model, provided that the borrower initially has been informed of the possible transfer of data.

Bank A must segregate the mortgage cash flows to Bank B from the rest of Bank A's assets to eliminate commingling risks. Bank A must transfer the funds to Bank B according to a payment schedule. Bank B has a preferential claim on the mortgage payments in Bank A in case of Bank A's insolvency.

Due to the mandatory condition of registration of the new creditor (bank B), the issuers risk in case of insolvency of the originator/servicer is reduced to the mortgage payments that have not yet been transferred to bank B. This minor risk is compensated by the segregation of received mortgage payments at the servicer. Furthermore, the issuer is granted a priority claim on mortgage payments due. And there is no claw back of funds transferred to the issuer according to the payment schedule. If the mortgage payments have not been properly segregated, the transfer of these funds might be voided according to normal insolvency rules; however if these funds are transferred according to the payment schedule, the transfer will as a general rule not be voided.

Each and every specific pooling model has to be approved by the DFSA. The provisions do not state whether foreign mortgages can be used or not. However, the DFSA will probably demand a similar foreign legal structure before the DFSA accepts

foreign mortgages in a Danish pooling model. This indicates that the pooling model mainly will be a domestic model.

2.3. France

The French pooling model of CRH, a specialized credit institution, is a fully legally regulated system, which is becoming more important with the reduction of deposits in French banks. The legal basis is the French Act N°85-695 of July 11th 1985 allowing the creation of CRH and referring to articles L.313-42 to L.313-49 and to article L.515-14 of Financial and monetary code.

The structure of the CRH pooling model is the following: Partner banks of CRH, who provide the capital of CRH, grant mortgage loans and keep them in their balance sheets. These partner banks borrow money from CRH. These borrowings take the legal form of promissory notes issued by these partner banks and purchased by CRH. The mortgage loans are pledged by law to secure the promissory notes, that are to say to cover the borrowings of the partner banks from CRH.

CRH is issuing covered bonds called “bonds regulated by article 13 of law of July 11th 1985”, which have the same conditions regarding maturity and interest rate like the promissory notes. So there is a full balance between covered bonds and cover assets (the promissory notes). There is no interest rate margin and there are no fees for the CRH, which has to get the financing of its costs by investing the equity.

Regarding banking secrecy, the legal provisions allow the transfer of data without the consent of the originator’s clients.

The partner banks have to risk weight their mortgage loans. CRH has to risk weight the promissory notes secured by legal pledge – French law allows a 10 % risk weight for them like for covered bonds. So, promissory notes and CRH covered bonds both get a preferential treatment in risk weighting.

In the case of insolvency of a partner bank, the pledged mortgage loans are automatically by law transferred to CRH – without any additional formalities. No contractual transfer of assets is necessary therefore. So far, only domestic mortgages are used for the CRH pooling model, but no cross-border mortgages.

2.4. Germany

For many years already, there are pooling models used in the sector of cooperative banks in a way that the Pfandbriefbank becomes directly lender of the mortgage loan, where it can be funded via Pfandbriefe. There is nothing special about it and no special provisions necessary, but it is a purely technical issue of cooperation in the process of origination.

There is no specific legal Act on pooling models in Germany. But there are legal provisions, which allow various pooling model structures in a way that mortgage assets are funded via Pfandbriefe. German Pfandbrief Act only allows the funding of mortgage loans, if the Pfandbriefbank is the holder of the assets – with one exemption: the use of the funding register. A funding loan, even in the form of a promissory note, secured by a pledge on mortgages, is not eligible for the cover of Pfandbriefe.

One pooling structure is used for the cooperation of Landesbanks and savings banks, which is estimated to have a potential volume of around 200 bn Euro: The savings banks are granting mortgage loans. They are selling these mortgage loans to a Landesbank. But only the claims out of the loan contracts are assigned to the Landesbank. The collateral, the real estate charge (Grundschuld) is kept in trust with the saving bank in favour of the Landesbank. The savings banks keep the servicing of the mortgage loans. The Pfandbriefbank registers the loan in its cover register as well as its claim to transfer the real estate charge.

In order to ensure that this real estate charge can be transferred later to the Landesbank, even when the saving bank should become insolvent, the savings bank is keeping a funding register and registers the collateral there. German Banking Act (KWG) regulates this funding register in art. 22a – 22o. The registration in this funding register has the effect that – in the case of insolvency of the saving bank – the registered assets will be segregated from the insolvency estate and transferred to the Pfandbriefbank (here the Landesbank).

In order not to reduce its balance sheet, the saving bank guarantees the mortgage loan with the consequence, that the saving bank has to risk weight this mortgage loan. The risk of the Landesbank (Pfandbriefbank) is the one of the saving bank, which is 0% as the protection system of the German financial group of savings banks is fully in line with EU law. This combination of assignment and guarantee has the effect that there is a difference in the legal status and the balance sheet treatment.

The technical platform for the electronic selling process is set up already. Over this IT platform, the offering, the acceptance, the calculation of the net present value calculation of the sales price of the loan and the transfer into the cover pool register is done. The platform is connected with the IT of the savings banks, with their IT centre – and with this there is a daily transfer of data from savings banks to Landesbanks. The transfer of data is allowed, because in the standard loan contract the borrowers agree with this data transfer for funding purposes.

This pooling model on the basis of the funding register is not restricted to saving banks and Landesbanks, but can be used by every German credit institution in relation to a Pfandbriefbank. Furthermore, the funding register can be used for portfolio transactions and syndications, too, without setting up a steady asset flow in the sense of a permanent pooling model. And this funding register is used already.

2.5. Hungary

In Hungary only specialized mortgage banks are allowed to issue mortgage bonds (specialist bank principle). Two out of three mortgage banks have funding agreements for pooling models with commercial banks in a way that real estate charges are purchased.

The commercial bank (originator) grants loans, which are secured via a special kind of real estate charges, which are legally independent from the loans. These real estate charges are sold and transferred from the commercial bank to the mortgage bank. The commercial bank repurchases the real estate charges at the pace as the original loan is repaid. With this structure, the commercial bank keeps the loans and the full relation to its clients.

The covered bonds, issued by the mortgage bank, are collateralized through real estate charges, which are registered in the cover register of the mortgage bank. The credit and prepayment risks stay with the originating commercial bank. The covered bond investors take only low risk since in case of the originating banks' insolvency, the mortgage loans are repaid directly to the mortgage bank.

If the refinancing is made by way of purchase and redemption of real estate charges, than at the time of announcing the liquidation of the original creditor the claims from the mortgage loans secured with real estate charges shall be transferred to the Mortgage Bank by law.

The commercial bank has to bear the risk weighting of the mortgage loan. The mortgage bank is weighting the risk of a loan to the commercial bank, because – regarding balance sheet treatment – the "sale" of the real estate charges is regarded as a secured loan from the mortgage bank to the commercial bank, because of the repurchase guarantee of the commercial bank.

Regarding banking secrecy and transfer of data there is a special provision in Section 51. (1) c) of the Banking Act. If the financial institution's interests for selling its receivables due from the customer requires so, the bank may transfer data that are qualifying as banking secret. Based on this provision data connected to a mortgage loan and a real estate charge may be transferred to another bank. Furthermore, the mortgage loan contracts usually contain the written consent of the debtor to the transfer of the data to the mortgage bank for the case that the claim due from the mortgage loan is assigned or the real estate charges linked to the mortgage loan is sold to a mortgage bank. In practice, the data are kept in separate IT systems.

2.6. Spain

There are four Cédulas securitisation programs in Spain, which are backed by Spanish covered bonds (Cédulas Hipotecarias): AyT, TdA (arranged by Caja Madrid), Intermoney and PITCH (arranged by Banco Santander), which by October 2007, as published by Spanish AIAF, together had a market share of around 25% (in fact 27.32%) of all mortgage backed securitisation in Spain – and around 40% (in fact 41,07%) of all cédulas hipotecarias were issued in these pooling models.

Whereas the other pooling models in Europe use mortgages from different originators to issue big volume covered bonds, the Spanish version is to use covered bonds, which are issued by different financial institutions, to pool them in a securitisation structure.

The structure of these pooling models is the following: Spanish financial institutions, mainly small to medium size Savings Banks, issue cédulas hipotecarias and sell them to “intermedia-sellers”. These intermedia-sellers sell the cédulas hipotecarias to an SPV (a “Fondo de Titulización de Activos” or simply a “Fondo”). The SPV is issuing bonds and selling them to investors.

According to Spanish legislation, a securitisation fund can only buy assets. This is the reason why there is a role for intermedia-sellers, who buy the covered bonds – and thus make out of them assets in the balance sheet of the intermedia-sellers.

The SPV is completely separated from the issuer of cédulas hipotecarias. As defined by Spanish legislation, the Fondo has no shareholders and no separate legal personality, and is managed and represented by a fund manager (“Sociedad Gestora”) licensed by CNMV. It does not have the status of a credit institution. From a legal perspective this SPV-structure for the pooling models is similar to Spanish MBS, but it is not the same in structural aspects such as typical capital structures, transaction participants, priority of payments etc.

Regarding the accounting treatment, the mortgage loans remain in the balance sheet of the issuer and are risk weighted there. The risk weighting of the cédulas hipotecarias is 10%. The bonds, which are issued by the SPV, are not cédulas hipotecarias. However, they get the same risk weighting as them, because in MBS there is a look-through principle for risk weighting, so that the bonds can be risk weighted like the underlying assets – and these are the cédulas hipotecarias.

2.7. Switzerland

The Swiss pooling model is regulated by the Pfandbrief law, an act of Parliament, which was revised only twice since its introduction in 1931. Based on this law only two institutions are allowed to issue „Pfandbriefe“: the Pfandbriefbank schweizerischer Hypothekarinstitute (for private banks) and the Pfandbriefzentrale schweizerischer Kantonalbanken (for public banks). Both are owned by their, respectively, 240 and 24 member banks. These two organisations are real pooling institutions. The Swiss law does not accept other Pfandbrief issuing institutions due to the size of the country. Swiss banks can easily apply for membership in the Pfandbrief institutions.

The two Swiss Pfandbrief institutes are of some economic importance. At the end of 2007, there were 123 Pfandbrief series outstanding. All are quoted on the stock exchange, totaling CHF 48 billions or

EUR 31 billions. This means a share of 17.6% of the Swiss Franc domestic bond market. 7.2% of Swiss mortgages are funded via Pfandbriefe. Based on the Swiss Pfandbrief law, only mortgage loans and no public sector loans are eligible.

The pooling model works as follows: The member bank originates the mortgage loan and pledges it together with the “Schuldbrief” (mortgage collateral deed) to the Pfandbrief institute in order to secure the funding loan, which the Pfandbrief institute grants to the member bank. This pledge is recorded in the Pfandbrief register (cover pool register) of the member bank (Pfandbrief Act article 21) and of the Pfandbrief institute (Pfandbrief Act article 16). Based on the double pledge regulated by the Pfandbrief law, the “Schuldbrief” needs not to be handed over from the member bank to the Pfandbrief institute, which facilitates the handling of the pledge very much.

The member bank decides if and when to pledge the mortgage to the Pfandbrief institute. The debtor of the mortgage loan needs not to be informed about this pledge. The member bank services the mortgage loan. The mortgage loan stays on the balance sheet of the member bank. The Pfandbrief institute issues the Pfandbrief and sells it to investors. The Pfandbrief institute decides when to issue a Pfandbrief. The data transfer between member banks and the Pfandbrief institute is not restricted (Pfandbrief Act article 11 and 13).

The cash flow structure is as follows: the investor buys a Pfandbrief from the Pfandbrief institute against cash. The Pfandbrief institute transfers the cash to the member bank against the pledge of the mortgage loan and the “Schuldbrief”. The member bank transfers the cash to the debtor of the mortgage loan against the pledge of the “Schuldbrief”. The borrower pays the interest to the member bank, the member bank to the Pfandbrief institute and the Pfandbrief institute to the investor.

The insolvency segregation is regulated by law as well: In the case of insolvency of a member bank the collateral pool is segregated from other assets of the member bank (Pfandbrief Act article 17 and 22) and will then be managed either by the Pfandbrief institute or even by the Swiss Banking Commission, which is part of the Swiss Ministry of Finance.

The basic LTV rules are fixed in the Pfandbrief law. the more detailed LTV rules are established by the Swiss Ministry of Finance, which also delegates a deputy in the board of directors in each of the two Pfandbrief institutes. Based on these rules, the Pfandbrief institute - and not the member bank - sets the LTV for each single mortgage with a maximum of 2/3 of the mortgage lending value of the mortgaged property; the valuation is done in a first step automatically by IT and in a second step by an employee.

The Pfandbrief institutes are supervised by an external audit firm and by the secretariat of the banking commission on a yearly basis.

3. SPECIFIC RATING ISSUES

Pooling models can provide an efficient way to source cover assets. High covered bond ratings generally require a high quality and diverse pool of cover assets. Smaller banks are initially at a disadvantage, because (1) regional concentration makes the asset quality potentially more susceptible to singular events, (2) small cover pools only allow for small covered bond issuance sizes leading to a low secondary market liquidity for investors and (3) the pace of asset origination only allows for infrequent access to the covered bond market requiring issuers to pay a premium due to lower name recognition. The pooling of assets and a joint issuance might help here.

A covered bond rating by S&P [note: rating approaches differ] reflects the rating agency's opinion as to the likelihood of timely and full payment of interest and principal. Only where a structure supports a conclusion that even in an insolvency of the issuing bank, covered bondholders can expect timely and full payment of interest and principal according to the original terms and conditions of the bonds, is it usually possible to assign a rating independent from the rating of the issuing bank (so-called "de-linked" rating).

In the context of a de-linked rating analysis of 'legislation enabled' covered bonds, the rating agency's legal analysis will focus on the following aspects in the context of an insolvency of the issuer: asset isolation (of the cover pool in case of the insolvency of the issuing bank), absence of acceleration of payments, survival of hedging agreements, ability to access liquidity after insolvency, absence of moratorium on the covered bonds and risk of any forced restructuring by law, and the ability to over-collateralize above what is legally required.

For pooled cover pool assets, the analysis may additionally encompass the isolation of assets from the originators' insolvency. If cover assets have not been originated by the issuer but acquired from another bank (the originator), S&P may ask for legal comfort as to what extent such an insolvency could affect the cover pool:

There are several ways in which an insolvency of the originator could impair the availability of the relevant assets to the cover pool and investors. This will dependent on the local law and the details of the pooling structure, including whether the isolation of the assets from an insolvency of the originator is to be achieved by a sale, a secured loan, a contingent transfer or otherwise, for example by use of a specific law (such as the German legal framework for Refinancing Registers). Prohibitions of assignment, bank secrecy and data protection rules, and mortgage re-registration issues could each impact on the effectiveness of the transfer of the assets to the issuing bank and the cover pool. A re-characterization of a "sale" of assets by a court as a "secured loan" could have a significant consequences depending on the applicable insolvency rules and/or laws governing the granting of security. Similarly, so-called preference rules can have the effect that the assets, although effectively transferred to the cover pool, may be "clawed-back" by the originator's insolvency officer.

The originator's insolvency could also affect the cash-flows generated by the transferred assets. If the debtors make their payments on the assets to a bank account of the originator, or if the cash received from the debtors otherwise flows through an account of the originator, such cash may either be lost or frozen in the insolvency. Depending on the exact legal position and structural mitigants, S&P may factor a loss or time delay into its cash-flow analysis.

The rating agency will also factor into its analysis the extent to which, on the basis of the local law, the debtors would be able to set-off claims they may have against the originator against their payment obligations on the transferred assets. This is of particular relevance where the debtors have deposits with the originator.

Finally, S&P will also seek to understand the legal provisions and/or structural arrangements for the continued servicing of the assets post-insolvency of the originator. Where for example the rating agency is asked to assume that the servicing will be carried by the insolvent originator through a special administrator appointed by law, its analysis may include aspects such as the powers, duties and resources of this administrator as well as the timing of the administrator's appointment. If on the other hand the assets are to be serviced by a third party following the originator's insolvency and this requires a transfer of the assets which had not occurred until then, the analysis is likely to focus around the costs and timing of such transfer.

4. SUMMARY

Pooling models exist in several countries. Some of them have outstanding market shares, others do not (yet) have big economic importance. The economic importance on national level of pooling models depends on the possibility of the originating bank to issue covered bonds themselves directly. This shows clearly a comparison of Austria, where the pooling model is not used at all nowadays, and Switzerland, where both the pooling institutes are the only ones, who are allowed to issue covered bonds.

Despite the increased complexity of pooling models, they can result in a win-win situation for both the originator and the issuer: higher operational costs for the originator are typically outweighed by lower funding costs. The pooling of assets allows for a more diverse cover pool. Additional origination capabilities from externally sourced assets allows for more frequent market access and higher issuance volumes.

The sourcing of cover pool assets from other banks require both a sound cooperation to assure high quality assets and a clear legal mechanism to transfer the assets. It is interesting to see that there is a big variety in Europe's pooling models regarding the transfer techniques: full legal transfer from the beginning (Denmark, Hungary), automatic legal transfer in the case of insolvency of the originator (France), legal pledge with trust status in insolvency (Switzerland), insolvency-proof claim against insolvency estate (Germany). All these structures are based on assets, which are transferred somehow and sometime from the originator to the issuer of covered bonds. Only the Spanish pooling models use covered bonds as assets for the issue of ABS according to securitisation techniques.

CHAPTER 2 – GENERIC SECTION

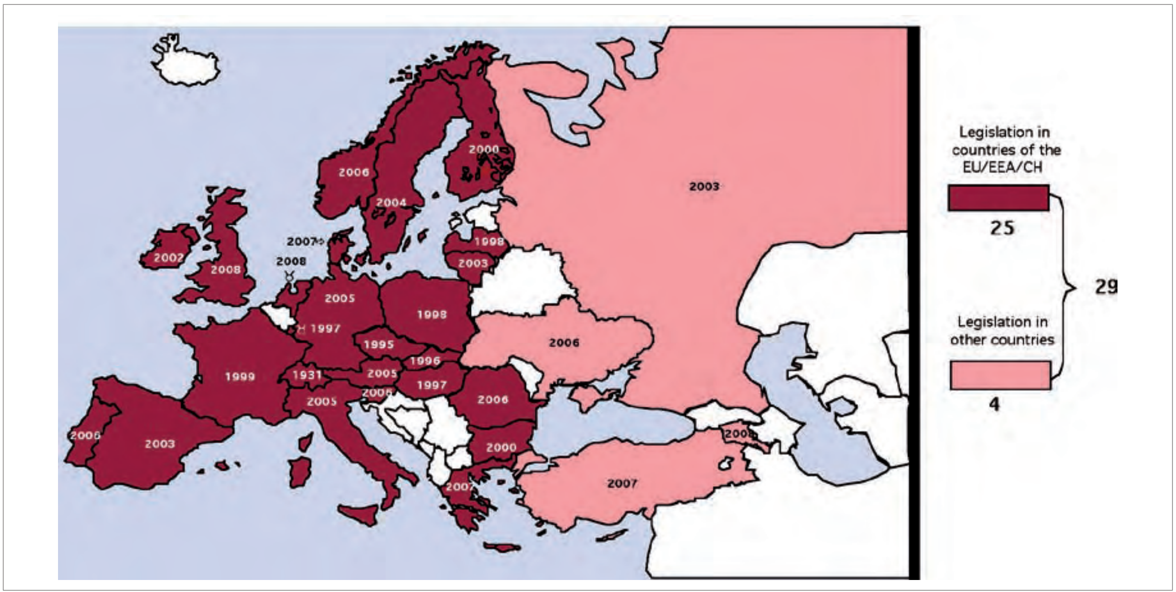
2.1 OVERVIEW OF COVERED BONDS

By 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 2007 amounting to EUR 2.1 trillion.[1] In 2008, the Covered Bond market is continuing its strong growth as increasingly countries discover that Covered Bonds offer lenders a cost-efficient instrument to raise long-term funding for mortgage or public-sector loans and provide investors with a high-grade substitute for government or agency debt. Throughout the recent financial crisis, covered bonds were one of the few funding instruments available at almost all times, demonstrating their resilience in a difficult environment. Today there are active Covered Bond markets in about 20 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 2008)



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.

In 2008, the UK and the Netherlands put their long-awaited covered bond legislation in place. Since the publication of the 2007 edition of the Fact Book, important changes of the legal frameworks have come

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

into force in Denmark, Ireland, France and Spain. Amendment of covered bond legislation is on its way in Germany, Luxembourg and Greece. In the US, the FDIC has issued an “Final Covered Bond Policy Statement”, which stipulates the conditions under which the protection of covered bond holder claims is strengthened in case of insolvency of a financial institution, which benefits from deposit insurance of the FDIC.

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.

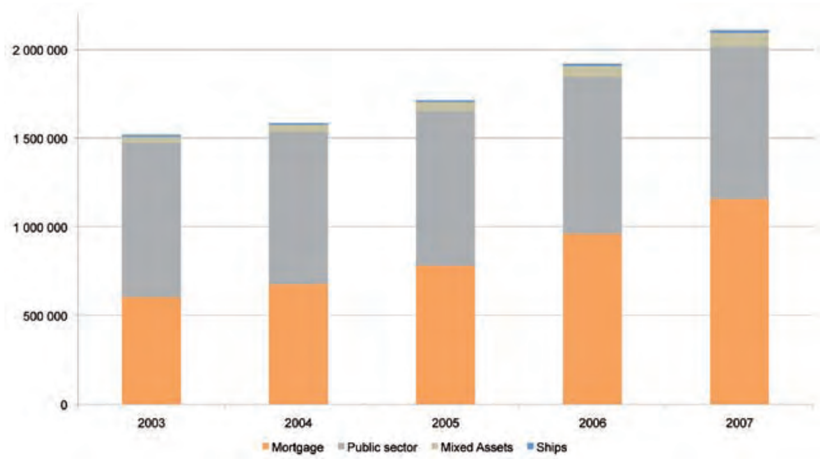
2.1.3 THE PURPOSE OF COVERED BONDS

The acquisition or construction of residential, commercial or agricultural property, public investment (such as infrastructure projects) and ships are long-term investments with relatively low credit risks. The required long-term funding in those areas is for a large part provided by credit institutions. Based on their creditworthiness, credit institutions in general find it easier to get short-term funding (customer deposits, short-term bonds, etc.) compared to long-term funding. In that respect, Covered Bonds offer lenders an efficient long-term funding instrument for their long-term lending activities. Covered Bonds allow the issuing institution to exploit the characteristics of the collateral (e.g. higher creditworthiness, long maturities, etc.) and this in turn reduces asset and liability mismatching.

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 (Germany, France, Ireland, Luxembourg, Austria, Italy and Spain). 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 2007



Source: EMF/ECBC - Covered Bonds outstanding at the end of 2007.

2.1.5 LEGAL FRAMEWORK

UCITS and CRD

1) UCITS

The special character of Covered Bonds has been enshrined in the Directive 2001/108/EC of the European Parliament and of the Council of 21 January 2002, amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS.

Article 22 (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 22 (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 22(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 22(4) allow 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
- 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 22 (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 22(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 March 2008, 19 EU Member States had sent notifications to the EU Commission. 14 states notified the EU Commission on bonds and authorised issuers fulfilling the criteria of Article 22(4) UCITS mentioned above. 5 states have so far only sent negative notifications, which should be changed as soon as they have set up Covered Bond legislation; although most of them meanwhile have introduced legislation on covered bonds, until March 2008 they did not change their previous notifications. Several states did not send any notification, although they have a Covered Bond legislation and issues. The situation is surprising and shows that either there are political reasons behind or just other priorities of the governments, where Covered Bonds do not yet play an important role on national market. The 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 new Capital Requirements Directive (CRD). 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 new CRD rules will 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)[2]. The national implementation of the CRD is scheduled for the end of 2007. 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

2 Directive 2006/48/EC.

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 22(4) of Directive 85/611/EEC (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.

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 22(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, 29 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.

In 2007, the ECBC Technical Issues Working Group has undertaken a comparative analysis, based on a questionnaire, which 17 countries have answered so far[3]. The questionnaire and the comparative overview are divided into 8 sections covering the essential features of Covered Bond systems. Here, we highlight some of the results of that comparative overview.

Structure of the issuer

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

- Universal credit institution: Latvia, The Netherlands, Austria, Portugal and Romania.
- Universal credit institution with a special license: Denmark, Germany, Sweden and UK.
- Specialised credit institution: Denmark, France, Ireland, Luxembourg, Poland, Portugal, Finland, Switzerland and Romania.
- Specialised financial institution: Austria (Pfandbriefstelle)

3 Detailed information is available on the website of the ECBC at: http://ecbc.hypo.org/content/default.asp?PageID=333 . The TIWG 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.

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 like eligible assets, specific asset valuation rules, assets-liability-management guidelines and transparency requirements, etc.

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 range of eligible cover assets in existing European Covered Bond systems is listed in the new EU CRD regulation on Covered Bonds: exposures to public sector entities, mortgage loans, exposures to credit institutions, senior MBS issued by securitisation entities and ship loans. Some Covered Bond systems distinguish between regular cover assets (usually mortgage, 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 recently 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 22(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 22(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 common characteristic is that Covered Bonds in Europe do not automatically accelerate, if the issuer becomes insolvent. Numerous Covered Bond systems have provisions that permit derivatives to continue in case of insolvency of the issuer. Derivative counterparties can rank *pari passu* or subordinated to Covered Bondholders. In some 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 22(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, reproduced in the Annex to this Chapter[4]. 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 17% of outstanding residential mortgage loans in the EU. The volume outstanding at the end of 2007 amounted to 2.1 trillion EUR (Covered Bonds covered by mortgage loans, public-sector loans and ship loans), which represents an increase of 10% year on year. The four largest issuing countries in 2007 were Denmark, Germany France 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.

4 They are also available at: http://ecbc.hypo.org/content/default.asp?PageID=367

Chart 3 – Volume outstanding CB in Europe end of 2007 in €m

	Mortgage	Public sector	Mixed Assets	Ships	Total
Germany	206,489	677,656	0	4,413	888,558
Denmark	335,849	0	0	8,723	344,572
Spain	266,959	16,375	0	0	283,334
France	63,555	56,403	80,097	0	200,055
Sweden	92,254	0	0	0	92,254
UK	81,964	0	0	0	81,964
Ireland	13,575	51,204	0	0	64,779
Luxembourg	150	33,741	0	0	33,891
Switzerland	29,013	0	0	0	29,013
Austria (e)	4,125	15,200			19,325
Netherlands	15,727	0	0	0	15,727
USA	12,859	0	0	0	12,859
Italy	0	8,063	0	0	8,063
Portugal	7,850	0	0	0	7,850
Czech Republic	7,850	0	0	0	7,850
Norway	6,009	0	0	0	6,009
Hungary	5,987	0	0	0	5,987
Finland	4,500	0	0	0	4,500
Iceland (e)	794	0	0	0	794
Canada	2,000	0	0	0	2,000
Poland	676	0	0	0	676
Latvia	36	0	0	0	36
TOTAL	1,158,222	858,642	80,097	13,136	2,110,097
%	50%	46%	3%	1%	100%

Source: EMF/ECBC

Note: In **Denmark**, 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 the refinancing and the bonds they are replacing are in ultimo figures. This means that if one takes the figures outstanding as of 31.01.2008, the total outstanding for the Danish market would be EUR 47 bn lower.
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
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 **Austria** and **Iceland**, the figures are estimates.

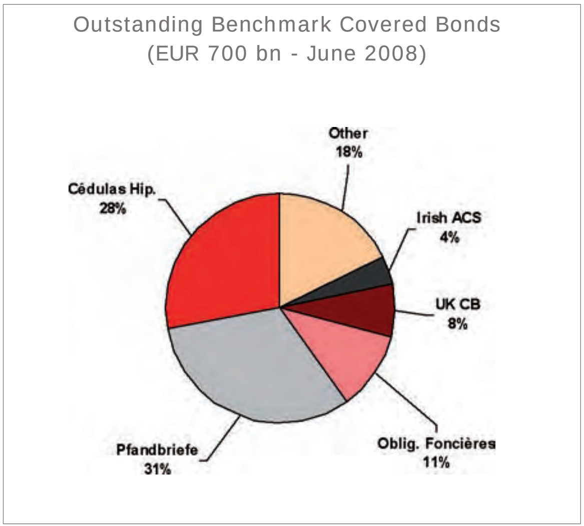
2.1.9 BENCHMARK COVERED BONDS

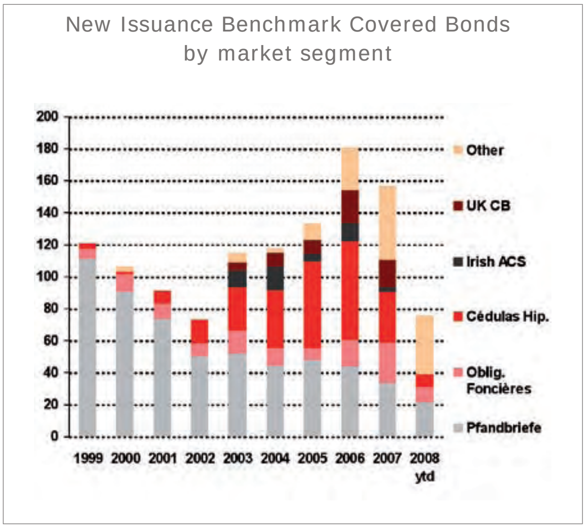
The Benchmark Covered Bond market constitutes the most liquid segment of the Covered Bond market. A Benchmark-format Covered Bond is a Euro-denominated, bullet maturity, fixed annual coupon bond with a defined minimum outstanding volume (in most cases EUR 1 bn). Benchmark Covered Bonds have to be quoted with narrow two-way prices by at least 5 market-makers, which should enable investors and market makers to execute rather large orders easily or unwind positions. Electronic trading platforms intend to further enhance pricing in the benchmark Covered Bond market (see the article on market-making by Richard Kemmish in Chapter 1).

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 700 bn (approx. 13% 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, Austria, Canada, Denmark, Finland, France, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, the UK and the USA.

CHART 4 – BENCHMARK COVERED BOND SUPPLY





Source: Market data, SG CIB;
Other comprise Austria, Finland, Luxembourg, Italy (CDP), Netherlands, Spain (Ced.Ter.), Portugal, French CB, US Covered Bonds, Sweden, Norway, Denmark, Canada

2.1.10 WHO INVESTS IN COVERED BONDS?

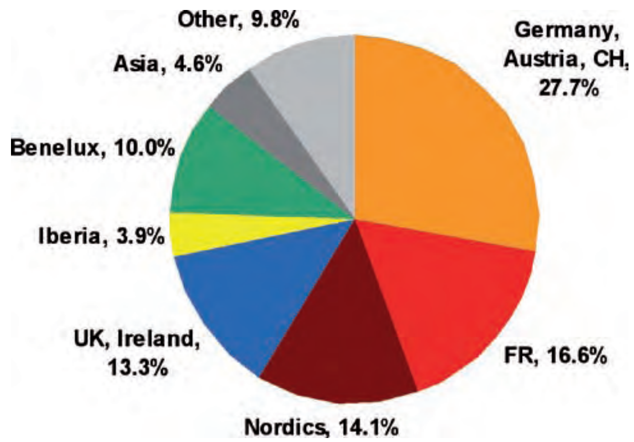
Covered Bonds are attractive financial investments because they offer excellent credit quality, high market liquidity, international diversification and a large choice of maturities. Moreover, Covered Bonds enjoy privileged treatment in different areas of EU financial market regulation.

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 France, Germany, Ireland, The Netherlands, Scandinavia, Spain, and the UK being the major investor areas.

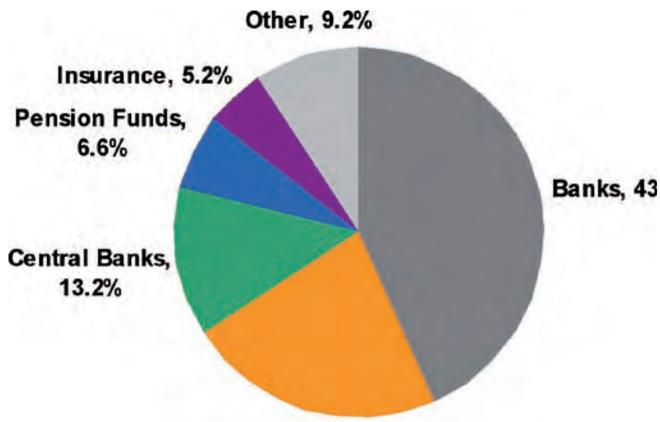
The trend towards longer maturities, which dominated the primary Benchmark Covered Bond market in the past years, has clearly reversed since the beginning of the financial crisis. While in January to April 2007 new issuance in maturities under 5Y accounted for 27% of total new Benchmark Covered Bond issuance, this share stood at 63% in the same period of 2008.

Chart 5 – Benchmark Covered Bond Primary market placement by country / geographical area (averages 2007-2008)



Source: SG CIB

Chart 6 – Benchmark Covered Bond Primary market Placement by type of investor (averages 2007-2008)



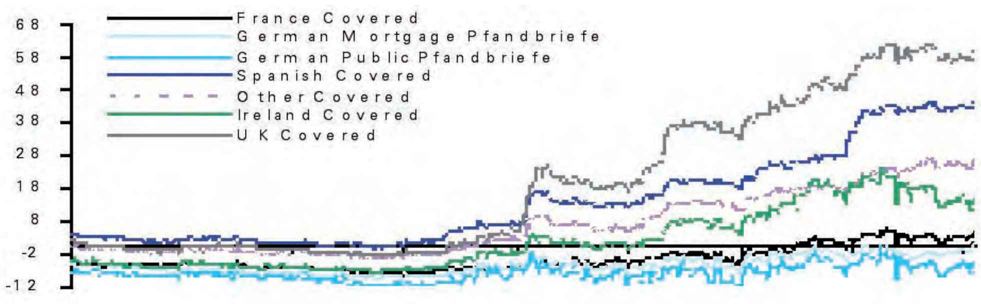
Source: SG CIB

2.2 RMBS VS. COVERED BONDS

By Bernd Volk, Deutsche Bank

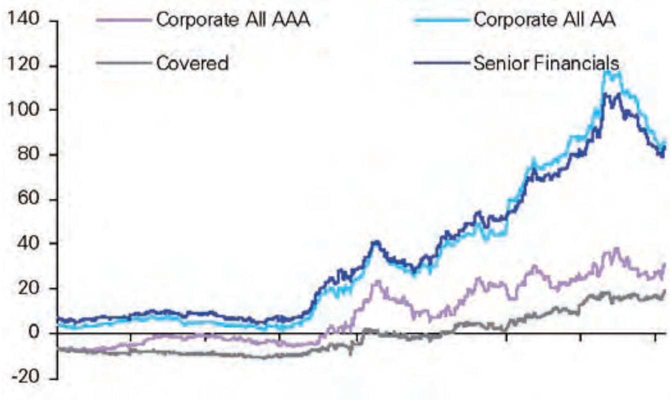
Given that holders of Covered Bonds have a claim against an issuing bank and a pool of mortgage (or public sector) collateral, spreads of Covered Bonds are typically compared to senior financials and MBS. As a result of the dual claim, Covered Bonds are expected to trade tighter than senior financials and MBS. In fact, spreads of Covered Bonds widened versus swaps in Q1 2008 but held up well compared with mortgage backed securities (MBS) and senior financials.

Covered Bond spreads diverged significantly



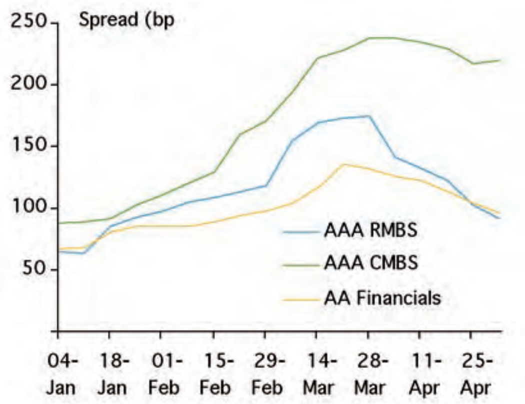
Source: iBoxx, Deutsche Bank

AAA corporate spreads tightened versus covered bonds in recent weeks



Source: iBoxx, Deutsche Bank

Cash spreads in selected MBS sectors versus financials

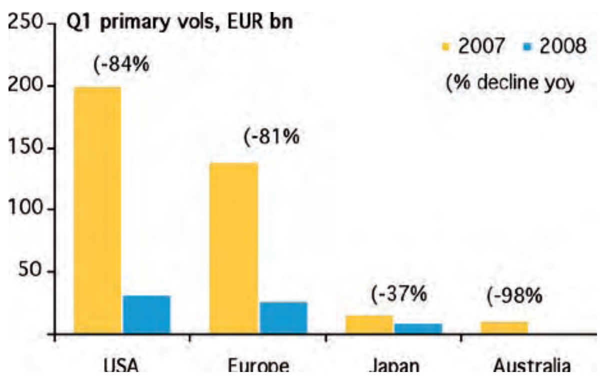


Source: Deutsche Bank

Financials crisis led to strong divergence in issuance volumes

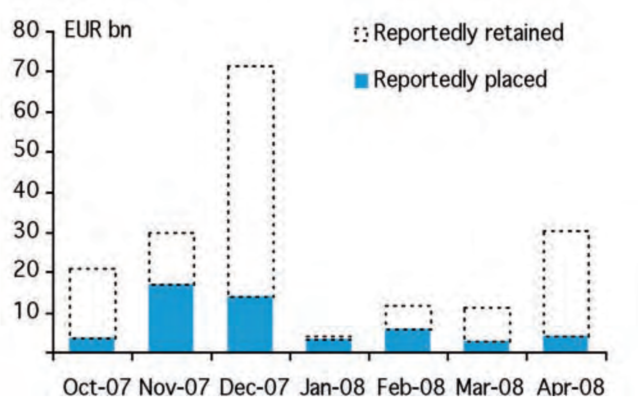
While new issuance in EUR Jumbo Covered Bonds declined by 40% in Q1 2008 versus Q1 2007 (and most of the new issuance was done in short dated covered bonds), the secondary market for MBS was almost completely closed. Hence, whereas covered bonds had ongoing access to the primary market, the situation was completely different in case of securitizations overall. Given the loss of key investor constituencies such as SIVs, conduits, money market funds and some bank treasuries, publicly-placed deal flow totalled a paltry EUR 16 billion in the first four months of 2008 compared to EUR Jumbo Covered Bond issuance of EUR 48 bn. Volumes were overwhelmingly dominated by banks' securitize-and-repo exercises.

Quarterly primary volumes in securitizations declined significantly in Q1 2008



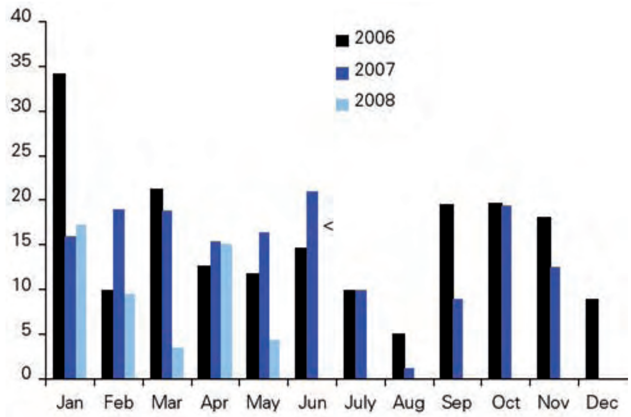
Source: Deutsche Bank

The true profile for structured finance issuance



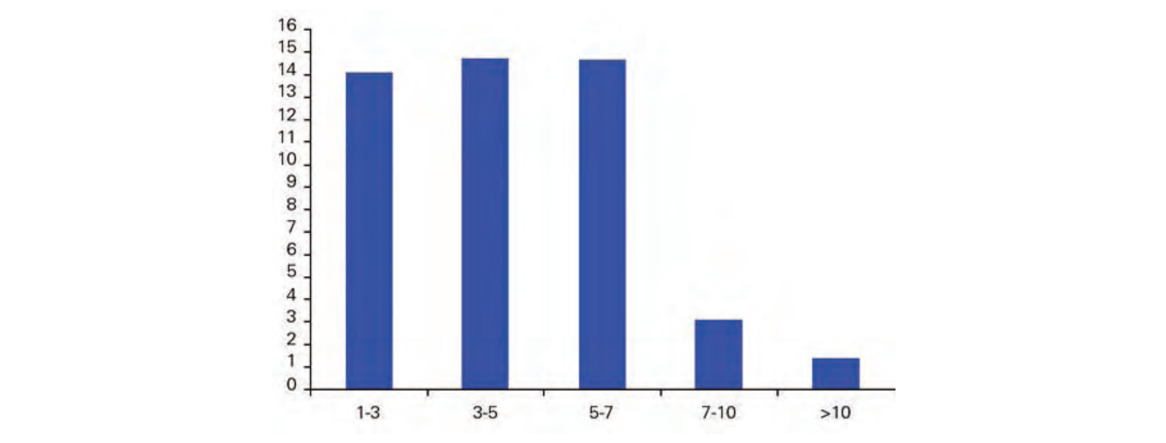
Source Deutsche Bank

New issuance of EUR Jumbo Covered down by 40% in Q1 2008



Source: iBoxx, Deutsche Bank

New issuance of EUR Jumbo Covered Bonds according to maturity brackets



Source: iBoxx, Deutsche Bank

Bank retained securitizations volumes are likely to get a renewed boost following the launch of the Bank of England's Liquidity Scheme. The Bank of England Liquidity Scheme is a bold securitization related central bank initiative (certainly in terms of financing duration and size), but the facility still risks, despite punitive terms, diverting more securitization volumes from the public markets, similar to how the ECB's normal repo operations have become a radical financing channel for the Eurozone securitising banks.

Primary volumes in the European securitisation market totalled a formidable EUR 40 billion in April 2008, around 50% higher than the comparable month a year (pre-crisis) ago. But this figure of course grossly exaggerates the extent of 'legitimate' asset-backed deals that were publicly-placed. On our count, nearly 90% of volumes seen over the past month, or EUR 36 billion, were retained by banks for internal or central bank financing purposes. Taken over a longer-term perspective since the onset of the credit crisis in August 2007, we calculate that around 75% to 80% of primary market volumes (almost EUR 160 billion) have been retained. (The ECB's latest report on monetary operations cites that ABS accounted for 18%, or nearly EUR 150 billion, of all collateral deposited with the Eurosystem as at end-2007. We expect this share to have increased in 2008.) The use of and reliance on the central bank's liquidity window for asset-backed financing has been nothing short of pervasive therefore, underpinning a very significant diversion of supply from the public markets while arguably blunting the impact of current market forces on banks' wholesale funding strategies. Indeed, central bank liquidity outlet has effectively replaced the disenfranchised short-term funded investors such as SIVs and conduits in the demand composition for European structured finance product, with the central bank now clearly the overwhelming 'buyer' of such bonds. Retained securitisations are likely to intensify going forward given that the Bank of England has made available a swap facility for UK-domiciled banks to deliberately monetise ABS / MBS, and therefore arguably prolong the hesitation of banks in returning to the public securitisation market.

Pre-crisis: Convergence of Covered Bonds and Securitizations

Pre-crisis the boundaries between Covered Bonds and MBS became blurred. In some jurisdictions, MBS are eligible as collateral for Covered Bonds in France, Italy and Ireland (Luxembourg will follow suit in the upcoming amendment of the legal framework for Lettres de Gage). Covered Bonds were used as collateral within synthetic securitisation transactions (e.g. senior notes of several Geldilux deals). Covered Bonds are often enhanced beyond the structure stipulated by the legal framework (e.g. CIFEUR, CFF, AYTCED, CEDTDA, IMCEDI, PITCH). Covered Bonds are also structured with the help of securitisation techniques to replicate the legislated Covered Bond method of funding (e.g. Dutch structured Covered Bonds, Canadian structured Covered Bonds, French structured Covered Bonds and – until the bonds are converted to the newly introduced legal framework also UK structured covered bonds). Given the change in the market environment, the convergence of Covered Bonds and securitizations is over for the foreseeable future.

Covered Bonds are on balance sheet funding

In contrast to securitizations, In the case of Covered Bonds, the assets are usually on the balance sheet of the issuer. Comparably new structures like French structured Covered Bonds, despite being issued by a credit institution, a specialized Covered Bond Bank, could be seen as a SPV specifically dedicated to the issuance of Covered Bonds. The specialised 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

The 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 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 real security of Covered Bonds is that the issuing bank (or the parent company) might be ‘too big to fail’. In our view, this is one of the main reasons for Covered Bonds outperforming MBS. At the end of the day, Covered Bonds are bank bonds. The preferential claim on the cover pool is only an add-on, something which may be valued more or less by investors.

Covered Bonds have a dynamic cover pool

Covered Bonds are typically backed by all loans in the cover pool. There is no connection between a specific cover pool or single loans and outstanding Covered Bonds. In case of issuer insolvency no further assets will be added to the cover pool and no further Covered Bonds will be issued. As long as the issuer is solvent, the issuer or the originator actively manages the cover pool. Cover assets have to be replaced if they no longer meet the eligibility criteria defined by the relevant legal framework or the issuer documentation. If the cover pool no longer adequately backs the outstanding Covered Bonds and the issuer is not able to fix this by substituting or adding assets or buying back Covered Bonds, the cover pool accelerates (depending on the relevant legal framework).

MBS have a static pool and credit enhancement by tranching

Generally, Covered Bond holders bear the risk resulting from the system of a dynamic pool i.e. the cover pool administrator loses the capability to bring in sufficient new assets in order comply with the coverage regulations. 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 AAA-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 variable rates mortgage loans. As a result of the dynamic pool, Covered Bonds typically have a longer maturity than MBS.

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 securitised. 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 benefit the investors as such in an 'old' issue. The underlying pool of mortgage loans decreases over time due to borrowers paying back their obligations. MBS Master Trusts also have revolving cover pools where principal repayments are being 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, 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).

Bankruptcy remoteness of Covered Bonds compared MBS

In the case of Covered Bonds, the segregation of the asset pool and its bankruptcy remoteness can usually be considered strong, thanks to specific regulation establishing asset segregation outside the normal insolvency proceedings.

In the case of structured Covered Bonds, based on contractual agreements and not on a specific law, the bankruptcy remoteness depends on the general law and jurisprudence regarding the bankruptcy process. For instance, in the case of UK structured Covered Bonds, asset segregation and insolvency remoteness is considered strong by the rating agencies, based on legal opinions.

Transparency

In the case of both MBS and Covered Bonds, the information concerning the underlying cover assets is regularly monitored by the rating agencies and usually also published to investors. Frequency and content depend on the national regulations and voluntary behaviour of the issuers.

The eligible assets: limited convergence

Eligible assets of Covered Bonds are defined by the respective legal frameworks which have to be in line with the CRD. According to the CRD, eligible assets are restricted to residential and commercial mortgage loans, public sector claims and ship mortgage loans. The issuers of structured Covered Bonds so far have restricted their issue documentations to these kinds of assets. Pre-crisis there were tendencies to include other assets in structured Covered Bonds in the future, e.g. car loans. However, given the new capital market environment, the success of such transactions is difficult. Generally, the notion 'Covered Bonds' is not legally protected. Hence, bonds backed by any types of assets or claims and based on any structure can be called Covered Bond.

As mentioned above, in France, Italy and Ireland (and shortly also in Luxembourg), MBS are permitted in Covered Bond pools. Ireland has just recently modified its legal framework to include MBS. The CRD had limited their share to a maximum of 20% of the pool. However, CRD allows 100% when the MBS are rated AAA. This temporary allowance of 100% is subject to a revision before 2010. The report of the Mortgage Funding Expert Group, which was established by the European Commission, recommends allowing AAA MBS in cover pools without limit, to encourage the MBS market at the European level and to increase the liquidity of these two complementary funding tools. Given the changed market environment for MBS, the upcoming European Commission decision seems less certain.

CONCLUSION

MBS investors are exposed to the risk of underperformance of the cover pool. Covered Bonds are banks bonds and hence holders of Covered Bonds benefit from the support of the issuing bank and every external support provided to the issuing bank. The increasing diversification of the Covered Bond structures was inspired by the use of securitisation techniques, even sometimes using the two types of instrument together directly.

However, the general trend in Europe is to implement a specific legal framework regulating the eligibility of assets, the segregation of the assets from the originator, the bankruptcy remoteness of the cover pool assets and the specific banking supervision to ensure the quality of the issuers' cover pool management got increasing support since the financial market crisis hit the securitization market in H2 2007. Structured Covered Bonds offer the issuers more flexibility regarding the eligibility of assets (like the loans guaranteed by a specialised institution in case of French structured Covered Bonds and not by a mortgage based on a property) or assets held in fiduciary duty. As a consequence of these innovations more analysis work is needed. Also rating agencies have to deepen their analysis, particularly regarding legal questions. All in all, influenced by the securitization market, the Covered Bond market became more heterogeneous without losing its characteristics, making Covered Bonds a unique funding tool for banks, some kind of enhanced, low cost bank bond which proved primary market access even in times of severe financial market crisis.

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 informs about recent proposals provided by the Committee of European Banking Supervisors (CEBS) with regards to the use of options and national discretions in the CRD.

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). 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. According to these criteria, the asset pool of a covered bond may include:

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

2) 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-.

3) 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.

4) 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 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 20% of the nominal amount of the outstanding issue.

5) 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 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 20% 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; in addition, ship mortgage loans with an LTV of up to 60% are allowed.

Until 31 December 2010, the 20% limit for RMBS/CMBS notes as specified in (4) and (5) does not apply, provided that those securitisation notes are rated AAA. Before the end of this period, the derogation shall be reviewed and consequent to such review the EC may, as appropriate, extend this period.

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. Compared with the debate about the definition of the term covered bond, the application of the general CRD/Basel II framework for corporate exposures to covered bonds was much less in the limelight. Thus, from the beginning, a rather strong link between the credit profile of an issuer's senior unsecured debt and the covered bond risk weighting was made in the RSA, as well as in the IRBA. In this respect, the CRD contrasts with most central bank regulations for repo business with covered bonds. For example, in the eurozone, Denmark, Norway and Switzerland, banks issuing covered bonds are allowed to use their own covered bonds as collateral for repo transactions with the central bank, as the respective authorities concentrate on the generally low likelihood of payment interruptions in case of the bank's insolvency, and thus focus more strongly on the default probability of underlying assets.

The RSA links covered bond risk weights to those of the issuers' senior debt

The revised standardised approach for covered bonds

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.

Two options for assigning bank senior risk weightings: sovereign-linked and bank credit-based

The derivation of risk weightings for covered bonds is complicated by the fact that 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.

For banks operating under Option 1, all covered bonds will be 10% weighted

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 eurozone, 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, all covered bond issues within the eurozone would be assigned a risk weighting of 10%. (As yet, there are no Greek or Maltese covered bonds).

Option 2 leads to 20% covered bond weightings for sub AA- issuers

In contrast, Option 2 would introduce 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 would lead 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. The process of implementing the CRD in national legislation is not terminated yet in all countries. Figure 4 below gives an overview on those EU countries which already decided on the respective options.

THE INTERNAL RATINGS-BASED APPROACH (IRBA) FOR COVERED BONDS

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 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. 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
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.

As the majority of covered bonds are rated AAA or comply with the criteria for the application of an 11.25% LGD level, our illustrations of risk weightings are based on an 11.25% LGD. Also, we illustrate 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 (1981-2007)	Moody's (1983-2007)	Fitch (1991-2007)
AAA/Aaa	0.00	0.00	0.01
AA/Aa	0.01	0.01	0.07
A/A	0.06	0.02	0.13
BBB/Baa	0.23	0.19	0.58
BB/Ba	1.00	1.17	1.49

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

Room for debate on default probabilities

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. In any event, the implication is of a very sharp rise in default probabilities for BBB and BB issuers.

Bank risk models probably apply higher default probabilities

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 slightly 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.

Low risk weightings for issuers with AA credit ratings…
… especially for shorter maturities

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.

For M = 2.5, risk weightings will be less than 10% for A- rated issuers and better

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 AND CONSULTATION ON NATIONAL DISCRETIONS

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 is 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. Within the consultation paper, CEBS suggests to keep as a national discretion approximately one fifth of the 152 provisions covered in its analysis.

Proposals regarding national discretions on covered bond regulations

With respect to covered bonds, it was suggested to keep the discretion provided in CRD Annex VI Part 1 point 68 (e) regarding the recognition of commercial mortgage cover pools with a higher LTV level of 70%. Similarly, it was also proposed to maintain the discretion regarding Annex VII Part 2 point 8 (2nd subparagraph) with regards to the transitional provision regarding the assignment of an 11.25% LGD to covered bonds in case certain conditions are met. Finally, it was proposed to eventually delete the discretionary part of the provision allowing national authorities to set a specific risk requirement

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

for covered bonds booked in a bank's trading book, which allow the application of a similar beneficial treatment as applied in the banking book.

ANNEX: ECBC ESSENTIAL FEATURES OF COVERED BONDS

The ECBC sets out below what it considers to be the essential features of covered bonds, together with explanatory notes[8]. It is intended that they to be read independently from any other definition or interpretation of covered bonds, such as those set out in the undertakings for collective investment in transferable securities (UCITS) and paragraph 68, Annex VI of the Banking Consolidation Directive (BCD).[9] These common essential features should be understood as the ECBC's minimum standards for covered bonds.

Essential Features

Covered bonds are characterised by the following common essential features that are achieved under special-law based frameworks or general-law based frameworks:

1. The bond is issued by—or bondholders otherwise have full recourse to—a credit institution which is subject to public supervision and regulation;
2. Bondholders have a claim against a cover pool of financial assets in priority to the unsecured creditors of the credit institution;
3. The credit institution has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times;
4. The obligations of the credit institution in respect of the cover pool are supervised by public or other independent bodies.

Explanatory Notes

Covered bonds are characterised by the following common essential features that are achieved under special-law based frameworks or general-law based frameworks

Special-law based frameworks

A special-law based framework is a legal framework based on a law and/or binding regulations of a public supervisory authority, specifically dedicated to regulate a covered bond system of a country. As of December 2007, special-law based frameworks exist in 26 countries in Europe.

Bonds issued in accordance with a special covered bond law may benefit from preferential risk weightings in the hands of certain regulated investors, depending on the jurisdiction of the investor and whether the bond otherwise meets the requirements of Article 22(4) of UCITS and paragraph 68, Annex VI of the BCD.

General-law based frameworks

A general-law based framework is a legal framework based on general law (such as contract law) or on law and/or regulations of a country not specifically dedicated to regulate a covered bonds system. As of December 2007, covered bonds based on general law-based frameworks exist in five countries worldwide.

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8 The Essential Features of Covered bonds can be downloaded from the ECBC website: http://ecbc.hypo.org/content/default.asp?PageID=367
9 Also known as the Capital Requirements Directive (CRD). See 2006/49/EC and 2006/48/EC.

1. The bond is issued by—or bondholders otherwise have full recourse to—a credit institution which is subject to public supervision and regulation;

Full recourse

A full recourse right creates an unrestricted unconditional obligation on the credit institution to repay a debt. Generally, default on a full recourse obligation leads to the insolvency of the obligor, and the creditor will have a claim on the general insolvency estate of the obligor on an equal basis with the other general creditors of the obligor.

In most covered bond structures, the bond is issued by a credit institution, giving investors direct full recourse to the credit institution's full resources. In some structures, however, the covered bond is issued by a special purpose entity (SPE), which on-lends the proceeds to a credit institution (whether by making a loan or buying a bond). This provides bondholders with full recourse to the underlying credit institution, albeit indirectly, through the SPE. For investors subject to the BCD, only covered bonds issued directly by a credit institution qualify for preferential risk weightings.

Full recourse to a credit institution is a key difference between securitisation and covered bonds. In securitisations, bondholders' only recourse is to the cashflows from a securitised portfolio of assets. The credit institution which originated the assets typically does not guarantee the performance of the securitisation. Therefore, if the cashflows from the securitized portfolio are insufficient to make payments on the securitisation units when expected, holders of the units would generally have no claim against the credit institution which originated the securitised assets.

A credit institution which is subject to public supervision and regulation

A credit institution is an entity licensed to carry on one or more banking activities, such as receiving deposits from the public, granting loans or providing payment services. Credit institutions are distinct from corporates in that—owing to their importance to the financial system—they are subject to public supervision and regulation which prescribes standards for the management of credit, liquidity, interest rate and operational risks.

2. Bondholders have a claim against a cover pool of financial assets in priority to the unsecured creditors of the credit institution;

Financial assets

Financial assets include loans, bonds and similar instruments, as well as derivatives designed to hedge interest and currency risks. Financial assets do not include equity securities, real property, commodities or tangible property. The most common cover assets are mortgage loans secured on residential or commercial property (or securitisation units backed by residential or commercial mortgage loans), mortgage loans secured on ships and loans to public sector entities. Most cover pools also include cash deposits and loans against credit institutions.

All covered bonds contain minimum cover pool asset quality standards. For covered bonds issued under a special law, these quality standards are set out in the law itself and/or binding regulations; however these may also be supplemented by contract. Where the covered bond is issued under general law, these quality standards are set out in the contracts which govern the covered bond issuance.

The BCD also imposes certain minimum standards for cover pool assets. For investors subject to the BCD, only covered bonds with BCD-compliant and national legislation compliant cover pools are eligible for preferential risk weightings.

Cover pool; priority to unsecured creditors

A cover pool is a clearly identified, "ring-fenced" pool of assets dedicated to secure the covered bonds. That is to say, in the event of the insolvency of the credit institution, the assets in the cover pool will be used to repay the covered bondholders before they are made available for the benefit of the credit institution's unsecured creditors.

The method used to "ring-fence" the cover pool varies. In most jurisdictions, the special law either excludes the cover pool from the insolvency estate of the credit institution, or provides covered bondholders with a preferred claim within the insolvency estate itself. In some jurisdictions, the cover pool is preserved from the insolvency estate of the credit institution by being transferred to an SPE, which guarantees the credit institution's obligations under the covered bond. Finally, some structures use the implementation of European Collateral Directive in their jurisdiction to pledge the cover pool assets.

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

Sufficient assets

The value of the cover pool assets meeting the minimum quality criteria described above must be at least equal to the value of the covered bonds.

In most jurisdictions, the value of the cover pool is required to exceed the value of the covered bonds by a prescribed amount, known as overcollateralisation. The minimum level of overcollateralisation is set by the special law or within the contracts governing the covered bond issuance. In some cases, the minimum level of overcollateralisation may be set by a combination of the two—the covered bond law prescribing a minimum level of overcollateralisation, but the credit institution committing to a higher level through either voluntary, non-binding commitments or contract.

Ongoing obligation

The credit institution has the obligation to ensure that the value of cover pool assets meeting the minimum quality criteria described above is equal to or higher than the value of the covered bonds at all times. The credit institution may therefore be required to add further assets to the cover pool to compensate for matured or defaulted assets. . In addition, the credit institution may be required to comply with specific provisions for mitigating different kinds of risks related to the management of cover pool and covered bonds, such as interest rate risk, FX risk or maturity mismatch.

In securitisations, by contrast, the sponsoring credit institution is generally not compelled to replace assets which enter into default after they have been transferred into the securitisation portfolio. Therefore, if defaults in the securitised portfolio are higher than anticipated when the securitisation was issued, the resulting losses will be borne by the investors in the securitisation, rather than by the sponsoring credit institution.

4. The obligations of the credit institution in respect of the cover pool are supervised by public or other independent bodies.

Supervision of the credit institution's obligations in respect of the cover pool ("special" supervision) is supervision specifically for the benefit of covered bondholders, as opposed to supervision relating to the general stability of financial or other markets, general customer interest, deposit protection, and the like.

Special supervision is therefore distinct from the general supervision of the credit institution referred to in paragraph 1 above. Each form of supervision is an "essential feature" common to Covered Bonds, as listed above.

The content and the level of the "special" supervision in respect of the cover pool varies from one system to another.

Typical features of "special" supervision include:

- a special cover pool monitor
- periodic audits of the cover pool by the cover pool monitor
- ongoing management and maintenance of the cover pool upon the credit institution's insolvency to ensure the timely payment of covered bondholders.

In special-law based frameworks, the task of special supervision is usually assigned to public authorities and the issuer is required to obtain a licence to issue covered bonds. In many countries, this public authority is the banking supervision authority; in others, the capital market supervision authority; in some, both. These public authorities will also appoint or approve the cover pool monitor, and these authorities may also conduct their own audits of the cover pool from time to time.

Special public supervision is a condition of Art. 22 (4) of the UCITS directive and of several other EC directives (including those regarding insurance companies and deposit insurance), making bonds which are subject to special public supervision eligible for favourable investment limits for certain investors. In addition, for investors subject to the BCD, only covered bonds subject to special public supervision are eligible for preferential risk weightings.

In covered bonds issued under general law frameworks, the key features of special supervision are replicated by contract, to the extent possible. Therefore, for example, the issuing or sponsoring credit institution will appoint an external auditor to audit the cover pool, and an external trustee will be appointed to safeguard bondholders' interests: changes to the contractual documents which set the terms of the programme may not be changed without the consent of the trustee, for example.

CHAPTER 3 - THE ISSUER'S PERSPECTIVE

3.1 AUSTRIA

By Michelle Bradley, Morgan Stanley Bank
and Roland Berger, Bank Austria Creditanstalt

I. FRAMEWORK

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

1. Mortgage Banking Act (Law of 7/13/1899)
2. Law on Secured Bank Bonds (Law of 12/27/1905)
3. 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

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. So Pfandbrief and Fundierte Bankschuldverschreibungen (FBS) will either be backed by mortgages or public-sector assets, but not a mixture of the two.

For mortgage cover pools, there are no restrictions on assets from Austria; assets from the EEA and Switzerland are allowable but must be from countries where the preferential claim of Pfandbrief holders is recognised. EEA countries that do not recognise a preferential claim are limited to 10% of domestic assets. For public-sector cover pools, the geographic scope extends to the EEA and Switzerland and can have a maximum risk-weighting of 20%.

The limits for FBS are similar, for public bonds loans to central governments and sub-sovereigns in EEA countries and Switzerland with a limit of 20% on the risk weighting. Other eligible bonds are those which have “Mündelgelder” status, this is a legal term which means safe bonds. Claims or loans which have a lien registered in a public book are also considered eligible assets.

Asset-backed securities are not eligible for the cover pool.

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

Substitution assets are allowable for Austrian Covered Bonds but there is a limit of 15% to the total volume of Covered Bonds outstanding. The substitute assets must be liquid and can comprise of cash, bank deposits and bonds from public issuers from EEA countries and Switzerland.

The June 2005 amendment to the Covered Bond legislation introduced the exclusion of set-off rights of credit users for mortgage bonds. Banks now 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.

IV. VALUATION AND LTV CRITERIA

The valuation of property is treated differently, depending on which legislation you look at. 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.

There is no provision for property valuation for Pfandbrief under the Mortgage Bank Act or for FBS. In practice, issuers have incorporated an LTV provision into their articles of association.

A similar set-up applies to monitoring of property valuation where a regular audit is necessary under the Mortgage Bank Act but not provided for in the Mortgage Bond Act or for FBS.

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 may need to be approved by the regulator.

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, the recent changes to the Covered Bond law have introduced mandatory overcollateralisation of 2%, which must be held in highly liquid substitute cover. FBS issuers may also include additional overcollateralisation limits in their articles of association.

As well as these rules, banks can make additional voluntary provision in their articles of association which can strengthen the legal framework. An example of this would be to extend the matching principle to a net present value instead of nominal value. 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, who is appointed by the Minister of Finance, on suggestion of the issuer. The trustee is liable according to the Austrian civil code and has formal functions only. There are no specific qualifications required but the trustee principle has been amended to market standard in the June 2005 update to the Covered Bond legislation. 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. HOW ARE SEGREGATION OF COVER ASSETS AND BANKRUPTCY-REMOTENESS OF COVERED BONDS REGULATED?

In order to identify the assets that belong to the cover pool, there is a provision for a cover pool register in both the Mortgage Banking and the Pfandbrief Act. Following the June 2005 amendments a cover register is also necessary for FBS. All mortgages, public-sector loans, substitute cover assets and derivative contracts need to be registered in the cover register. The cover register allows the liquidator to segregate the assets that will belong to the cover pool in the case of issuer insolvency. Any asset that is not on the cover register will become part of the insolvency estate. The cover register is managed by the credit institution and supervised by the trustee.

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 ‘Sondermasse’ 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 of the FMA.

Impact of insolvency proceedings on Covered Bonds and derivatives

The Covered Bonds are not accelerated in the case of insolvency of the issuer. 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. In respect of derivatives there is no legal consequence of insolvency and the counterparty claims under derivative transactions rank pari passu with the claims of the Covered Bond holders.

There is a provision for the bonds to be accelerated if the net present value of the cover pool means that the bonds can be repaid in full. This option does need to be incorporated in the issuer’s by-laws.

Preferential treatment of Covered Bond holders

Covered Bond holders enjoy special treatment to the extent that they have a claim on the cover assets in the event of issuer insolvency. If the claims of the Covered Bond holders are not satisfied by the Sondermasse, the Covered Bond holders would then have recourse to the issuer for the remainder of their claim. They would rank pari passu with other senior unsecured creditors.

A moratorium on the insolvency estate is unlikely to affect the Covered Bond holders. Once the assets are segregated, the cover pool administrator is supposed to use the cash flow from the assets in the cover pool to satisfy the claims of the Covered Bond holders. In the case where the cash flow does not satisfy the Covered Bond claims, then the Covered Bonds could be accelerated.

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 Covered Bonds 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.

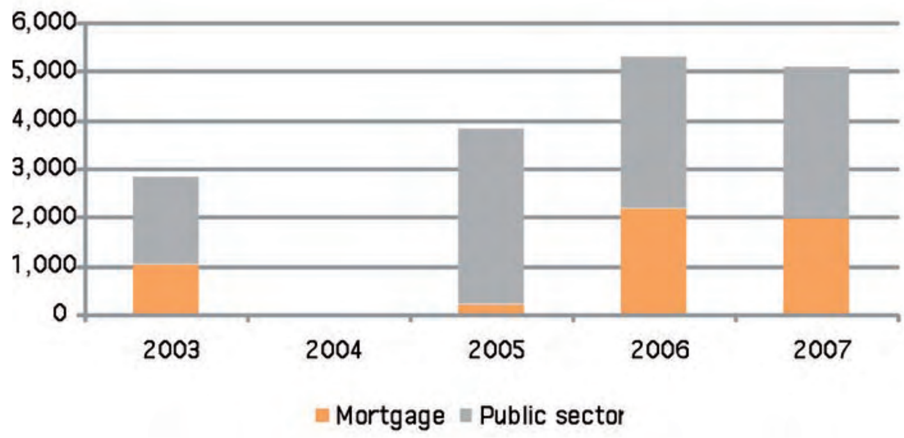
Finally, Covered Bonds in Austrian have special treatment from asset management companies. They are allowed a higher exposure to UCITS 22(4) eligible Covered Bonds compared to senior Covered Bonds.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2007, €M

Source: EMF/ECBC

Note: Data is an estimate. Issuance data for 2004 not available.

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2007, €M



Source: EMF/ECBC

Note: Data is an estimate. Issuance data for 2004 not available.

3.2 BULGARIA

Yolanda Hristova, Unicredit BulBank and
Franz Rudolf, Unicredit

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 with subsequent amendments.

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 3 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 refer to with, or include in their appellation, the extension "mortgage-backed bond", or any combination of these words.

COVER ASSETS

The outstanding mortgage–backed bonds shall be covered by mortgage loans of the issuing bank (principal cover). To substitute loans from the principle 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.

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.

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.

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.

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.

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.

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.

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

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.

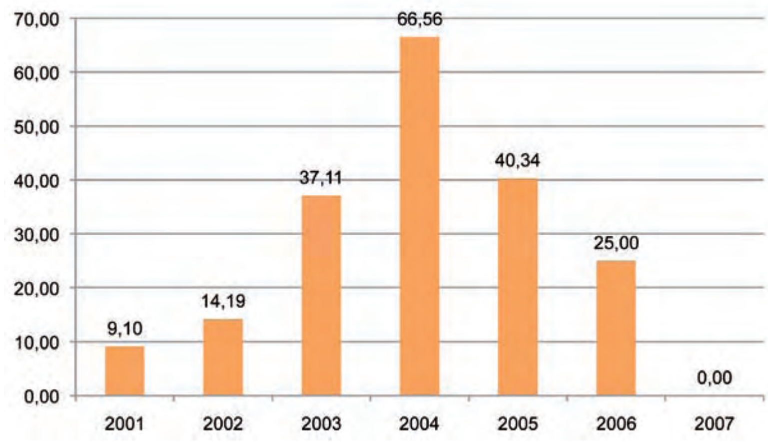
The Trustee shall have the powers of an assignee in bankruptcy in respect of the asset pool described above, as well as in respect of any outstanding liabilities of the issuing bank under mortgage backed bonds. The Trustee shall manage the above mentioned assets separately for any mortgage-backed bond 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 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.

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.

> FIGURE 1: MORTGAGE-BACKED BONDS ISSUANCE 2001-2007, €M



As of 31 March 2008, the outstanding amount of the issued mortgage bonds since 2001 is EUR 192.3 m.

3.3 CANADA

By David Power, RBC
and 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. Canadian Covered Bond programs are structured in line with the UK programs, given the similarity of the legal systems (Canadian law is derived from English common law).

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, four 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) and Canadian Imperial Bank of Commerce (CIBC). Covered Bonds have been issued under the first two programs.

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 Bonds obligations using the cash flows generated from the cover assets. The Guarantor is permitted to sell the mortgages 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 certain trigger events, for example, downgrade of the Issuer below BBB- (S&P), Baa3/P-1 (Moody's) BBB- (Fitch), A(low) (DBRS)[1] 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 stringent 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

1 For the BNS program only the Moody's and Fitch ratings are applicable as these two rating agencies rated the program

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 with the flexibility to access the market within a very short timeline as the cover assets have already been analyzed and monitored by the rating agencies. CIBC’s program is supported entirely by Canadian government insured mortgages.

III. COVER ASSETS

In all the Canadian Covered Bond programs to date the cover assets comprise residential mortgages. The cover assets within the RBC and BNS programs currently comprise uninsured mortgages (otherwise known as prime or conventional mortgages with a maximum loan to value (“LTV”) of 80% and full documentation). The BMO program includes uninsured as well as a portion of insured mortgages. Under the Canadian Bank Act, mortgage insurance is required for any mortgage originated by a regulated financial institution with an LTV in excess of 80%. Mortgage insurance is provided by the Canada Mortgage and Housing Corporation (“CMHC”), a Canadian Government entity, and other approved third party insurers, including Genworth Financial and AIG.

The structure of Canadian mortgages differs from those in the US and the UK. The term of Canadian mortgages is typically five years (based on an amortization term of twenty-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.

Certain Canadian mortgage products are often structured to provide the borrower with flexibility. This enables the borrower to split their mortgage into various terms as well as gain access to a line of credit or a secured credit card (BNS), backed by the same property. These various facilities are subject to a maximum LTV for each borrower determined during the underwriting process. At this stage, only the mortgage tranches have been included as collateral within the Canadian programs.

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, rating agency limits and consent of the interest rate swap counterparty in certain cases.

IV. VALUATION AND LTV CRITERIA

In Canada, every property is 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. There is no official property price index in Canada and as such, indexation has not been incorporated into the asset coverage test, unlike with the UK programs. 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.

Similar to the other structured 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 value of the asset pool is determined, factoring in the required level of over collateralisation through the asset percentage and adjusting for potential negative carry. The asset percentage is stipulated by the rating agencies, based 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 all the Canadian Covered Bond programs is currently 94.5%, which is higher than the UK programs. In addition, the Issuers have voluntarily incorporated a minimum level of over collateralisation within their programs, by capping the asset percentage at 97%.

An LTV cap of 80% for uninsured mortgages and 90% for insured mortgages (BMO) is applied to the latest valuation when determining the asset balance for the ACT. In addition, the maximum mortgage size is limited to CAD$3 million. Uninsured mortgages that are greater than ninety days delinquent are considered non-performing and are not given any credit for purposes of the asset coverage test. Insured mortgages under the BMO program are multiplied by a factor of 0.9 if they are non-performing.

V. 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 mortgage cash flows into Canadian floating rate, which is used by the Guarantor to meet the interest payments on the inter company loan. The Guarantor also enters into a forward starting exchange rate swap at closing to swap the Canadian floating rate into fixed rate Euro (all the Canadian Covered Bonds issued to date have been fixed rate Euro denominated). Cash flows under this swap are only exchanged following an Issuer event of default, as following this event the Guarantor requires the Euro fixed rate amounts to make payments to the Covered Bondholders. Based on 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.

If the ACT (see above) 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 in the case of the BNS program

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

Similar to the UK programs, 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
> 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 have an unsecured claim against the Issuer for the shortfall.

The existing Canadian Covered Bonds programs permit the issuance of soft-bullet bonds, with an extension period of up to twelve months. Under the BNS program, the Issuer is also able to issue 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 a period up to 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.

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

A reserve fund is required to be funded by the Guarantor following a downgrade of the Issuer below A-1+(S&P), P-1(Moody’s), F1(Fitch) or R-1(middle)/A(high) (DBRS). The balance of the reserve fund will be an amount equal to one month’s interest on the outstanding Covered Bonds under the program, plus one twelfth of the anticipated annual senior expenses, interest due on the Demand Loan, servcing fees and swap payments, if applicable. 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.

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 effectively 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 a Notification or Title Transfer Event which comprise the following:

> An Issuer event of default and service of a notice to pay on the Guarantor
> Notification is necessary under law or following an order from a court or regulatory authority
> Replacement of the Issuer as servicer of the cover assets
> Downgrade of the Issuer below BBB- (S&P), BBB- (Fitch), Baa3 (Moody's), A(low)(DBRS)
> Insolvency of the Issuer
> The Issuer requests a transfer of title
> Request from the Guarantor following the sale of a loan (BNS)
> Request from the security trustee (BNS)

Following any of the above events, the Issuer will 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.

IX. THE CANADIAN ECONOMY AND MORTGAGE MARKET

The Canadian economy continues to perform strongly compared to its G7 peers. Over the last decade, Canada has been ranked #1 for economic strength and employment growth and has achieved the highest real GDP growth within the G7. Canada has enjoyed consecutive fiscal and current account surpluses over the last nine years, which was ranked #2 by the World Economic Forum, is strong and stable. Net foreign indebtedness is the lowest since 1945 and the unemployment rate is near a 33-year low.

The mortgage and consumer fundamentals in Canada continue to remain solid. The mortgage products available in Canada are reasonably vanilla (typically a 5yr term with a 25yr amortization period, with no teaser rate or hybrid products), and prepayment penalties discourage refinancing booms. Sub-prime mortgage make up a very small component of the Canadian mortgage originations (approximately 5% compared to over 20% in the US in 2007). 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 2)

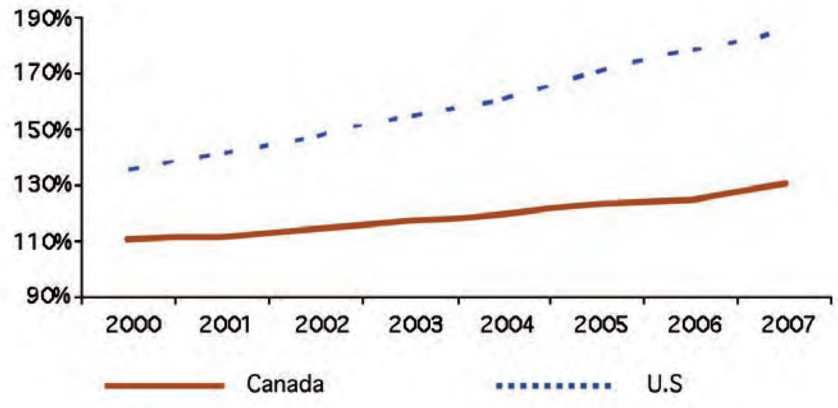
House prices in Canada have remained steady and according to the IMF the Canadian housing market is not over-valued (see figure 3). The conservative lending practices in Canada and the strong economic and consumer fundamentals have resulted in slightly declining delinquency rate (90+ days) over the last five years (see figure 4).

> FIGURE 1: OVERVIEW – CANADIAN COVERED BOND PROGRAMMES

	RBC	BMO	BNS
Programme Volume in (€ bn)	€15bn	€7bn	US$15bn
Outstanding Covered Bonds	€2.00bn due November 2012 €1.25bn due January 2018	€1bn due November, 2012	N/A
LTV cap	80%	80% for uninsured mortgages 90% for insured mortgages	80%
Asset percentage applied in ACT	94.5%	94.5%	94.5%
Overcollateralisation	105.8%	105.8%	105.8%
Non performing mortgages	No recognition for the ACT	No recognition for the ACT if uninsured. If insured, multiplied by a factor of 0.9	No recognition for the ACT
Soft Bullet	Yes (12 month extension)	Yes (12 month extension)	Yes (12 month extension); Ability to issue hard-bullet bonds with a pre-maturity test run twelve months prior to maturity
Asset monitor	Deloitte	KPMG	KPMG

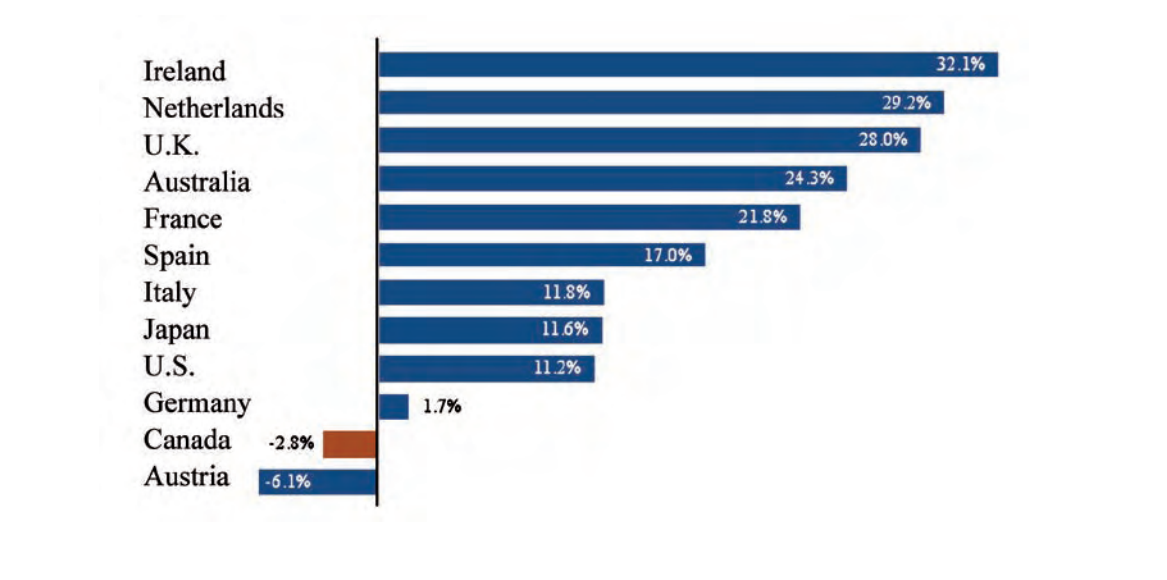
Source: Transaction documents

> FIGURE 2: HOUSEHOLD DEBT AS % OF DISPOSABLE INCOME



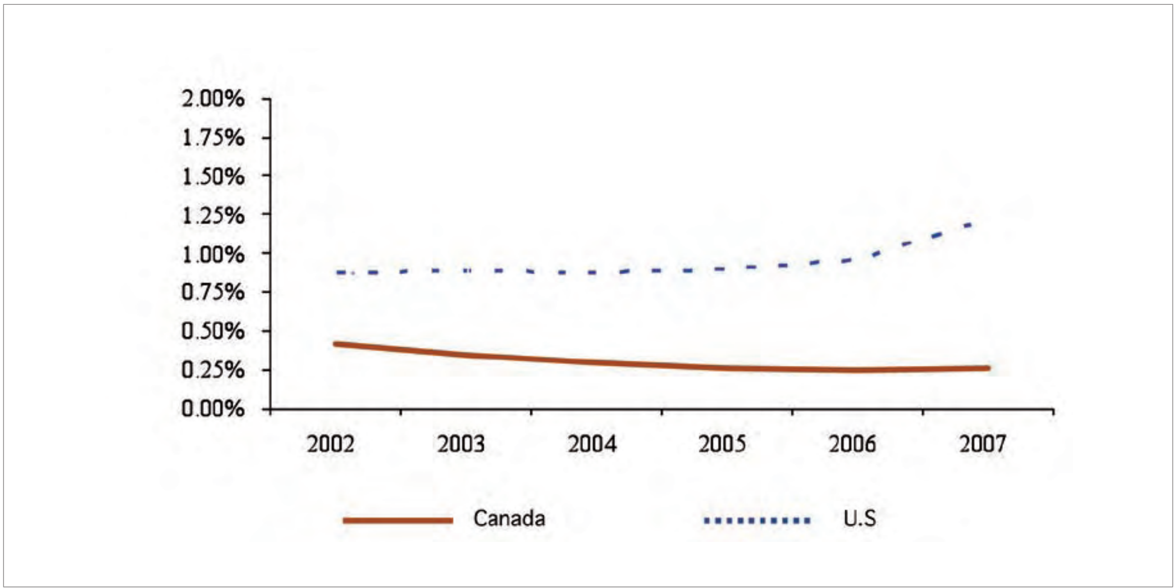
Source: Statistics Canada, Bank of Canada, U.S. Federal Reserve, U.S. Bureau of Economic Analysis, RBC Economics Research

> FIGURE 3: OVERVALUED AND UNDERVALUED HOME PRICES (% OVER OR UNDER VALUED)



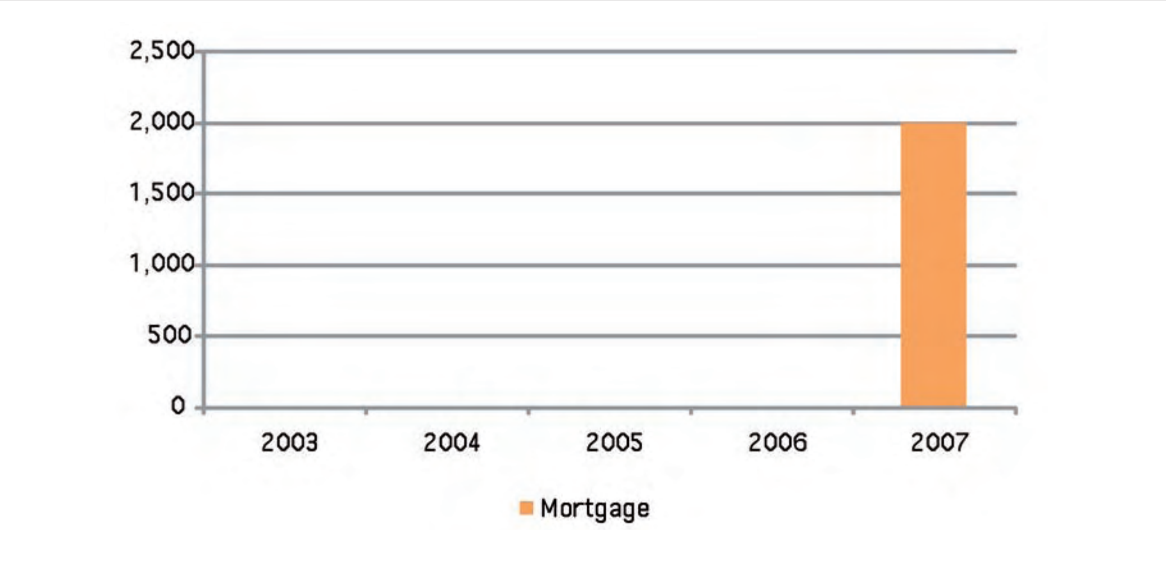
Source: International Monetary Fund, 2007

> FIGURE 4: MORTGAGE DELINQUENCIES (90+ DAYS)



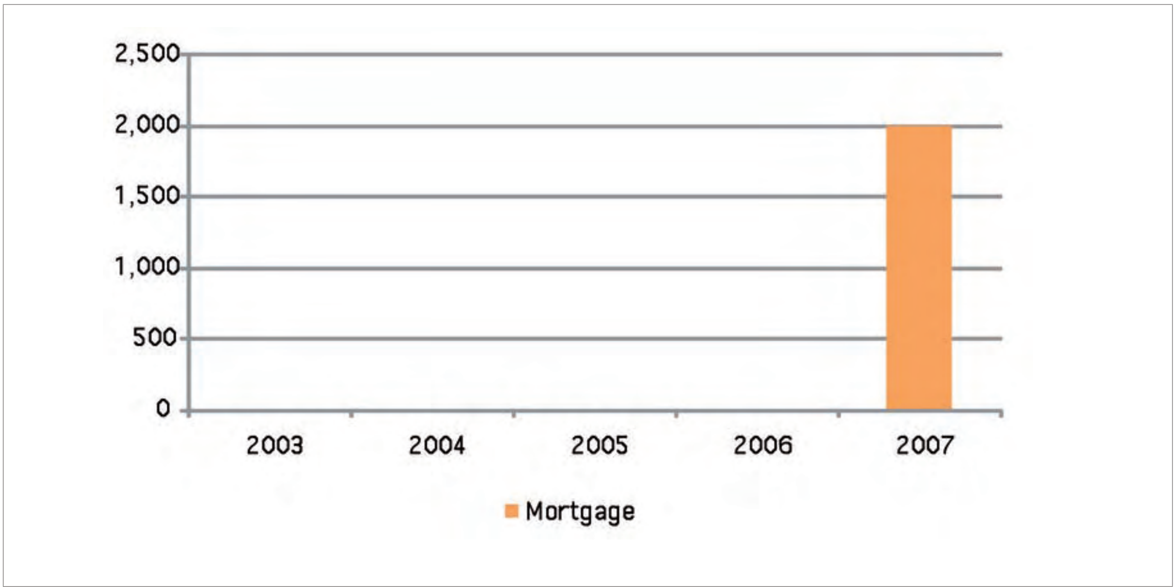
Source: Canadian Banker's Association, Mortgage Bankers' Association, RBC Economics Research

> FIGURE 5: COVERED BONDS OUTSTANDING 2003-2007, €M



Source: EMF/ECBC

> FIGURE 6: COVERED BONDS ISSUANCE, 2003-2007, €M



Source: EMF/ECBC

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.

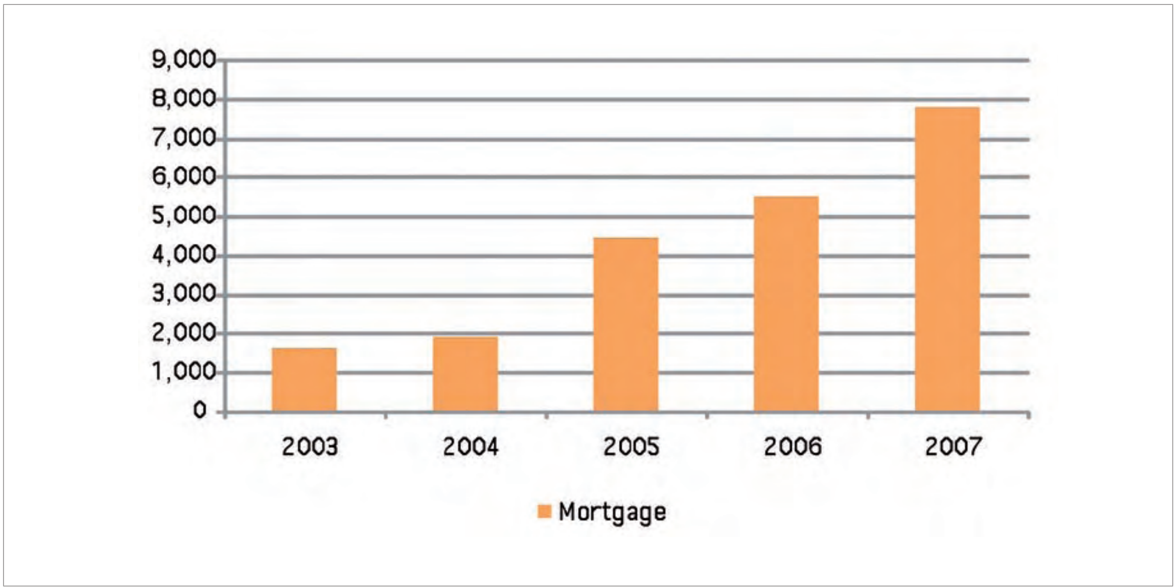
The CNB also supervises the issuer activities from the position of a Government supervisory body over the capital market. Each issuer having its MCBs in circulation is obligated to send to the CNB the reports showing its economic results and its financial situations in the determined intervals and to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

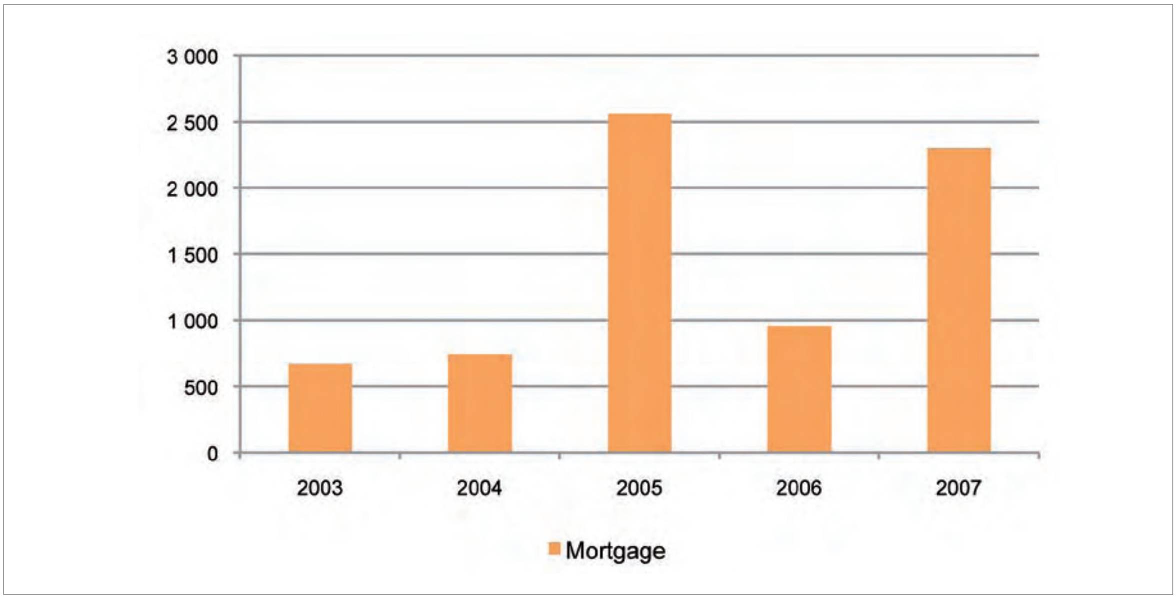
The Czech MCB legislation complies with the requirements of Art. 22 par. IV UCITS Directive.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2007, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2007, €M



Source: EMF/ECBC

Notes: Data for 2007 is estimated

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. Danish mortgage banks are also governed by the Danish Mortgage-Credit Loans and Mortgage-Credit Bonds etc. Act (the "Mortgage Act"). 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-247f 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

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

guarantees issued by public authorities. Mortgage banks may also carry on other business related to mortgage banking.

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 is planned to be in place in November 2008 and will crown 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 70%1)	80% or 70%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 70% for loans with an unlimited maturity and interest-only period. From July 2009 the limit rises to 75%.
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 70% (75% as from 1 July 2009) for owner-occupied dwellings etc is exceeded, supplementary security will be required when the LTV exceeds 80%.

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

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

V. ASSET - LIABILITY MANAGEMENT

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

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

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

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

Types of risk	Specific balance principle	General balance principle
Interest rate risk	Stress test on level and structure + Loss limit of 1 per cent of capital base + Risks in different currencies cannot be set off	Stress test on level and structure Loss limit for **mortgage banks** dependent of stress test: 1 per cent/ 5 per cent of capital adequacy requirement + 2 per cent/10 per cent of the additional excess cover Loss limit for **commercial banks** dependent of stress test: 10 percent/100 percent of excess cover
Currency risk	Exchange rate indicator 2 (few currencies) + Loss limit of 0.1 per cent of capital base	Simple stress test Loss limit for **mortgage banks**: 10 pct. of capital adequacy requirement + 10 per cent of the additional excess cover for EUR and 1 per cent of capital adequacy requirement + 1 per cent of additional excess cover of other currencies Loss limit for **commercial banks**: 10 percent of excess cover
Option risk	Maximum term of 4 year + Structural limits on call options and index-linking	Stress test on volatility Loss limit for **mortgage banks**: 0,5 per cent of capital adequacy requirement + 1 per cent of the additional excess cover No maturity or structural limits Loss limit for **commercial banks:** 5 percent of excess cover No maturity or structural limits

Types of risk	Specific balance principle	General balance principle
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 the junior covered bonds. Junior covered bonds 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.

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);
> 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. The lender will have a first priority secured claim against the assets provided as security but not against the mortgages.

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".

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.

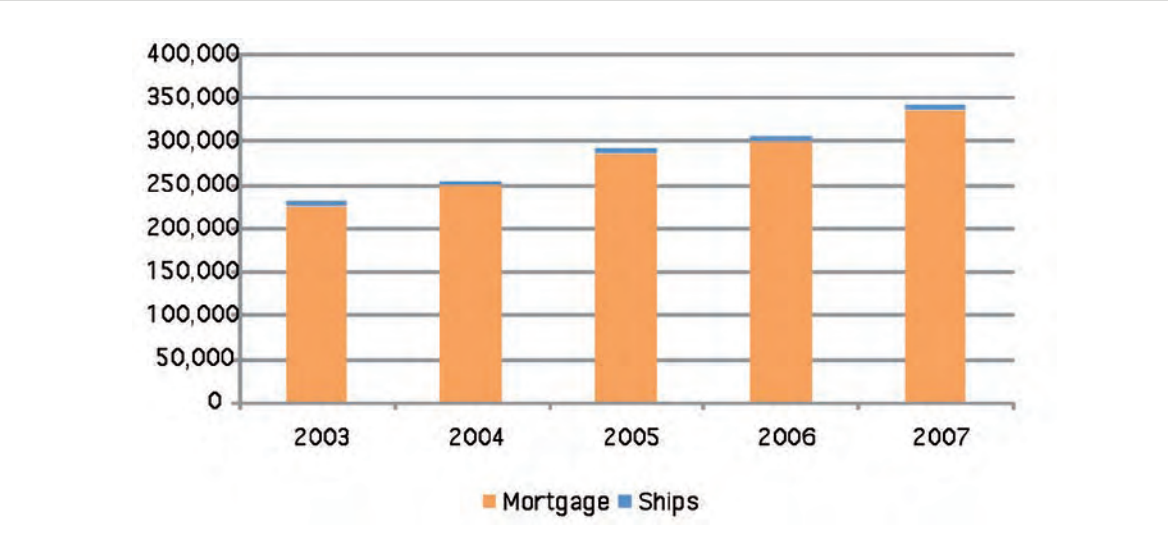
The register is – contrary to the capital centres of mortgage banks – not subject to any specific statutory minimum requirement as to capital adequacy. The 8% capital adequacy requirement must only be fulfilled at the level of the commercial bank.

VIII. RISK WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

SDOs and SDROs qualify as covered bonds under the CRD. ROs issued before 1 January 2008 will maintain the low risk weighting of 10% throughout the maturity of the bonds in accordance with the grandfathering option under the CRD. ROs issued after 1 January 2008 carry a risk weight of 20%. ROs, SDOs and SDROs are eligible for repo transactions and may be used as collateral for loans with the Danish central bank (Danmarks Nationalbank).

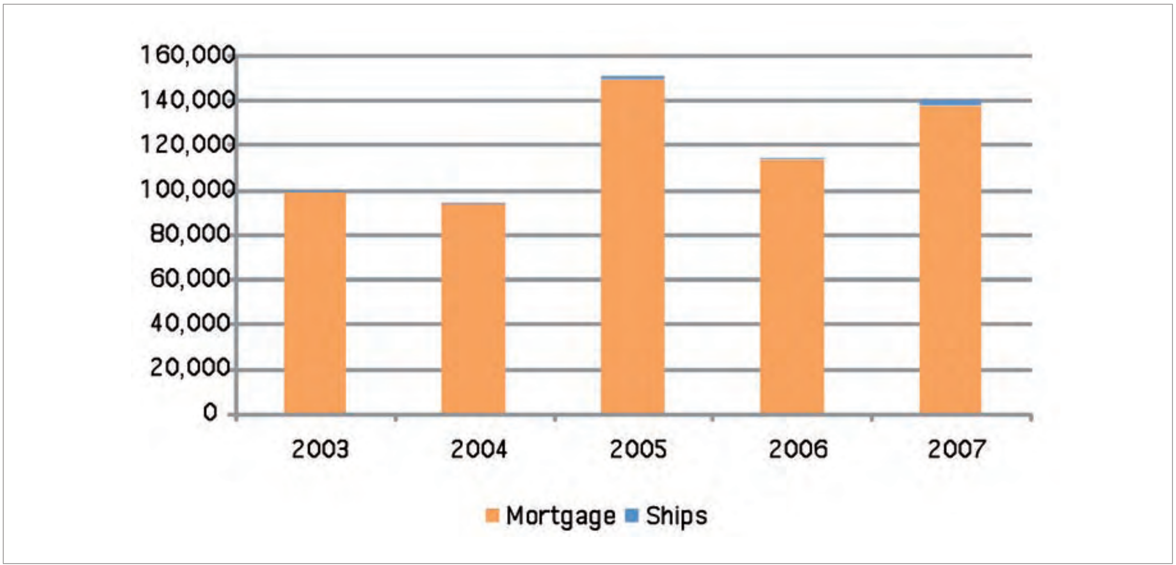
When investing in ROs, SDOs and SDROs, the Danish investment legislation allows pension funds etc to exceed the usual limits on exposures to a single issuer. thus acknowledging the reduced risk associated with covered bond assets (cf the Financial Business Act (for insurers) and the Act on Investment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

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2007, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2007, €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 2007 the mortgage banks' outstanding volume of covered bonds was EUR 335 bn.

Since the new Danish regulation on Covered Bonds intered into force on 1 July 2007 only one commercial bank, Danske Bank A/S, has used the possiblity to issue covered bonds. Danske Bank has issued a non-pass-through benchmark euro covered bond of a value of around EUR 2.75 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

I. FRAMEWORK

In Finland, the legal basis for covered bond issuance is the mortgage bank act MBA) 1240/1999. It was passed by Finnish Parliament in 1999 and has been amended in October 2000. Another rather technical amendment in connection with changes in the national banking legislation has been passed in February 2007.

II. STRUCTURE OF THE ISSUER

The issuer of Finnish Covered Bonds has to be a specialized bank, e.g. a bank, which has been licensed under the MBA. Such a Mortgage Bank is by law only allowed to pursue the business of lending to the public sector as well as mortgage lending and business and other activities which are closely related to both sectors mentioned before. For refinancing these businesses, in Finland only such a mortgage bank is allowed to issue Finnish Covered Bonds.

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 for the claims of the holders of Finnish Covered Bonds.

So far, the three issuers of Covered Bonds from Finland are using structural features in order to enhance the safety of their issues. Only two of these Finnish issuers have been active in 2007. Currently only Bonds covered by mortgages were issued by Finnish mortgage banks. A separate cover pool would be required if these banks were to start the issuance of public-sector backed Finnish Covered Bonds.

III. COVER ASSETS

Cover assets are so far produced from mortgage lending. ABS or MBS tranches are not eligible for the cover pool.

Up to 20% of the mortgage cover pool is allowed to consist of substitute cover assets. These assets must comply with the Tier-1 definition as used by the European Central Bank

The geographical scope of eligible mortgage assets is restricted to the European Economic Area (EEA). So far, the Finnish issuers restrict themselves to domestic mortgages on a voluntary basis.

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

The nature of the cover pool is dynamic. There are no explicit transparency requirements regarding the cover assets

IV. VALUATION AND LTV CRITERIA

The property valuation within the legal framework for Covered Bonds in Finland is based on market values.

The LTV limit is 60 % of the market value. This LTV is a relative limit, i.e. when a loan exceeds the 60 % limit, the part of the loan up to 60 % 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. Additionally, the national Financial Supervision Authority (FSA) requires stress tests for cash flows from variable interest rate payment. The stress test comprises a 1% i.e. 100 basis points parallel shift of the yield curve.

The Finnish law also sets out rules with regard to duration of cover assets and bonds. The average term to maturity of the outstanding notes must be shorter than the average term to maturity of the collateral assets.

Also the net present value of outstanding Covered Bonds must be lower than the net present value of the cover assets.

With regard to foreign exchange risk, the Finnish MBA requires complete matching of cover assets and outstanding Covered Bonds after taking into account possible hedging transactions.

So far, the MBA requires no formal over-collateralisation. In practice, the Finnish issuers so far established a minimum level of over-collateralisation within their programmes.

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 mortgage bank in question.

So far, rating agencies have no explicit role in the legal framework of Finnish Covered Bonds. Nevertheless, all current issuers by using structural enhancements have assigned a certain role to the rating agencies.

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 this 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 mortgage bank, which in turn is supervised by the FSA.

The cover register contains information about the principle amount of Covered Bonds issued, the loans 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 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 junior to Covered Bond holders but pari passu with unsecured creditors of the issuer. 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 mortgage bank depend on the relevant contracts. In any case, the claims of the derivative counterparties rank junior to Covered Bond holders but pari passu with unsecured creditors of the issuer.

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 bank's assets.

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 MBA foresees no possibility for the pool administrator to take up a loan on behalf of the cover pool to create more liquidity.

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

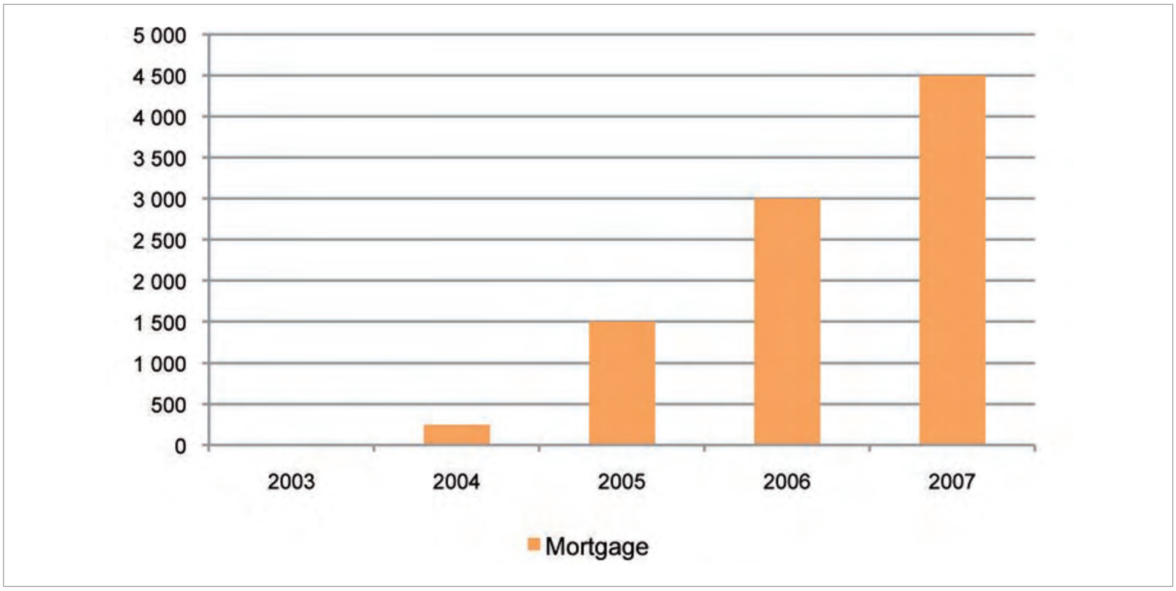
VII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Finnish Covered Bonds comply with the requirements of Art. 22 par. 4 UCITS Directive as well as with those of the CRD Directive, Annex VI, Part 1, Paragraph 65 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.

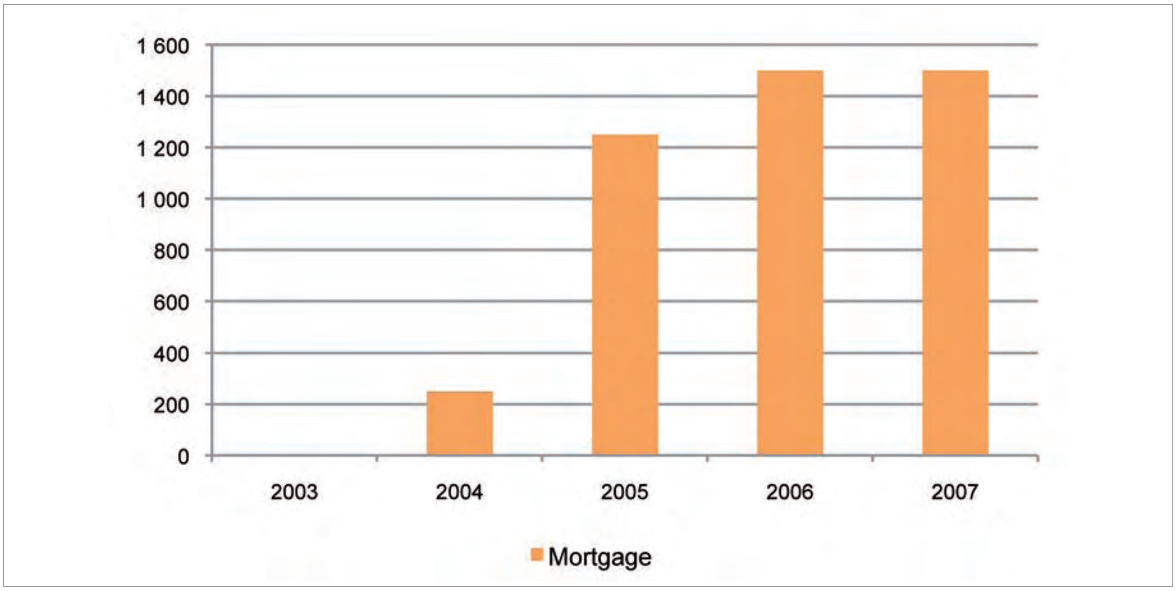
As far as the domestic issuers are aware, there are no further specific investment regulations regarding Finnish Covered Bonds.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2007, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2007, €M



Source: EMF/ECBC

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 updated in 2007 according to the implementation of the European Capital Requirements Directive N° 2006/49.

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

While some countries allow ordinary credit institutions to issue directly covered bonds, provided that the assets pool backing the covered bonds is segregated in their balance sheet, France requires the setting up of a special company, the *société de crédit foncier* independent from the other group companies and specifically dedicated to the issuance of *obligations foncières* - the French legal covered bonds.

I. LEGAL FRAMEWORK

Obligations foncières, issued by *sociétés de crédit foncier* are strictly regulated in order to offer bondholders high credit quality and strong default protection.

Sociétés de crédit foncier are specialised credit institutions governed by articles L.515-13 and seq. of the French Monetary and Financial Code. Licensed by the *Comité des Etablissements de crédit et des entreprises d'investissement (CECEI),* 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. They may also issue or contract other debts benefiting or not from the Privilege.

Sociétés de crédit foncier are supervised by the French banking regulator (the *Commission Bancaire)* and subject to special rules in addition to ordinary banking regulations.

They have a special status departing from general laws and especially bankruptcy law.

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 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 French Monetary and Financial 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 Monetary and Financial 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).

III. PRIVILEGE

Pursuant to article L.515-19 of the Monetary and Financial Code, holders of *obligations foncières* and other privileged debts have preferred creditor status and the right to be paid prior to 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.

The 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 equity shares 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 French Monetary and Financial 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 1.

From a regulatory standpoint, the coverage ratio is calculated by applying different weights to certain classes of assets: senior units of securitisation funds, for instance, 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.

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".

The mission of the Specific Controller involves the following verifications:

- that all assets 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 "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

Sociétés de crédit foncier are under the supervision of the *Commission Bancaire*, the French banking regulator, which can impose administrative measures and sanctions if the company does not fully comply with banking and *sociétés de crédit foncier* regulations. The *Commission Bancaire* receives a regular monthly bank statement sent by the *société de crédit foncier* and an annual report by the Specific Controller on his missions and achievements.

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, 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 French Monetary and Financial 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.

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 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

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 in 2007 was 5.8 times. Two of CRH issues have a size of 5 euro billion.

XI. RISK - WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

CRH's debt is 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 presented 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 loan business and circa two thirds of its current originations are secured by guarantees. Following on BNP Paribas' footsteps, Credit Mutuel and Banque Populaire set up structured covered bond programmes in 2007. In 2008, Groupe Caisse d'Epargne set up its €25bn CB programme (GCE CB), although it has not yet issued its inaugural covered bond.

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 financial regulations, which allows for a segregation of the assets without transfer of assets to the issuer of the structured covered bonds. This directive was implemented into the French Code Monétaire et Financier (Article L.431-7) by ordinance N° 2005-171 of 24 February 2005. Pursuant to the article L.431-7-3-1 of the Code, the pledges and the cash collateral shall be enforceable, when the relevant guarantor or cash collateral provider is the subject of any insolvency proceedings.

Issuers of French common law-based covered bonds use a two-step structure. A bank originating collateral transfers or assigns or pledges potential collateral to a subsidiary institution, which in most cases is an affiliate of the sponsor bank which has the legal status of a credit institution with limited purpose.

Since such CB programs are conducted outside the OF framework, the key aspects of the structure, management principles and eligible assets have been agreed on a contractual basis, notably with regard to minimum overcollateralisation, which is set at 8.11% for all the common-law based programmes currently outstanding (i.e. the Asset Coverage Test (ACT) must be no more than 92.5% at all times).

II. STRUCTURE OF THE ISSUER

All issuers to date are credit institutions regulated by the Commission Bancaire and the CECEI (*Comité des Etablissements de Credit et des Entreprises d'Investissement*). These specialised credit institutions are usually an affiliate of the sponsor bank, with limited purpose. In the case of BNP Paribas Covered Bonds, the issuer is "BNP Paribas Covered Bonds S.A.", a specialised credit institution in which BNPP holds a 99.9% stake. For Credit Mutuel-CIC, the issuer is "CM-CIC Covered Bonds S.A.", a subsidiary of Banque Fédérative du Crédit Mutuel and licensed as a credit institution with limited and exclusive purpose. Finally, in the case of Banque Populaire, the issuer is Banques Populaires Covered Bonds S.A. (BPCB), which 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 Financial Code. The issuer is a special affiliate of the Banque Populaire Group and has been licensed by the French banking regulator notably for the purpose of making Borrower Loans and issuing Covered Bonds. Finally, GCE CB is a subsidiary of Caisse Nationale des Caisses d'Epargne and licensed as a credit institution with limited and exclusive purpose by the French CECEI. In all structured 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 issuers grant advances to the sponsoring bank. The terms and conditions of these advances are designed to match those of the covered bonds. The covered bonds are either fungible with an existing series, or constitute a new series with different terms. All covered bonds issued under the respective programme rank pari passu with each other and share equally in the security.

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 a third-party which is a financial institution. Being a structured program, geographical restrictions to date have been self imposed. Although the outstanding BNP and CM-CIC covered bonds consist exclusively of French housing loans, the respective covered bond programmes allow for the inclusion of loans from other countries. In contrast, the Banque Populaire CB program only allows 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, 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, which would be removed from the collateral portfolio.

Substitution assets can be included in the cover pool. Their aggregate value can make up to 20% of cover assets and may consist of exposures which are subject to rather high quality criteria. They consist of short-term (<1year) investments, namely bank deposits, at least rated A-1+ AA-, F1+, RMBS notes or government debt, which all must be at least rated triple A.

IV. VALUATION AND LTV CRITERIA

The properties are valued using 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 reduce the risk of there being a shortfall, 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. Apart from the results of this calculation, a minimum overcollateralisation level has to be maintained (*see Figure 1*). This minimum level of OC may be increased from time to time if the credit quality of the mortgages in the collateral pool decreases.

V. ASSET-LIABILITY MANAGEMEMT

Within all the French structured CB programmes there are contractual provisions that stipulate that exposure to interest rate and currency risk needs to be neutralised. In addition, downgrade rating triggers for swap counterparties, the pre-maturity test, maturity extension rules and the amortisation test all ensure cashflow adequacy.

All French structured 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 account banks, and independent audits of the calculations are undertaken on a regular basis.

An amortisation test has been created to ensure that the assets will be sufficient to enable the issuer to repay the covered bonds. It only applies after a borrower enforcement notice has been delivered and, therefore, covered bondholders will be relying on the proceeds from cover assets. The amortisation test will fail if the aggregate loan amount falls below the outstanding balance of all the covered bonds. In addition, if the borrower's short term ratings are downgraded below a certain level, the borrower will be required to establish a reserve fund to retain an amount sufficient to meet interest and principal payments over a specific period (e.g. two months for BNP Paribas, nine months for Crédit Mutuel, Banque Populaire and Groupe Caisse d'Epargne) on each series of covered bonds.

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 (*Commission Bancaire*) and CECEI (*Comité des Etablissements de Credit et des Entreprises d'Investissement*). In its role as sponsor bank, 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 an asset monitor agreement, an 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 checked 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 bond 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 upon a borrower enforcement notice or an 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 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 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 security 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 the failure of an amortisation test. This would cause the acceleration of payments to covered bondholders and their redemption at the early amount relevant to that particular covered bond.

A third important trigger event would be a covered bond issuer event of default. This would arise after the covered bond issuer failed to make any payments when due, legal proceedings were started against the issuer, the failure of an amortisation test, or the failure to enter into hedging agreements following a downgrade of the sponsor below a predefined level. In this case, the issuer's security agent shall be entitled to enforce its rights, payments to covered bondholders would be accelerated and the covered bonds would be redeemed at the early redemption amount including accrued and unpaid interest relevant to that particular covered bond.

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.

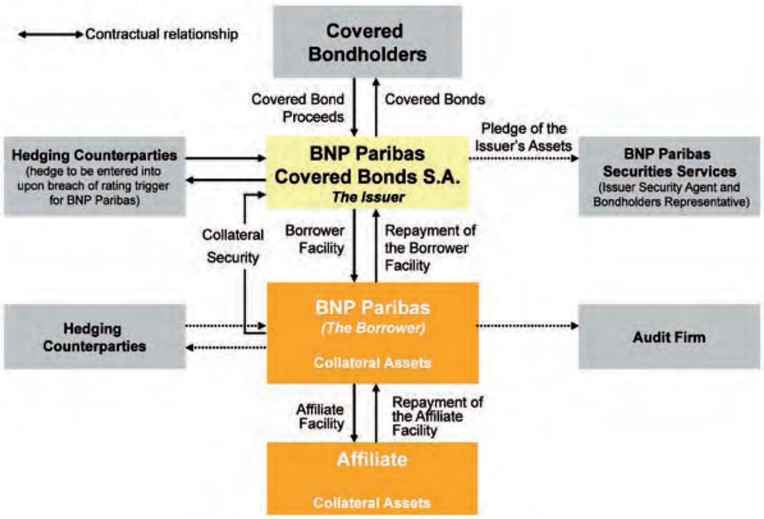
Figure 1: Overview - French Common Law Based CB Programmes

	BNPP CB	CM-CIC CB	Banques Populaires CB	GCE CB
Long Term Issuer Ratings (Moodys, S&P, Fitch)	Aa1 / AA+ / AA	Aa3 / AA- / AA-	Aa2 / AA- / -	Aa2/AA(neg)/AA-(neg)
Programme Volume in € bn	25	15	25	25
Collateral assets	Residential mortgages	Residential mortgages	Residential mortgages	Residential mortgages
RMBS tranches allowed as substitution assets?	Up to 20%	Up to 20%	No	up to 20% of assets in ACT
Underlying properties	Located in France but other countries possible (e.g.in Italy with BNL)	Located in France but other countries possible	Located in France only	Located in France only
Asset percentage applied in ACT	92.5%	92.5%	92.5%	92.5%
Minimum overcollateralisation	8.11%	8.11%	8.11%	8.11%
EURO Benchmark CB Outstanding (in € bn)	11.0	4.5	2.0	-
Number of loans	179,729	134,154	36,977	159,698
Seasoning (in months)	37.3	45.0	31	37
Remaining terms in months	188	187	176	186
WA Current LTV	71.42%	68.0%	71.0%	69.9%
WA Indexed LTV	59.23%	60.0%	61.0%	58.1%
Ownership Status	82% Owner occupied 13% Buy-to-let 5% Vacation/Second Home	84% Owner occupied 13% Buy-to-let 3% Vacation/Second Home	89% Owner occupied 8% Buy-to-Let 3% Vacation/Second Home	94% Owner occupied 2% Vacation/Second Home 4% Buy-to-Let
Interest Payment Type (as % of total amount)	85% fixed 15% variable	78% fixed 22% floating	96% fixed 4% floating	84% fixed 16% floating
Geographical Distribution (as a % of Total Balance)	36% Paris region 10% PACA 7% Rhône Alpes	32% Paris Region 16% Rhone Alpes 14% Alsace	32% Paris region 8% Rhône Alpes 9% Pays de la Loire 8% Britany	19,8% Paris region 11,60% Provence Alpes Côte d'Azur 10,30% Rhône Alpes 7,50% Nord Pas de Calais
Home Loan Security Interests	Mortgage 55% Crédit logement 45%	44% secured by a mortgages 31% guaranteed by CMH 25% guaranteed dy Crédit Logement	29% 1st Rank Mortgages 2% Credit Logement 41% In house mutual insurance co. 28% CASDEN	28% Mortgage 2% Crédit Logement 70% SACCEF

BNPP CB: data as at May 2008 except for home loan security as at March 2008; CM-CIC: data as at May 2008 except for home loan security as at Oct 2007; Banques Populaires CB: data as at March 2008; GCE CB: data as of May 2008

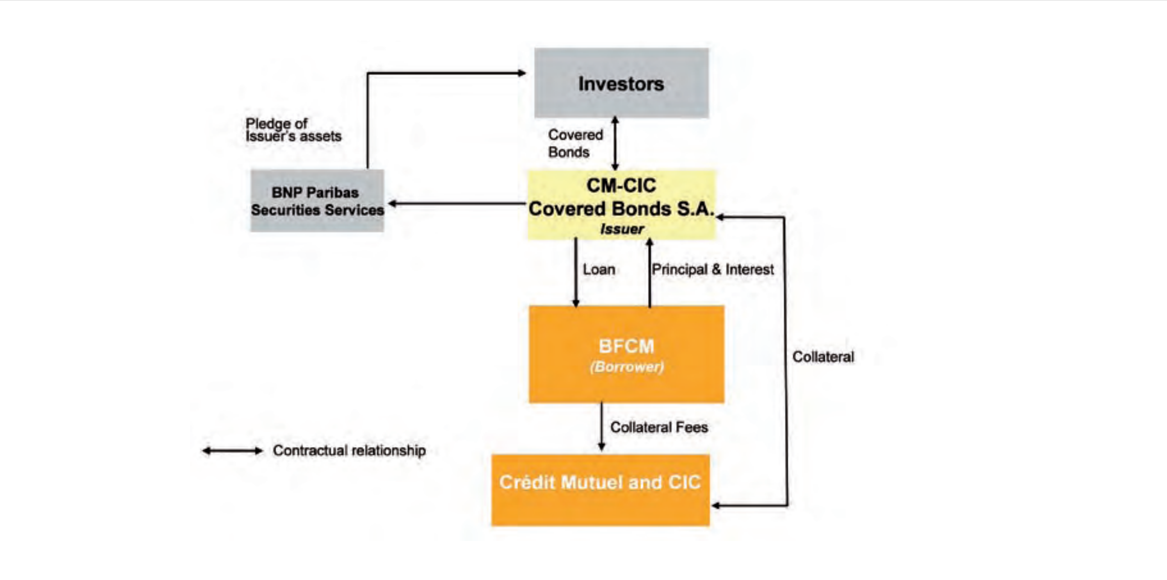
Source: Investor reports, Rating agencies, NATIXIS

Figure 2: BNP Paribas Covered Bond Structure



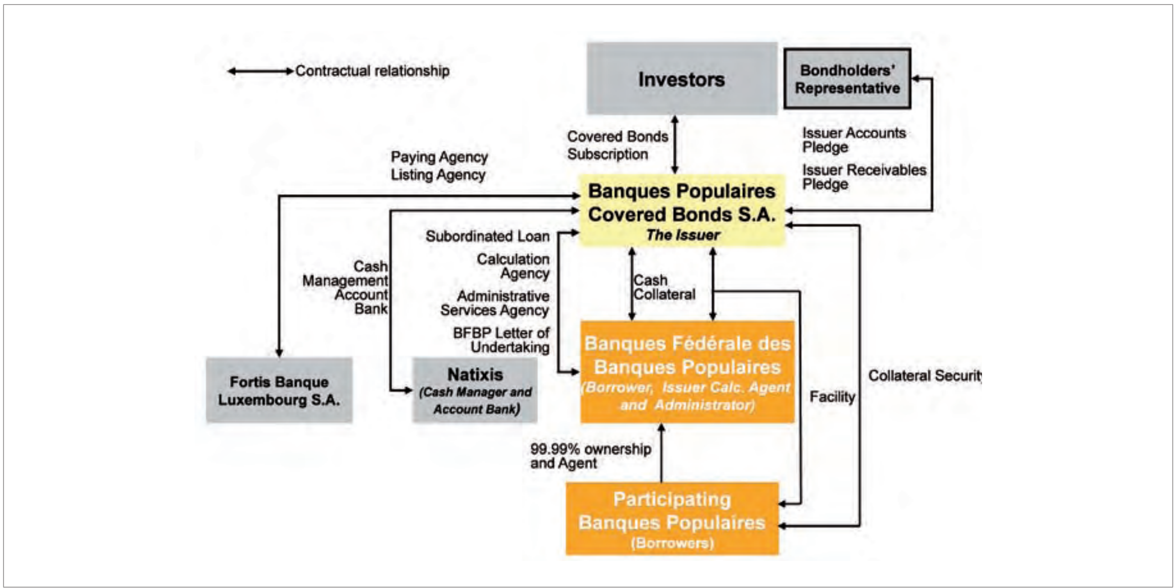
Source: Rating Agencies, NATIXIS

Figure 3: Credit Mutuel-CIC Covered Bond Structure



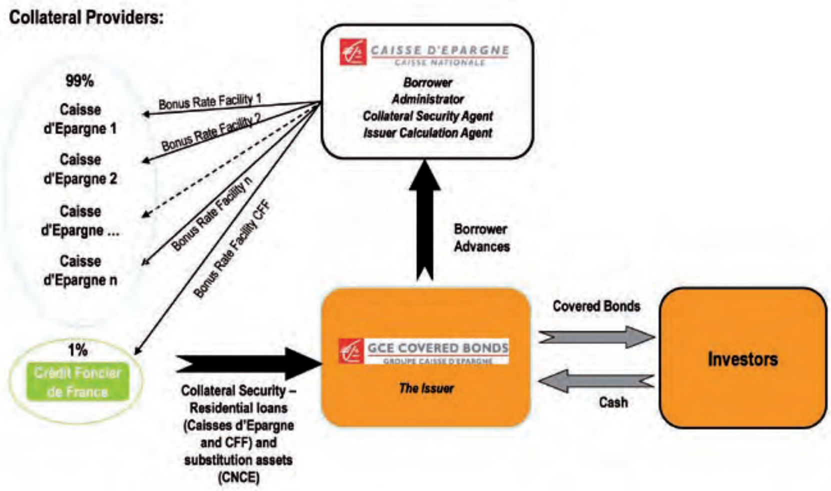
Source: Rating Agencies, NATIXIS

Figure 4: Banque Populaire Covered Bond Structure



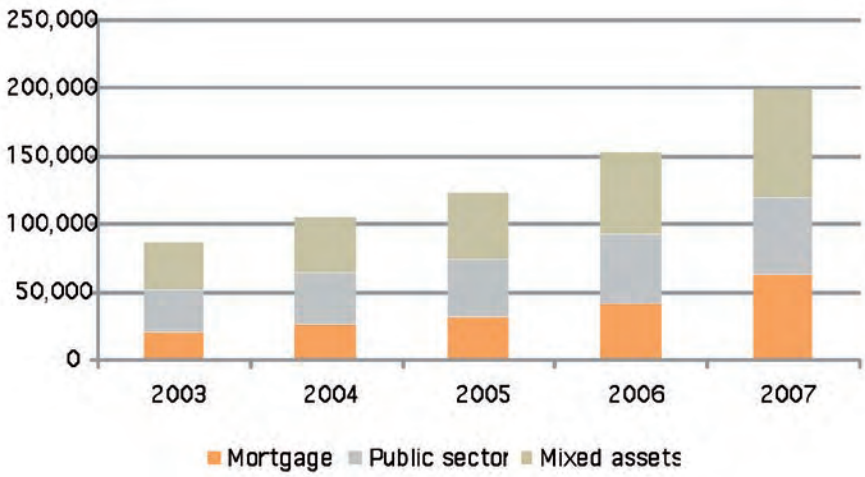
Source: Rating Agencies, NATIXIS

Figure 5: Group Caisse d'Epargne Covered Bond Structure



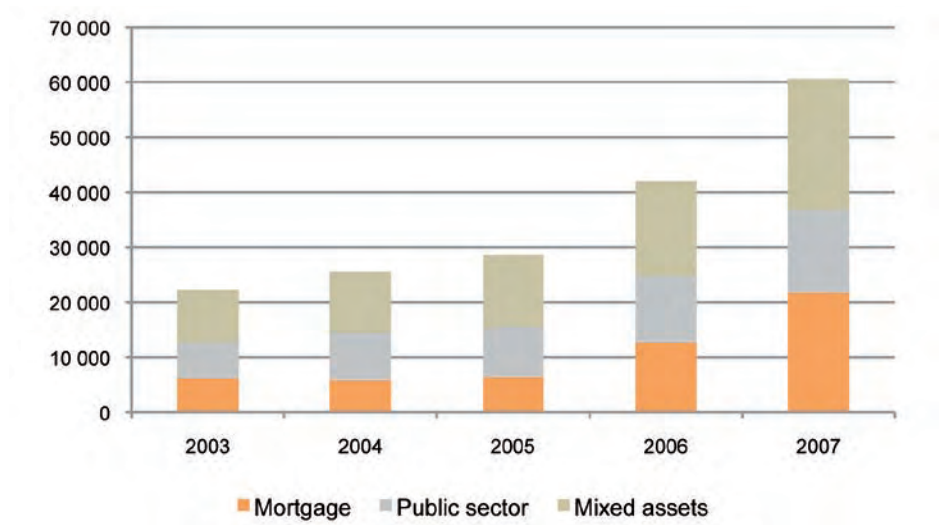
Source: Rating Agencies, NATIXIS

Figure 6: Covered Bonds Outstanding 2003-2007, €m



Source: EMF/ECBC

Figure 7: Covered Bonds Issuance, 2003-2007, €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 eight Covered Bond issuers in France: Compagnie de Financement Foncier (CFF), CIF Euromortgage, Dexia Municipal Agency, Caisse de Refinancement de l'Habitat (CRH), BNP Paribas, CM-CIC, Banque Populaire and CFCAL.

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 Pfandbriefgesetz (PfandBG – Pfandbrief Act) 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, Postbank Covered Bonds and Landwirtschaftliche Rentenbank Covered Bonds). The range of cover assets is slightly different compared to Pfandbriefe (they include for instance 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.

A ministry draft on amendments of the PfandBG was released in June 2008 and Parliamentary proceedings are due to commence in autumn 2008. The amendments of the PfandBG are expected to be adopted in spring 2009.

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 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. 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 and ship financing activities. ABS/MBS are not eligible. A specific class of Covered Bonds corresponds to each of these cover asset classes: Hypothekenpfandbriefe, Öffentliche Pfandbriefe and Schiffspfandbriefe. The respective Pfandbrief must be fully secured by its specific cover asset class (§ 4 PfandBG). Detailed transparency requirements are regulated in § 28 PfandBG.

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.

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 mortgages (§ 22 V 2 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 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 Pfandbriefe and the interest yield must be at least the same.

In addition, the new Pfandbrief Act requires that Pfandbriefe are covered on a net present value basis even in the event of severe interest rate changes. The issuer has to provide an overcollateralisation of at least 2% after stress tests which have to be carried out weekly. Both the maturity of outstanding Pfandbriefe and the fixed-interest periods of the cover pool are disclosed on a quarterly basis.

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 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 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 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, § 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), but automatically form a separate legal estate (or separate property: “Sondervermögen”).

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). 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.

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 the BaFin 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 Covered Bonds.

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 specific regulation exists with respect to the insolvency remoteness of voluntary overcollateralisation. However, the insolvency administrator may only demand that the overcollateralisation be surrendered to the insolvent’s estate if those amounts will obviously not be necessary as cover for the respective Pfandbrief category (§ 30 IV 1 PfandBG).

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.

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

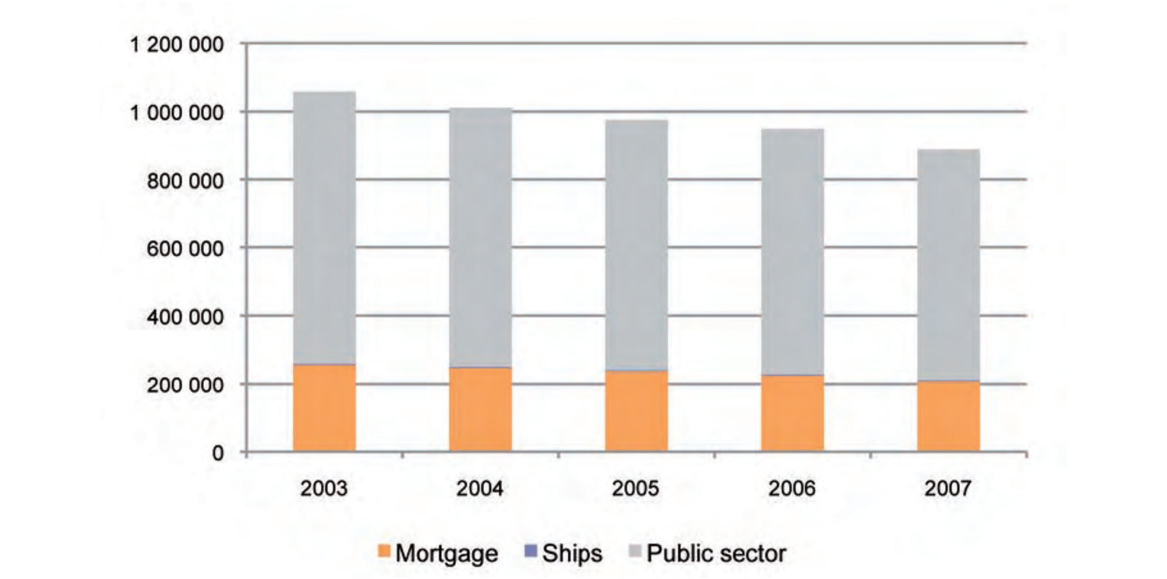
The risk weighting of Covered Bonds (German Pfandbriefe and foreign Covered Bonds) is regulated by Article 20a Kreditwesengesetz (KWG) and the Solvabilitätsverordnung (SolvV), transposing the Capital Requirements Directive into German law.

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).

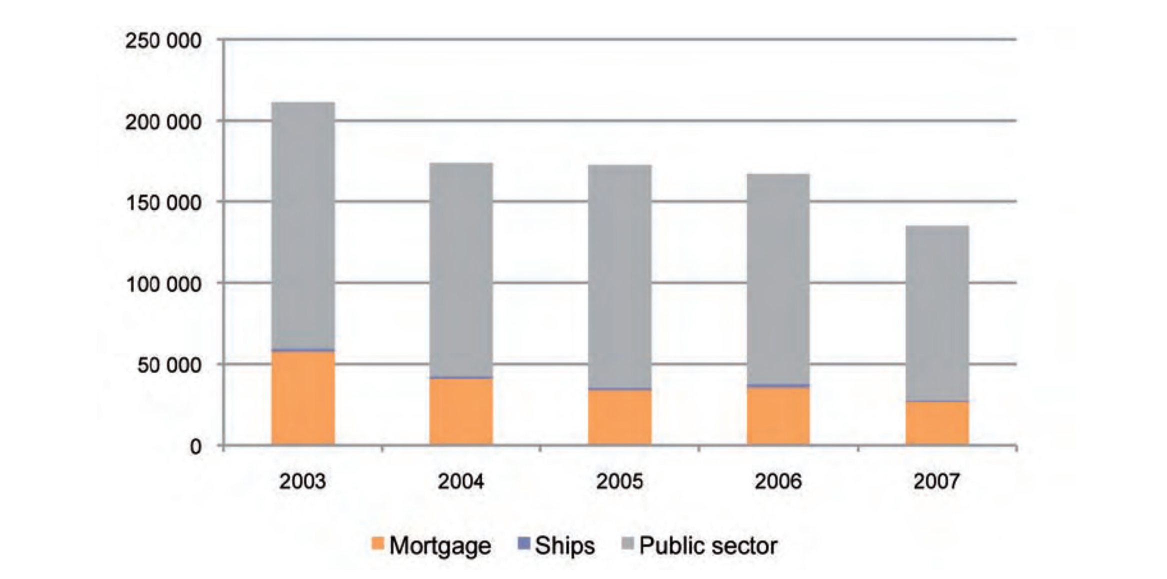
Finally, German investment legislation allows investment funds to invest up to 25% of the fund's assets in Pfandbriefe and furthermore in Covered Bonds issued by credit institutions complying with the requirements of Art. 22 par. 4 UCITS Directive (Article 60 par. 2 German Investment Act)

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2007, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2007, €M



Source: EMF/ECBC

Issuers: There are currently about 60 Pfandbriefbanken in Germany, breaking down into circa 20 former mortgage banks, circa 25 Sparkassen (savings banks), 8 Landesbanken (regional public banks) and 4 specialised public sector banks. . Also, an increasing number of private universal banks became Pfandbriefbanks within the last years 5 Pfandbriefbanken currently issue ship Pfandbriefe.

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 favor 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.

3.10 HUNGARY

By Andras Gabor Botos, Association of Hungarian Mortgage Banks
and Rita Mayer, FHB Land Credit & Mortgage Bank

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. The mortgage lending value of real properties shall be determined by listed property appraisers who shall hold a college or university degree and shall meet the requirements set forth in a separate regulation.

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 stipulate in the mortgage loan contract that the mortgage loan may not be prepaid prior to its maturity. In case prepayment is allowed, the mortgage bank is entitled to charge for any profit losses resulting from it.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The coverage supervisor (cover pool monitor) shall be appointed by the mortgage bank and approved by HFSA. According to Section 16 of the Mortgage Bank Act, a company auditor or an auditor may be appointed; however, the coverage supervisor may not be identical with the auditor of the mortgage bank.

As a matter of fact, Hungarian mortgage banks have had one of the “big four” audit companies as coverage supervisor from the beginning of their operations. The coverage supervisor is responsible for monitoring and certifying, on a permanent basis:

> the existence of eligible security; and

> the registration of the eligible security in the coverage register. In accordance with Section 11 (2) (n) of the Mortgage Bank Act, a certificate from the coverage supervisor shall be attached to each mortgage bond regarding the existence of the coverage.

According to section 16 (7) of the Mortgage Bank Act, a coverage supervisor may be appointed for a fixed period of time, not exceeding five years, however, he may be re-appointed following the termination of the period of his appointment. Although the contract of appointment concluded between the mortgage bank and the coverage supervisor is governed by civil law, it may not be lawfully terminated without the approval of the HFSA. Within the scope of his coverage supervision activities, the coverage supervisor may not be instructed by the mortgage bank.

The HFSA is responsible for verifying the compliance of the credit institutions, including the mortgage banks, with the Credit Institutions Act and other acts e.g. the Mortgage Banks Act, and applicable banking regulations. The HFSA is entitled to impose various sanctions on credit institutions, including warnings of non-compliance, withdrawing licences and imposing fines on credit institutions and their management. Section 22 and 23 of the Mortgage Bank Act provides that the Hungarian Financial Supervisory Authority shall exercise special supervision over mortgage banks in addition to the provisions of the Credit Institutions Act and the provisions of the Capital Markets Act. Within the framework of such special supervision, HFSA shall draw up an analysis schedule and conduct on site audits of mortgage banks according to the analysis schedule it compiles.

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

The sophisticated new 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.

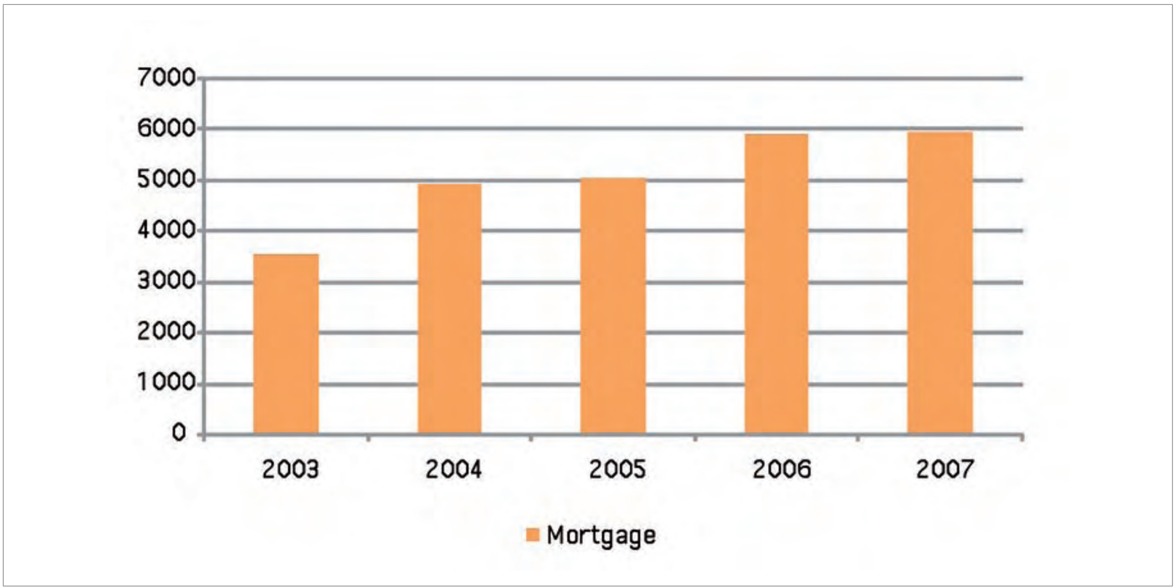
For example, the HFSA is entitled to delegate a Supervisory Commissioner to the mortgage bank. This extraordinary measurement may be taken by the HFSA prior to the commencement of any insolvency procedure – in accordance with Section 157 (1) of the Credit Institution Act. In this case both the rights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

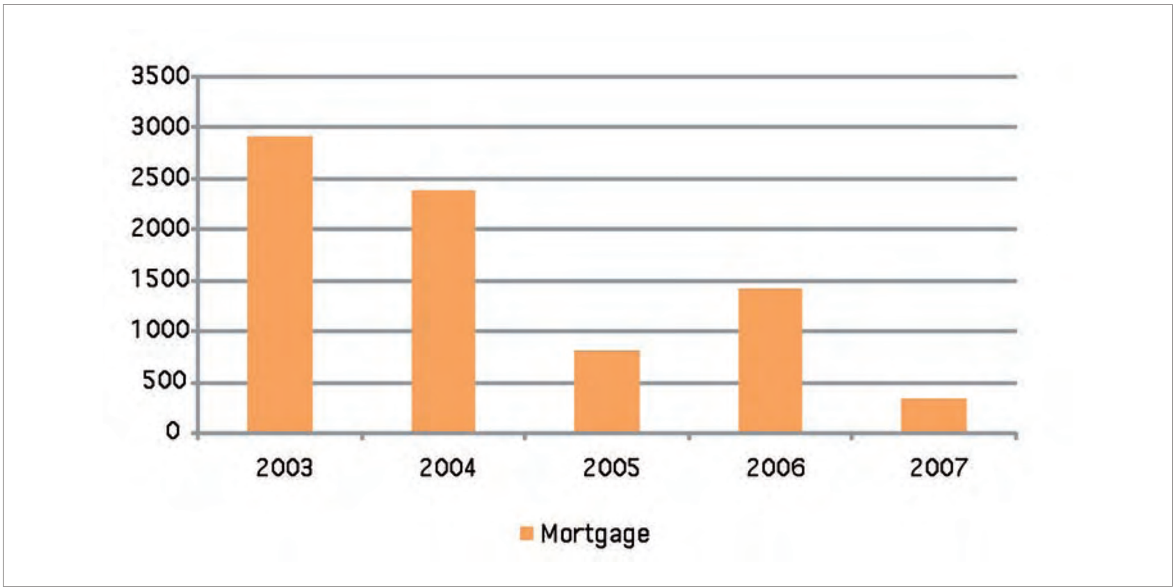
Hungarian covered bonds issued in euro zone countries qualify as ECB eligible; furthermore, in February 2008 one of the Hungarian mortgage banks successfully closed its debut transaction in the “Jumbo” covered bond market. The covered bonds issued by FHB Mortgage Bank Ltd. are rated Aa3, while the covered bonds issued by OTP Mortgage Bank Ltd. are rated Aa1 by Moody’s.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2007, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2007, €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

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 (as amended by the Asset Covered Securities (Amendment) Act 2007) and relevant regulations (the "**ACS Act**"). 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 it must obtain the status of a designated credit institution to issue asset covered securities ("**ACS**") according to the rules of the ACS Act from such Regulator. It will do this as 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, or two or all of these activities.

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 is free to move cover assets in and out of the cover pool provided they do so in accordance within the controls and 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.

Privilege

The ACS are secured by a statutory preference under the ACS Act on the cover pool which protects the ACS holders against the general Irish bankruptcy 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.

Under the ACS Act its 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

Assets which are eligible for inclusion in a cover pool depend 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 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..

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 this means deposits with eligible financial institutions or property of institutions with minimum independent credit ratings of at least Step 2, with a limited duration of 100 days and where the total volume of such assets is limited to 15% of the total prudent market value of the cover pool.

III. COVER ASSET MONITOR AND BANKING SUPERVISION

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

There are strict eligibility requirements for a CAM. A CAM must be a body corporate or partnership, comprising personnel or partners who are members of a professional representative body. They must demonstrate to the Regulator that they are experienced and competent in (i) financial risk management techniques, (ii) regulatory compliance reporting and (iii) capital markets, derivatives, public credit business. The CAM must demonstrate that it has sufficient resources at its disposal, sufficient academic or professional qualifications and experience in the financial services industry to satisfy firstly the designated credit institution and secondly the Financial Regulator, that it is capable of fulfilling this role.

The CAM is responsible for monitoring the cover pool, the ACS Issuer's compliance with specific provisions of the ACS Act and to report breaches to the Financial Regulator. The CAM issues regular reports to the ACS Issuer (every 1-4 weeks) and submits a report on a quarterly basis to the Financial Regulator.

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

The Financial Regulator is responsible for supervising each ACS Issuer. The Financial Regulator may, with the consent of the Minister for Finance, revoke the registration of an ACS Issuer and/or suspend its business if an ACS Issuer breaches any provision of the ACS Act.

IV. VALUATION AND LTV CRITERIA

Mortgage ACS Issuers

For a mortgage ACS Issuer the maximum prudent LTV levels for mortgages in the cover pool are 75% for residential and 60% for commercial. Prudent LTV levels for loans in the cover pool can exceed the 75% threshold, however the balance of the loan above the 75% is not considered for eligibility 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 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 market practice for a mortgage ACS Issuer to have received a valuation report on the property from an independent valuer before the loan is advanced. 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 terms and conditions of each issue. 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 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.

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 insolvency the cover pool is segregated 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 a new parent. 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

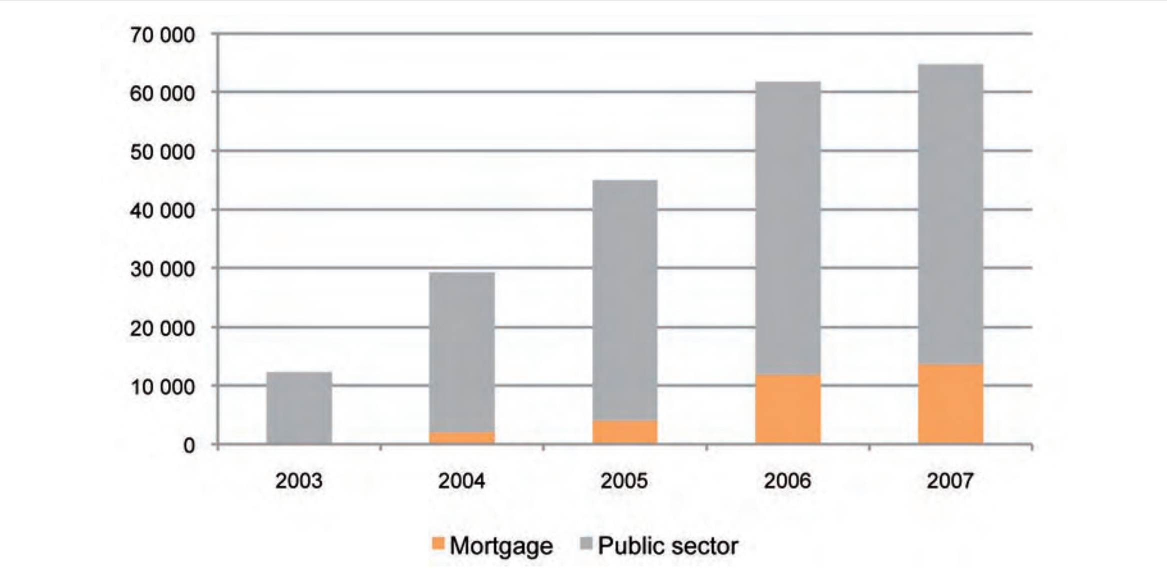
ACS holders are preferred creditors in relation to the cover assets (ranking after the CAM and the NTMA and equally with the hedge counterparties). Cover assets included in a cover pool do not form part of the assets of the ACS Issuer for the purposes of insolvency until such time as the creditors benefiting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

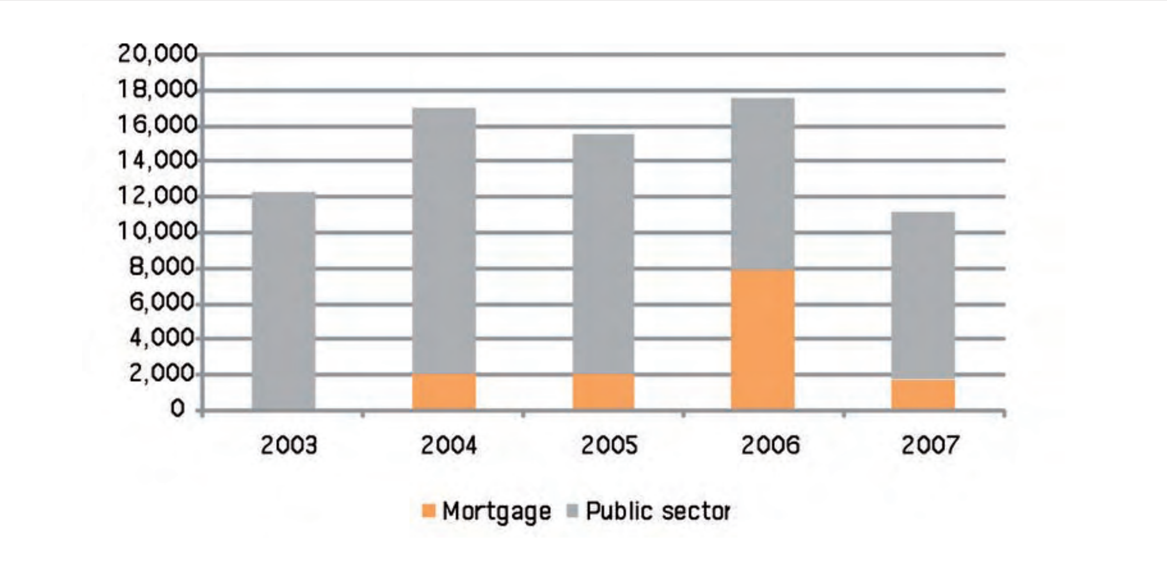
The ACS meet the requirements of UCITS 22(4) and currently benefit from a risk-weighting of 10% as applied by the Financial Regulator. The eligibility of cover assets set out in the ACS Act also match the criteria for the preferential risk weighting of covered bonds set out in the CRD.

> FIGURE 1 : COVERED BONDS OUTSTANDING 2003-2007, €M



Source : EMF/ECBC

> FIGURE 2 : COVERED BONDS ISSUANCE, 2003-2007, €M



Source : EMF/ECBC

Issuers

There are 4 active issuers in Ireland: Bank of Ireland Mortgages, Depfa ACS, West LB Covered Bond Bank and Allied Irish Banks (AIB).

3.12.1 ITALY (GENERAL FRAMEWORK)

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%.

3.12. 2 ITALY (CDP)

By Monica Tamisari
Cassa Depositi e Prestiti

I. FRAMEWORK

Cassa Depositi e Prestiti (CDP) has been transformed from a public administration entity into a joint stock company with the majority-owned by the Italian State (Article 5 of Decree Law 269 of 30 September 2003, the so-called Transformation Law). This law allows it to issue bonds backed by a pool of assets owing to specific provisions on asset segregation.

Structural features have been introduced via contractual agreements to replicate the distinctive features of a Covered Bond product while enhancing the protection for investors. In particular, specific structure finance mechanisms have been built into the structure, which are triggered on the occurrence of certain adverse events including, *inter alia*, a deterioration of the rating of the issuer, providing for a "de-linkage" from the credit risk of the issuer as well as the Republic of Italy.

II. STRUCTURE OF THE ISSUER

CDP is a specialised entity with a narrowly defined scope of business activities as provided for by the Transformation Law and by the Articles of Association of the company.

The cover pool securing the bonds is held on the balance sheet of the originator, which also issues the bonds. The issuer is a fully equipped financial institution, who maintains an adequate operational structures and resources for running and controlling the cover business and the Covered Bond issuance.

Until the occurrence of certain events, the issuer makes the payments due under the Covered Bonds out of the cash flows arising from its whole balance sheet and freely uses the cash flows arising from the cover pool. The issuer is also responsible for managing the cover pool, and is obliged to replace non-performing and maturing assets with new eligible assets originated out of its public sector lending activity in order to maintain the quality of the cover pool and the required over-collateralisation at all times.

The cover assets collateralise all the outstanding Covered Bonds, meaning that any new series of Covered Bond will rely on the same cover pool (ranking *pari passu* among each other regardless of the date of issue) and any new assets that are segregated will be for the benefit of all Covered Bondholders (there is no direct legal link between one bond and one asset).

III. COVER ASSETS

Cover assets are produced by CDP's public sector lending business, and thus are restricted to loans repayable or guaranteed by Italian local and central governments, who comply with certain individual and aggregate eligibility criteria agreed with rating agencies.

In this respect, it should be noted that as to date CDP is not allowed, under the Italian Law, to lend money to public sector entities outside Italy. Nevertheless, it is currently envisaged in the transaction documents that in the future the cover pool might also include loans and bonds repayable or guaranteed by central governments and sub-sovereign public authorities from other highly-rated EEA countries in which Covered Bondholders' preferential claim is recognised. Senior high-rated not subordinated (in terms of principal and interest payment obligations, to any other series of ABS issued by the same issuer) ABS backed by loans to public sector entities in eligible EEA countries are also allowed as collateral. The criteria for the assignment of those assets (e.g. exposure limits) will be previously agreed with rating agencies.

Derivatives are permitted in the cover pool for hedging purposes.

The cover pool is dynamic until the occurrence of certain trigger events including the insolvency of the issuer.

IV. VALUATION AND LTV CRITERIA

None, as the cover pool is composed of public sector assets.

V. ASSET - LIABILITY MANAGEMENT

By contractual provisions, any interest rate or currency risk arising from the issuance of Covered Bonds must be hedged through swap agreements, which can be segregated in favour of Covered Bondholders, and which constitute part of the cover pool. The swap counterparties must comply with eligibility criteria agreed with rating agencies.

On the asset side, it has been provided that in respect of any asset paying a variable rate of interest, only the fixed portion of such interest will be considered for the purpose of calculating the level of over-collateralisation. Alternatively, CDP may enter into an interest rate swap to transform the floating rate cash flows into fixed rate cash flows. With regard to the currency risk, eligibility criteria for the collateral assets provide for currency risk to be hedged (if any) through proper swap agreements.

The liquidity risk arising from any asset liability mismatch is addressed via sufficient overcollateralisation even though there are no specific requirements in law to match interest payments or to limit the duration mismatch between the cover assets and the outstanding liabilities. In this respect, it has been provided that (i) the eligible assets must always exceed outstanding Covered Bonds (nominal matching), and (ii) the future cash flows expected out of the cover pool (not including claims which are in arrear or no longer eligible for any reason) must exceed the payments due under the Covered Bonds by 15% at any future payment date, in order to pass the *Asset and Cash-Flow Coverage Test.* A principal accumulation mechanism has been designed to allow for a perfect cash-flow matching between amortising assets and bullet bonds. Should the test reveal a cash-flow shortfall at any future payment date, the issuer will be obliged to add further eligible assets to the pool in order to cover such a shortfall (otherwise the Programme would terminate).

With regard to the early repayment of the loans, it has been contractually provided that on the occurrence of a downgrading of the issuer a cash reserve must be established. This cash reserve must be on a proper collection account held with an eligible institution and its purpose is to make up for the risk arising from the fact that any prepayment penalty paid by the relevant debtor during the collection period is collected by the issuer, as well as a certain amount to cover any prepayment risk associated to loans with no prepayment penalty, were the latter be included in the cover pool.

By contractual provisions, CDP must disclose information on the cover assets (including details of any loans in arrears or no longer eligible), as well as the results of the *Asset and Cash Flow Coverage Test* to the representative of Covered Bondholders and rating agencies on a regular basis.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

By contractual provisions, a qualified third-party entity constantly monitors the cover pool. In the role of Programme Calculation Agent, the third party monitor performs the *Asset and Cash Flow Coverage Test*) with the purpose of making sure that cash flows arising out of the collateral portfolio will at any time be sufficient to cover any payments due under the Covered Bonds, maintaining at the same time the required minimum level of cash flow over-collateralisation.

The agreement by which the Programme Calculation Agent has undertaken to carry out the above-mentioned activities, together with any rights and obligations arising there from (the Intercreditor Agreement), has been segregated in favour of the Covered Bondholders and will continue to have full force and effect upon insolvency of the issuer.

The cover pool is regularly monitored by rating agencies and cash flows arising out of the cover assets verified under AAA stressed scenarios at any new issuance for the purpose of confirming the rating to the outstanding bonds and awarding the AAA rating to the debt issued.

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

Asset Segregation

According to the Transformation Law, CDP may “segregate” any of its assets and legal rights for the benefit of the holders of certain bonds issued by it. It does this by adopting a specific corporate resolution to be deposited with the Chamber of Commerce of Rome. In relation to each “segregated asset” CDP will hold separate accounting books and accounting records as required by the Italian civil code (see Article 5 Paragraph 18 of Law Decree 269/2003).

Such a corporate resolution will contain the exact description of the assets to be secured, the parties in favour of whom the assets are secured (i.e. the Covered Bondholders), the rights conferred to the Covered Bondholders and the ways in which those assets may be transferred, supplemented and replaced. As at the date the corporate resolution is deposited the segregated assets and legal rights are exclusively secured for the repayment of the rights of the Covered Bondholders and constitute separate assets from those of CDP (the so-called *Patrimonio Destinato*).

Once the cover assets have been secured for the benefit of Covered Bondholders by adopting a specific corporate resolution, CDP is deprived of the power to change the destination of those assets, including by revoking the related corporate resolution, except for any change in the cover pool provided for and authorised by such corporate resolution.

In case of insolvency of the issuer, the recorded assets and legal rights which form a separate legal estate will be immediately identified and automatically separated from the insolvency’s estate by operation of law.

Impact of insolvency proceedings on Covered Bonds and derivatives

The insolvency of the issuer does not trigger the acceleration of the Covered Bonds.

If insolvency proceedings are opened, the cover pool and the pertaining Covered Bonds will be run on a separate basis and the cash-flows arising from the cover assets will be exclusively used to timely pay the Covered Bondholders.

According to the Transformation Law, in the event of insolvency of CDP the entities in charge of the liquidation procedures (i.e. the administrative receivers appointed under the Italian Law upon CDP becoming subject to insolvency proceedings) will look after the cover pool on behalf of Covered Bondholders. In order to ensure timely payments of principal and interest under the Covered Bonds, the relevant receivers will be entitled to transfer or entrust the management of the cover pool and the pertaining Covered Bonds to banks.

Derivatives which are part of the cover pool will continue to have full force and effect after the insolvency of the issuer by operation of law. Accordingly, there is a specific documentation in place for derivatives to be taken in the cover pool providing for continuation in case of insolvency.

Derivative counterparties rank *pari passu* with Covered Bonds provided that the risk weighting applicable in Germany with respect to the outstanding Covered Bonds is not negatively affected. Otherwise, it has been provided that the claims of the relevant counterparties *vis-à-vis* CDP under the hedging agreements entered into in connection with the issuance of bonds are subordinated in the priority of payments to all payments under the Covered Bonds (including the repayment of principal).

As long as the separate legal estate has sufficient liquidity, a moratorium on the insolvency's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of interest and principle on Covered Bonds.

Preferential treatment of Covered Bondholders

According to the Transformation Law, if CDP were to become insolvent the Covered Bondholders have a preferential claim on the segregated assets. The cover pool will be excluded from other creditors' claims (including the Italian tax authorities and CDP's employees) until all the claims of the Covered Bondholders have been satisfied.

Formally, there is no residual claim against the issuer in case the Covered Bondholders are not fully satisfied by the proceeds of the cover pool. However, the issuer's obligation to replace non-performing and maturing assets gives the Covered Bondholders a potential claim over all the assets arising out of CDP's public sector lending business, thus substantially reproducing the effects of a conventional full recourse formula against a specialised lender to the public sector.

Access to liquidity in case of insolvency

In the event of insolvency of the issuer, the Asset Manager shall be entitled to sell in whole or in part the cover assets in order to fulfil the payment obligations towards the Covered Bondholders. This sale must be (i) in the interest and for the benefit of the Covered Bondholders; (ii) for a "fair price" (based upon a reputable bank or financial institution evaluation of the assets); (iii) if in full, for a price not lower than the amount necessary to pay interest and repay principal on the relevant due dates on all outstanding Covered Bonds.

With the insolvency of CDP, a third-party back-up servicer will undertake the activities to be performed by the issuer as Asset Manager (being already nominated upon CDP losing its investment-grade rating). The agreement by which the Asset Manager will undertake to carry out the above-mentioned activities, together with any rights and obligations arising there from (the Intercreditor Agreement), will be segregated in favour of the Covered Bondholders and will continue to have full force and effect upon insolvency of the issuer.

Indeed, the entities in charge of post-insolvency procedures are always entitled to sell the cover assets. Article 58 of the Consolidated Banking Act contains special provisions for the sale and transfer of loans in favour of banks which make the sale easy.

Any existing over-collateralisation, beyond the insolvency of the issue is available to Covered Bondholders r and cannot be released to the unsecured creditors of CDP.

Acceleration of Covered Bonds

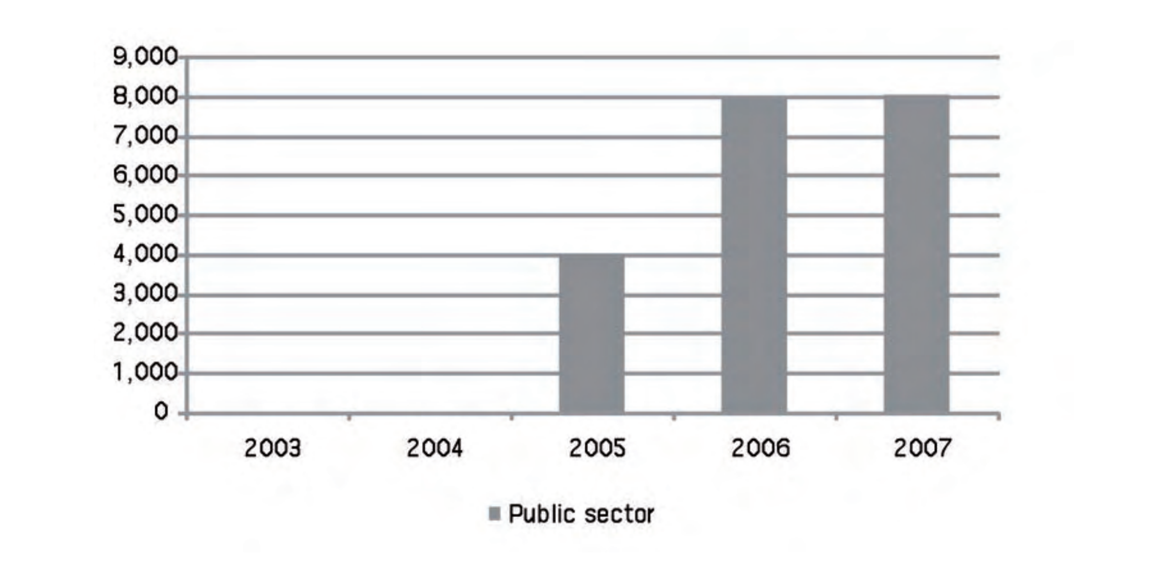
Insolvency of the cover pool is the only reason that might trigger an acceleration of Covered Bonds. In the event that the payment of interest and the repayment of principal is not made when due under the Covered Bonds in respect of any series, all series of Covered Bonds become due and payable.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

CDP's Covered Bonds do not fulfil all the criteria set out in Article 22(4) of the UCITS Directive. In particular, they do not meet the formal requirement to be issued by a 20% risk-weighted credit institution registered in the European Union. According to the Transformation Law, CDP is supervised by the Bank of Italy under specific regulations, which have not been completed yet.

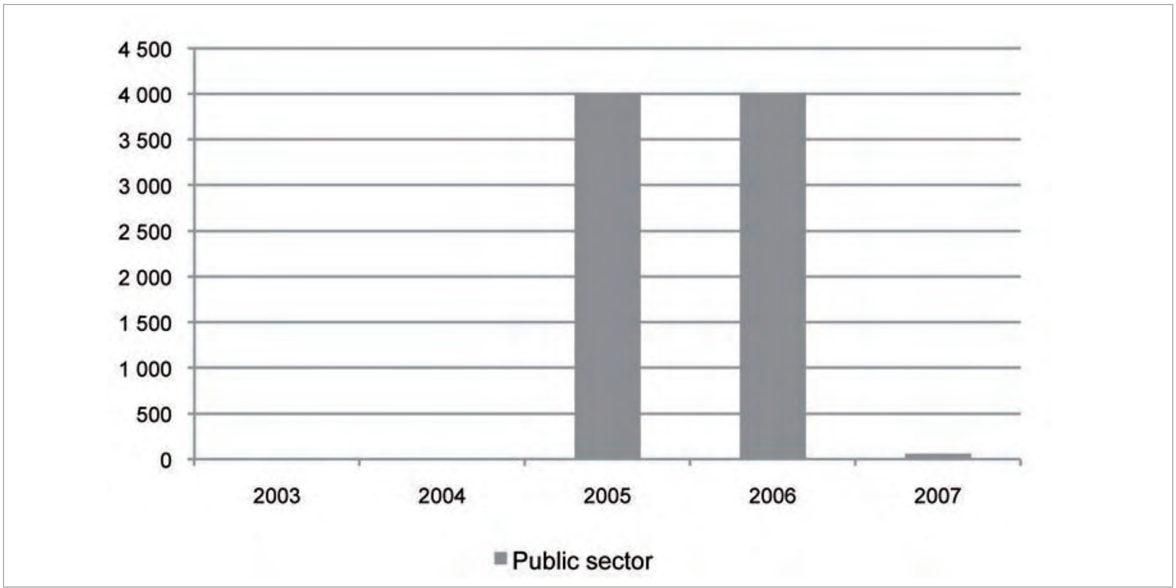
CDP's Covered Bonds are eligible in repo transactions with the ECB.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2007, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2007, €M



Source: EMF/ECBC

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 (1st of June 2000, 5th of July 2001, 6th of November 2002 and 25th 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 25th of October 2006) stipulates that the market value of property registered in the EU member state is determined by the persons who have received professional, real estate valuation, licence according to the legislation of particular EU member state.

The issuer is responsible for the monitoring of the property value. The frequency of monitoring is not defined by the HKZL, but it is prescribed by the regulations of the FCMC and by-laws of the issuer.

Article 14 of the HKZL stipulates that a mortgage loan together with debts previously registered with the national property register may not exceed 75% of the market value of residential property and 60% of the market value of other type of property.

V. ASSET - LIABILITY MANAGEMENT

Article 9 of the HKZL stipulates the following requirements to the asset-liability management of the cover pool:

> the total volume of the cover assets must be larger than the total volume of outstanding mortgage bonds at their face value by at least 10% of the risk weighted value of the cover assets, where risk weighted value of the cover assets is calculated based on specific weights of each type of the cover assets;

> The currency of the cover assets and that of the outstanding mortgage bonds may differ only if the issuer has taken all the necessary measures to prevent the currency risk in the cover pool;

> The total interest income from the cover assets must exceed the total interest expenses on outstanding mortgage bonds;

> The cash-flows from the outstanding mortgage bonds (in accordance with the mortgage prospectus) must always be covered by the cash-flows from the cover assets in terms of volumes and maturities.

The issuer of the Covered Bonds has to prepare a report on the cash-flow mismatches and submit it to the FCMC on a semi-annual basis.

The latest amendment to the HKZL stipulates that the issuer should separate loans secured by a mortgage and loans secured by central or municipal governments. This requirement was introduced in order to separate mortgage bonds and public sector bonds.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The Latvian Covered Bond legislation does not require the appointment of a special entity to monitor the cover pool. Instead, the cover pool is managed by the issuing bank and it is the issuing bank's responsibility to set up a system to ensure that the cover pool is managed properly. In some banks, monitoring of the cover pool is executed by the internal audit department

The FCMC supervises cover pools. It inspects cover pool (quality and eligibility of the cover assets, quality of the asset-liability management) during regular banking supervisory audits which are carried out on average every two years.

The FCMC has the right to suspend the issue of mortgage bonds under the following circumstances:

- The issuing bank does not comply with the conditions laid down in the Law on Mortgage Bonds;
- The issuer does not ensure that the redemption and interest payments on outstanding mortgage bonds are always covered by the principal and interest payments of the cover assets of a higher value;
- By-laws on the valuation of properties securing the mortgage assets and by-laws on the management of cover pool submitted to the FCMC are not followed.

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

A cover register facilitates the identification of the cover assets, because all the cover assets, including substitute cover as well as derivatives, are recorded in the cover register. The type and scope of the information recorded regarding the cover assets in the cover register are determined by FCMC regulations

The legal effect of registration is the fact that in the case of insolvency of the issuer, the assets which form part of the separate legal estate can be identified and all assets recorded in the cover register qualify as part of this separate legal estate.

Asset segregation

A cover pool is a part of the general estate of the issuing bank as long as the issuer is solvent. If the insolvency proceedings are opened, by operation of law, the assets recorded in the cover register are excluded from the insolvency estate of the issuer. Those assets will not be affected by the opening of the insolvency proceedings, but automatically form a separate legal estate.

After the opening of the insolvency proceedings, a special cover pool administrator initiated by the FCMC and appointed by court carries out the administration of the cover assets.

Impact of insolvency proceedings on Covered Bonds and derivatives

Covered Bonds do not automatically accelerate when the issuing institution becomes insolvent, but will be repaid at the time of their contractual maturity. The same applies to derivatives which are registered in the cover register and form part of the cover pool. During an insolvency procedure, derivatives' counterparties have the same rights as the holders of mortgage bonds.

Preferential treatment of Covered Bond holders

Covered Bond holders enjoy a preferential treatment as the HKZL and the Law on Credit Institutions stipulates the separation of the cover assets in a case of the insolvency of the issuing bank. According to Article 191 of the Law on Credit Institutions, mortgage bond holders have the first access rights to the cashflows generated by the assets recorded in the cover register

In the case of insolvency of the issuer, it is forbidden to modify the content of the cover register and all cash flows from the cover assets must be accrued within it. As long as there is sufficient cover, a moratorium on the insolvency's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of Covered Bond holders.

Only in the case of over-indebtedness or insolvency of the cover assets shall the FCMC file an application to court regarding the insolvency of the cover register (Article 26 of the HKZL). Insolvency of the cover pool is the only catalyst which could the trigger acceleration of Covered Bonds.

Access to liquidity in case of insolvency

With the appointment of the cover pool administrator, the right to manage the cover assets is transferred to him by law. Thus, the cover pool administrator has first access to the cover assets and collects the cash flows according to their contractual maturity.

The cash-flows from the cover assets may only be used for the following purposes and the use of assets in any other manner is inadmissible:

> Disbursements to mortgage bond holders if the term for interest payments or mortgage bond redemption has become due
> Purchase of mortgage bonds issued by the issuer itself with their subsequent redemption in the public securities market at a price not exceeding the face value of the mortgage bonds if the remaining cover assets are sufficient to cover outstanding mortgage bonds
> Payments under derivatives' agreements concluded on the cover asset risk mitigation, provided that the contracting parties have met the conditions of such agreements.

The cover pool administrator is permitted, in case of the insolvency of the issuer, to exceed the substitute cover limit.

No specific regulation exists with respect to the insolvency remoteness of voluntary overcollateralisation. However, the cover pool administrator is not allowed to use voluntary overcollateralisation until all payments to mortgage bond holders are made fully and on time.

The cover pool administrator may carry out legal transactions in respect of the cover pools in so far as this is necessary for an orderly settlement of the cover pool and for the full and timely satisfaction of the cover pool's creditors.

Sale and transfer of mortgage assets to other issuers

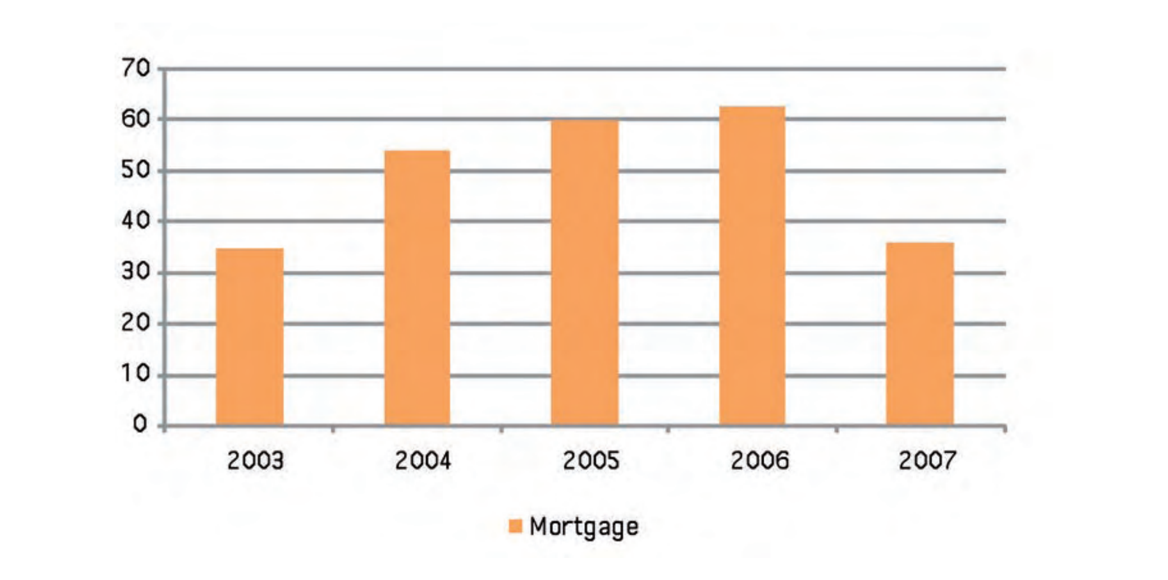
The HKZL and the Law on Credit Institutions provide that the cover assets in a case of insolvency of issuer are transferred to other bank chosen by the FCMC. The bank to which the cover assets are transferred, also takes responsibility for all the obligations arising from outstanding mortgage bonds.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Latvian mortgage bonds comply with the requirements of Art. 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%.

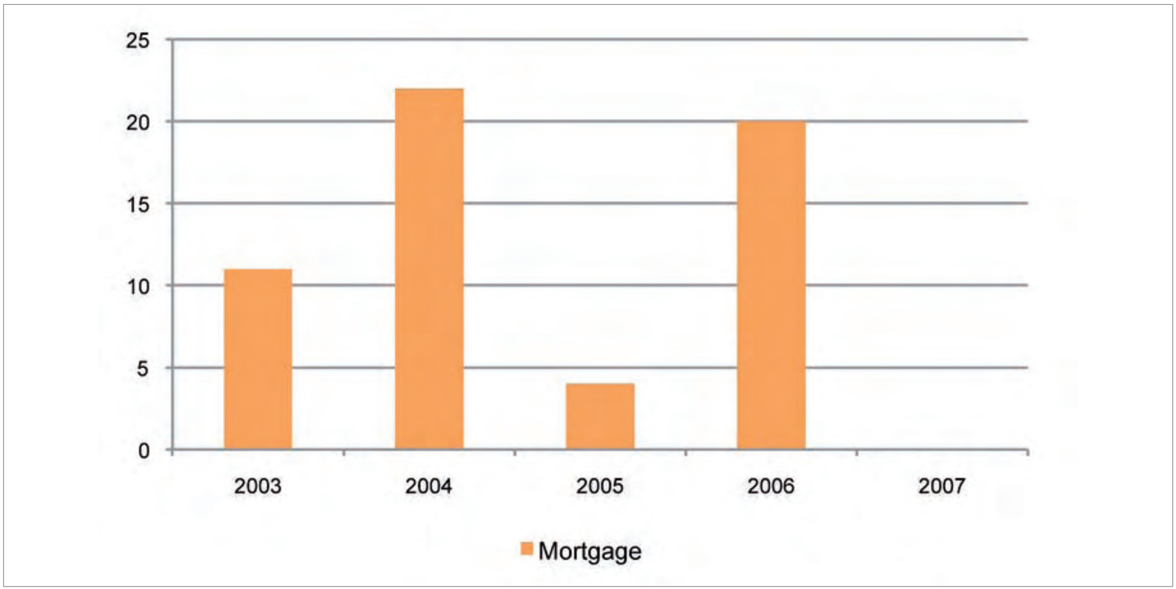
Latvian investment legislation allows mutual funds to invest up to 25% of their assets in mortgage bonds and pension funds – up to 10% of their assets.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2007, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2007, €M



Source: EMF/ECBC

3.14 LUXEMBOURG

By Frank Will, RBS

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. 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.

In February 2008, the Luxembourg government introduced a new bill to amend the existing Lettre de Gage legislation which has to be approved by Luxembourg Parliament. (At the end of H1 2008, the law had not been approved and the proposed changes of the existing covered bond legislation have been marked in italics). The proposed amendments 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 possibility to include securitised assets. The most important modification, however, is the introduction of a new form of Lettres de Gage backed by movable assets including ships, aircraft 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: the bank's principal activities are limited to mortgage lending and public sector financing. These assets are primarily funded by issuing Lettres de Gage Hypothécaires and Lettres de Gage Publiques. 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 a separate register. The register has two parts, the first for assets which are allocated to mortgage Covered Bonds and the second for the cover assets of public sector Covered Bonds. The cover assets remain on the balance sheet of the issuer as long as the issuer is not insolvent. They are not transferred to another legal entity (special purpose vehicle) as in a securitisation. 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 and Lettres de Gage Publiques (including any derivatives benefiting from the preferential treatment) are backed by the assets in their 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 that is legally possible. In addition, the way of permitted outsourcing is described in detail in different CSSF Circulars.

The proposed bill introduced a new type of Lettres de Gage which is backed by movable assets (Lettres de Gage Mobilières). Moveable assets can be ships, aircraft and trains. However, other classes of movable assets are possible as well provided that they are registered in a public register. Each of these asset classes will require 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. Consequently, the permitted principal activities of an issuer would be widened to allow the origination of those movable assets.

III. COVER ASSETS

The eligible cover pool assets are defined in Article 12-1 of the Financial Sector Act of 5 April 1993. There are two asset classes: mortgage assets and public sector exposures. In each of the two 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 42 (3) of the law of 30 March 1988 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.

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.

The new Lettres de Gage Mobilières will be backed by movable assets, i.e. mortgage loans on ships, aircraft, 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.

Under the new law, it will be 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.

In addition, securitised assets will become 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 will allow only true sale transactions and synthetic securitisations will be 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.

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 commercial and residential property is 60%. The actual loan, however, can exceed the 60% limit. In this case, only the first 60% of the mortgage lending value is eligible for the cover pool.

The proposed amendments include a change of the LTV limit for residential properties which will be increased from 60% to 80% of the mortgage lending value. The LTV ratio of 60% will remain in force for all other immovable and movable properties.

V. ASSET-LIABILITY MANAGEMENT

The total outstanding volume of Lettres de Gage must be covered by assets at all times. Sufficient coverage of the outstanding Lettres de Gage must be ensured on a nominal basis and as well as on a net present value basis. 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.

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.

At present mandatory overcollateralisation is not required by law or supervisory regulations. Nevertheless, there are of course the requirements imposed by the rating agencies.

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.

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.

The new law proposes the introduction of a minimum overcollateralisation level of 2% on a nominal basis as well as on a net present value basis. The Luxembourg regulator will have the right to review and adjust these over-collateralisation levels.

Moreover, the proposed law changes include removing the current restriction of the outstanding volume of Lettres de Gage to 60 times the issuer's equity.

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.

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 1984 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.

Under the new law, the Commission de Surveillance du Secteur Financier (CSSF) will be 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.

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

The cover registers for mortgage and public sector 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 Lettre 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

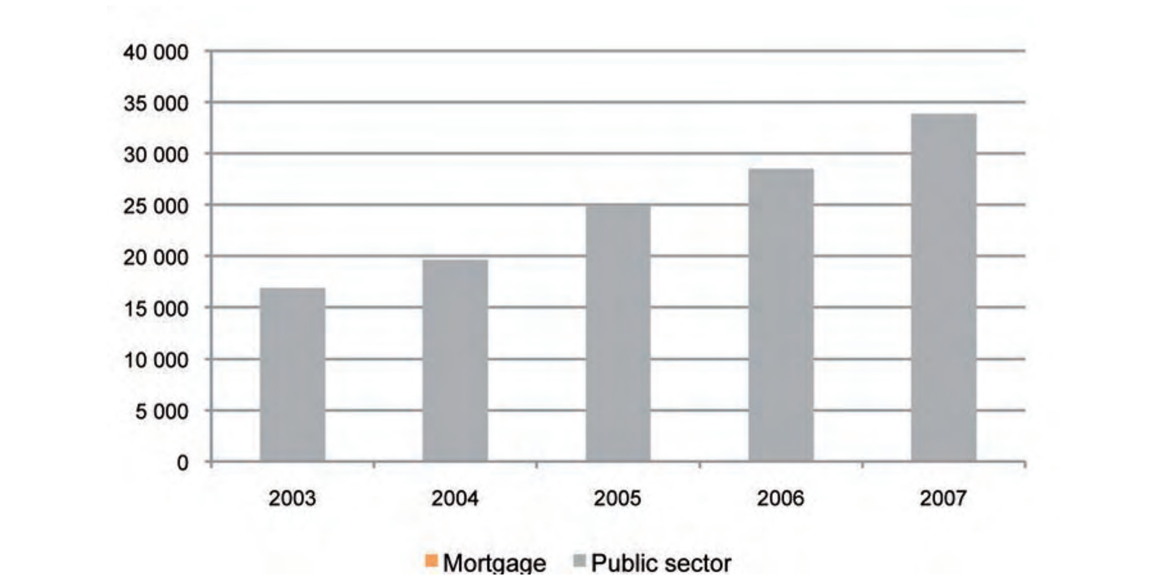
The Luxembourg Covered Bond legislation fulfils the criteria of Art. 22 (4) of the UCITS Directive (Council Directive of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)) and Lettres 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). 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.

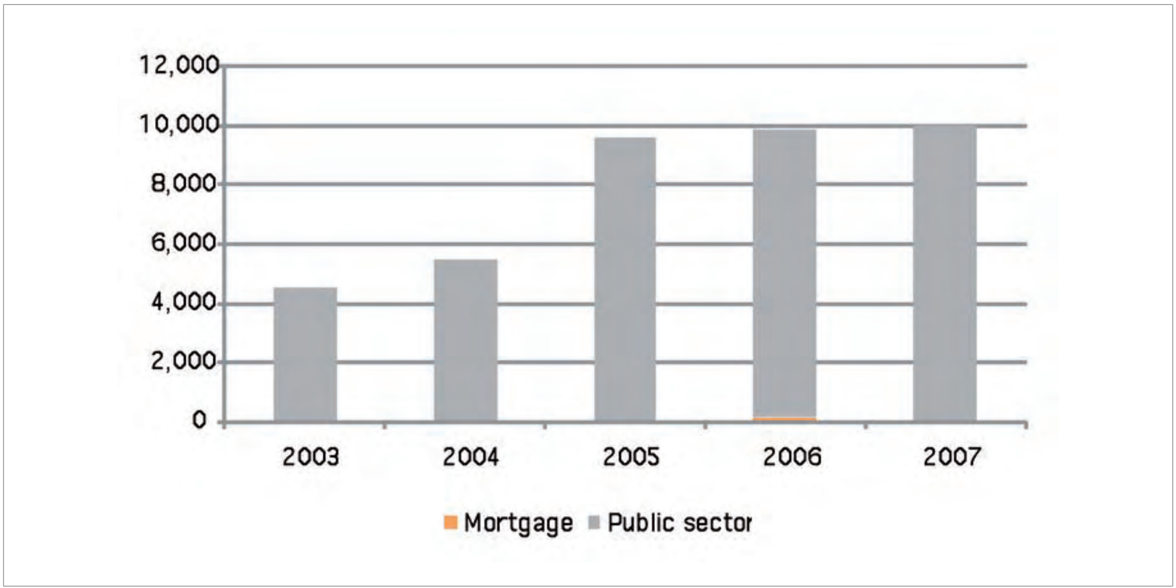
The proposed amendments of the Luxembourg covered bond legislation will not make the Lettres de Gage legislation CRD-compliant. However, as with the current legislation, it should be possible for issuers to make their outstanding Lettres de Gage “CRD compliant” by limiting their cover pool exposure.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2007, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2007, €M



Source: EMF/ECBC

3.15 THE NETHERLANDS

By Christian Moor
HSBC Bank

I. FRAMEWORK

In the Netherlands, general legislation, based on contractual arrangements under civil law ("privaatrecht"), is used to structure the Covered Bonds.

In September 2006, the Ministry of Finance started with the preparations for a specific Covered Bond legislation to provided Dutch issuers with a level playing field versus other European issuers.

The law is drafted using a principle based approach (like the recently established CB legislation in the UK). The final version of the proposed legislative framework should be ready by 1st July 2008 and is expected (depending on Parliament) to be in place by September 2008.

The new covered bond legislation will allow two types of covered bonds: a covered bond and a covered debt instrument.

The covered bond under the new legislation will be UCITS 22(4) and CRD compliant, while the cover debt instrument will not restrict mortgage loans to a maximum loan-to-value of 80% and therefore not compliant with the CRD.

Current structured covered bonds (ABN AMRO, ING, SNS, ACHMEA and NIB Capital) will be transformed to legislative covered bonds. It's expected that most covered bond programmes will meet the more stringent covered bond criteria once the legislation is passed.

II. STRUCTURE OF THE ISSUER

The issuer must be a financial institution regulated by the Dutch Central Bank ("DNB").

The Covered Bonds are senior unsecured obligations of the Issuer that rank pari passu among themselves and are guaranteed by a Covered Bond company ("CBC").

The CBC is an insolvency remote private company established solely for the purpose of the Covered Bond programme and provides an irrevocable guarantee whereby, under certain circumstances, interest and principal will be paid on the Covered Bonds. The guarantee will only come into effect upon the occurrence of one of the following: 1) issuer default and the serving of an issuer acceleration notice and a notice to pay the CBC and 2) CBC default and the serving by the trustee of a CBC acceleration notice on the CBC.

The covered assets are transferred to the CBC and held on its balance sheet, which in turn is consolidated into the balance sheet of the issuer.

As legal title to the cover assets has been transferred to the CBC, the CBC becomes the legal owner and holds claim on the covered assets. The CBC grants several security rights ("pandrechten") to the trustee (on the secured properties backing the cover assets) for the benefit of the structured creditors (including Covered Bondholders). In case of insolvency of the CBC, the trustee, as pledgee, can exercise the rights afforded by Dutch law to pledgees as if there were no insolvency proceedings.

The CBC is entirely owned by a Foundation ("Stichting") established under the laws of the Netherlands. The management of the CBC and the Foundation is provided by a trust company and the scope of activities of the CBC is limited to owning the receivables, issuing the guarantee, and entering into derivatives and other contracts related to the programme. Neither the CBC nor the Foundation has employees.

The issuer has to meet the requirements by the regulator, but there are no restrictions on the business activities within these regulations. The issuer can have its own employees and, as long as the regulatory conditions are met, outsourcing to subcontractors is allowed.

III. COVER ASSETS

Being a structured programme, the restrictions have been self-imposed to mirror the international Covered Bond market. To date the collateral has only consisted of prime Dutch residential mortgages.

The programme allows for the inclusion of non-Dutch residential mortgages and other assets within the cover pool. The transfer of any such assets to the CBC is subject to prior confirmation by the rating agencies that this will not affect the existing rating of the Covered Bonds.

Substitution assets may be included as cover assets; the aggregated value of the substitution assets, other than governments' securities may not exceed 10% of the CBC assets at any time. Substitution assets include:

> Exposures to or guaranteed by governments or other public sector entities that are zero risk weighted under the standardised approach according to the European Capital Adequacy Directive (equivalent to entities rated at least 'AA-');

> Exposures to institutions that qualify for a 10% risk weighting under the standardised approach;

> Exposures to institutions that qualify for a 20% risk weighting under the standardised approach, limited to 10% of the outstanding Covered Bonds; and

> RMBS tranches rated 'AAA', limited to 10% of the outstanding Covered Bonds.

Derivatives (total return swaps, interest rate swaps and structured swaps) are used and included in the cover pool. The derivatives are only used to mitigate mismatches between the cover assets and the cover bonds, and the documentation includes rating agency determined language to mitigate counterparty risk. Derivatives as such do not form part of the cover assets (i.e. with the purpose of providing collateral for the bonds).

IV. VALUATION AND LTV CRITERIA

The properties are valued using Dutch mortgage market accepted practices. Normally this is carried out by an independent Dutch surveyor upon granting the loan and indexation using a reputable index thereafter.

The appraisal reports are usually obligatory and based on the foreclosure value of a property. The foreclosure value equals approximately 85%-90% of the appraisal value. However, if the LTV is below 60%, an assessment can be made by the Netherlands tax authorities on the basis of the Act on Valuation of Real Property (Wet Waardering Onroerende Zaken) and this is sufficient to enable lending[1].

The properties are not re-valued by a surveyor, but generally re-valued using one of the well-established indices in the Netherlands. There is generally no relationship between the valuer and the issuer.

1 Since 2001 a new standardised model for appraisal reports has been implemented to ensure consistency across valuations. It is used for appraisals conducted by real estate agents, valuation agencies and mortgage lenders.

Being a structured instrument, the LTV limit can be chosen. There a currently five (ABN AMRO, ING, SNS, ACHMEA and NIB Capital) Dutch covered bond programmes, to date. It's expected that most covered bond programmes will meet the more stringent covered bond criteria once the legislation is passed.

V. ASSET - LIABILITY MANAGEMENT

The interest and currency rate risks are mitigated through swaps, which removes these risks on the assets and liabilities. The swaps are based on contractual provisions and the documentation includes rating agency determined language to mitigate counterparty risk.

To mitigate other risks (early repayments, reinvestment, etc) that may create cash flow mismatches between the cover assets and Covered Bonds the issuer has contractually, and in conjunction with the rating agencies, mitigated these risks through overcollateralisation and structural features of the Covered Bonds. The programme includes among others an asset coverage test ("ACT") and an amortisation test.

The ACT ensures that on each calculation date, the adjusted aggregate asset amount (covered assets under stressed assumptions) is at least equal to the Euro equivalent of the aggregate principal amount outstanding of the Covered Bonds. If on any calculation date the adjusted aggregate asset amount is less than the aggregate principal amount outstanding of all Covered Bonds, the issuer has to transfer sufficient further eligible assets to the CBC to ensure that the asset cover test is met. Breach of the asset cover test will not constitute an issuer event of default. However, it will prevent the issuer from issuing any further Covered Bond under the programme until remedied and, if it is not remedied by the immediately succeeding calculation date, the trustee will serve a notice to pay on the CBC.

Following the serving of a notice to pay on the CBC, the amortisation test has to be met. This test checks whether the Covered Bonds are adequately collateralised by sufficient assets in the cover portfolio. The test would fail if the current balance of the cover portfolio (including substitution assets), minus an adjusted negative carry stress, is lower than the amount of outstanding Covered Bonds. If the amortisation test is not met, then that shall constitute a "breach of the amortisation test" and the CBC shall immediately notify the trustee. The trustee shall be entitled to serve a CBC acceleration notice and the Covered Bonds become immediately due against the CBC and the security becomes enforceable.

The rating agencies cash flow models calculate the NPVs of stressed cash flows in order to make sure that the bonds (principal & interest) can be repaid at any (future) moment.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The issuer in its role as administrator is responsible for the monthly pool monitoring and also conducts various tests on the portfolio i.e. the ACT (all tests are determined by the rating agencies). The rating agencies are heavily involved in the programme and need to re-affirm the ratings of the programme upon each issuance. They also monitor the amount of overcollateralisation required to maintain the triple-A rating.

Given that there is no specific Covered Bond legislation, there are no established requirements and the special cover pool monitor is generally performed by the auditor of the issuer. The independent auditor, called the asset monitor, checks the ACT and amortisation test once a year. The auditor agrees to conduct the tests on the arithmetic accuracy of the calculations performed by the administrator with a view to confirm the accuracy of such calculations.

Furthermore, the Dutch Central Bank is supervising the issuer and the Covered Bonds fall under the same legislation as other debt issuances. General measures as described in the Dutch Act on the Supervision of Credit Institutions 1992 ("Wtk") apply.

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

The cover assets are all owned by the CBC. The mortgage assets are sold to the CBC. The sale specifies which assets are owned by the CBC and, thus, segregated from the bankruptcy estate of the issuer. Any other assets (swaps, substitution assets) are also owned by the CBC. The issuer is responsible for ensuring the restrictions with respect to the collateral are met.

Asset segregation

The assets are segregated from the issuer at inception of the programme/issuance through a sale to the CBC. Any principal payment will be used by the CBC to purchase new collateral, which will be segregated from the issuer's estate.

The transfer of the legal ownership will take place by way of undisclosed assignment (stille cessie) without notifying the debtors of the mortgage receivables. Notification to the debtors will only take place after the occurrence of certain events including a rating downgrade of the issuer below app. BBB (depending on the issuer). Notification of the assignment of the receivables by the originator to the CBC is only necessary to achieve that debtors can no longer discharge their obligations by paying to the relevant originator. Prior to notification of the assignment, the debtors can only validly pay to the relevant originator.

The issuer will manage the collateral as long as it is solvent, but the trustee on behalf of the investors will take control should the issuer be insolvent. There are triggers to replace the issuer as servicer to ensure cash flows from the mortgage is collected.

Impact of insolvency proceedings on Covered Bonds and derivatives

Upon insolvency of the issuer, the cover bonds will be serviced with the cash flows from the collateral under the guarantee provided by the CBC. As bankruptcy is remote from the issuer, the administrator does not have the ability to interrupt these payments and the Covered Bond investors should be repaid as scheduled to triple-A probability. In the unlikely event that the collateral is insufficient to pay the Covered Bond investors, the amortisation test would be breached and the Covered Bonds accelerate. Upon acceleration all investors would have a claim on the CBC for the nominal amount of the bond.

Derivatives as such do not form part of the cover assets but are in place to address the risks involved between the mismatch of the assets and bonds.

Preferential treatment of Covered Bond holders

In case of default of the CBC, Covered Bond holders have a priority claim on the CBC. In case, after enforcement of the security, the cover assets are not sufficient to meet the claims of all secured creditors (including bondholders), the secured creditors still have an unsecured claim against the issuer for the shortfall.

Access to liquidity and sale of mortgage assets (in case of insolvency)

After a notification event, the CBC will receive the interest and principal on the principal of the mortgage assets and the rating agencies will ensure that there is enough collateral cash flow to pay interest on the

Covered Bonds. To repay principal when scheduled the CBC would need to attract funds, which it can do by selling substitute assets (which are extremely liquid) or mortgage assets. In addition pre-maturity test and/or extendible maturities (depending on the programme) ensure that adequate cash flows are available to meet contractual agreements.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

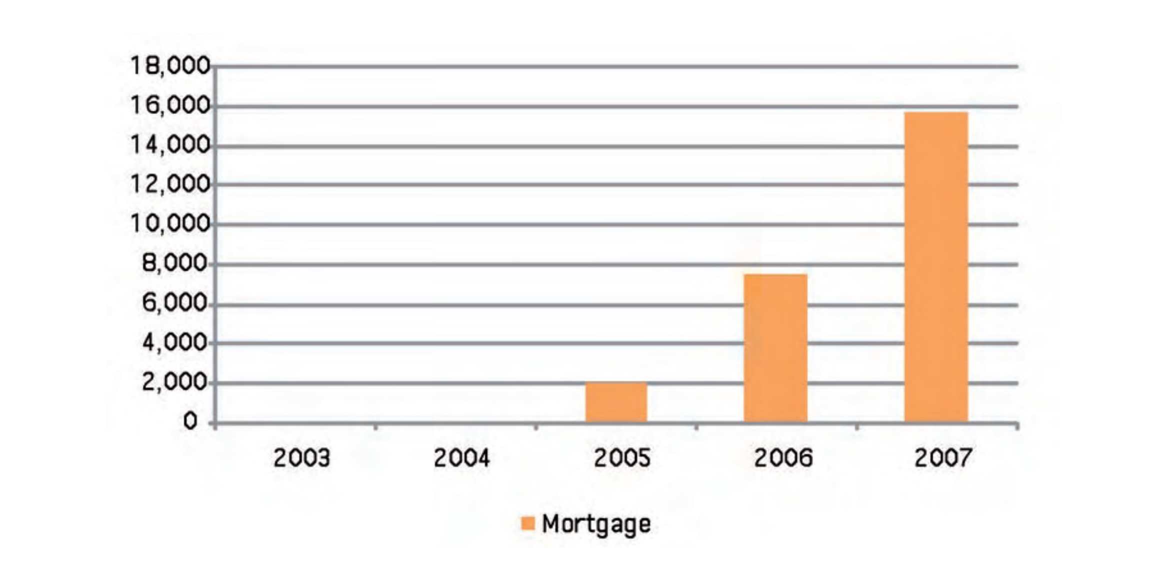
The new covered bond legislation will allow two types of covered bonds: a covered bond and a covered debt instrument.

The covered bond under the new legislation will be UCITS 22(4) and CRD compliant and thus 10% risk weighed, while the cover debt instrument will not restrict mortgage loans to a maximum loan-to-value of 80% and therefore not compliant with the CRD and will be 20% risk weighted.

Currently due to the lack of specific covered bond legislation all Dutch covered bonds are 20% risk weighed

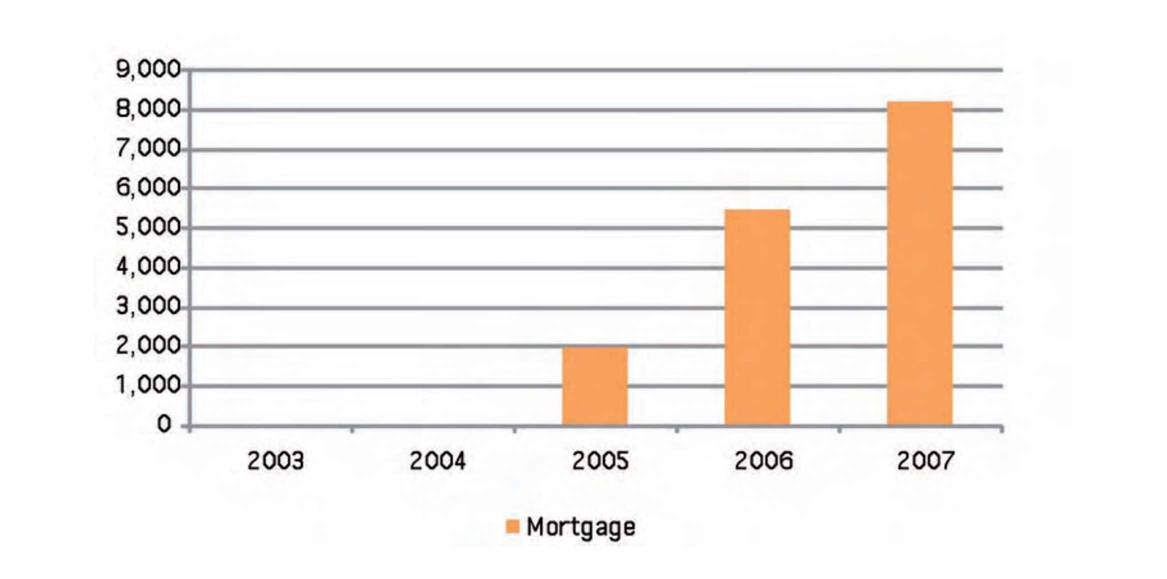
The Covered Bonds are Repo eligible by the Dutch Central Bank and the Central Bank recognises other Covered Bonds and assigns them a 10% risk-weighting.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2007, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2007, €M



Source: EMF/ECBC

3.16 NORWAY

By Stein Sjølie, Finansnæringens Hovedorganisasjon,
and Bernd Volk, Deutsche Bank

I. NORWEGIAN HOUSING AND MORTGAGE MARKET

The price increase in the secondary housing market has been strong since end-2002. The average annual house price growth 2002-2007 was 10%. However, the housing market saw 1.2% decline in house prices in October 2007. However, in April 2008 Norwegian house prices grew for the third consecutive month as higher salaries and low unemployment helped households overcome higher borrowing costs after experiencing a slowdown in H2 2007. The average house price gained a seasonally adjusted 0.1% to NOK 2.44 m, compared with growth of 0.5% in March 2008, according to the Norwegian Association of Real Estate Agents. The national statistics agency forecasts house prices will increase 2.9% in 2008. Owner-occupied mortgage loans benefit from full tax relief on interest payments in Norway. With over 90% of the mortgages are floating rate, the Norwegian market is a floating interest market. Rates on floating rate mortgages can be reset at any time and at the bank's own discretion, by giving debtors 6 week notice.

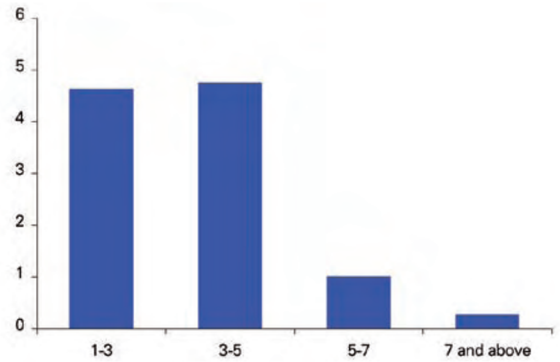
II. NORWEGIAN COVERED BOND MARKET

The Norwegian housing loan market is primarily a banking market. As bank lending has increased more rapidly than bank deposits for several years, banks are experiencing an increasing funding gap, and are therefore searching for alternative funding sources. Covered bonds are considered the best answer to this funding need, being probably the most cost-effective solution, which also enables sizable issuance volumes.

The total outstanding volume (Jumbo and non-Jumbo in all currencies) of Norwegian covered bonds amounted to EUR 10.9 bn as of 1 May 2008. With a market share of 62%, DnB NOR is the biggest issuer of Norwegian covered bonds. Sparebank1 follows with a market share of 25% and Terra Boligkreditt with a market share of 11%. The outstanding volume of Norwegian EUR Jumbo covered bonds amounted EUR 7.5 bn as of 1 May 2008. In its inaugural year 2007, the outstanding volume of Norwegian EUR Jumbo covered bonds amounted to EUR 4.5 bn. With two issues amounting to EUR 3 bn, DnB NOR Boligkreditt dominated the market followed by Sparebank1 Boligkreditt (EUR 1.5 bn). In February 2008, DnB NOR Boligkreditt tapped the market with a EUR 2 bn issue. Sparebank1 Boligkreditt followed with a EUR 1 bn issue. In April 2008 with Terra Boligkreditt the third Norwegian issuer tapped the EUR covered bond market (even though not in Jumbo size) by issuing a EUR 500 m covered bond. Before this, Terra Boligkreditt issued only in NOK and CHF. DnB NOR also issued in CHF and in JPY. All three issuers issued in NOK. In April 2008, the fourth Norwegian bank, Storebrand announced to issue covered bonds and started with issuing two issues in NOK. Storebrand will also issue EUR Jumbo covered bonds in the future.

EUR is the main issuing currency of Norwegian covered bonds

Short to medium term issues dominate Norwegian covered bonds (term to maturity at issuance)



Source: Deutsche Bank, May 2008

Legal Framework for Norwegian Covered Bonds

III. ISSUE STRUCTURE

In Dec 2002 the Norwegian legal framework for covered bonds was established by amendments to the Law on the Financing Business. The necessary secondary legislation was 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.

IV. COVER POOL CREDIT QUALITY

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,
- 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% cent 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, cf. 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 counterparty:

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.

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.

V. 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 rate 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 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, as the Norwegian Krona is quite volatile versus the EUR, 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.

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 months horizon.

VI. 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 in 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.

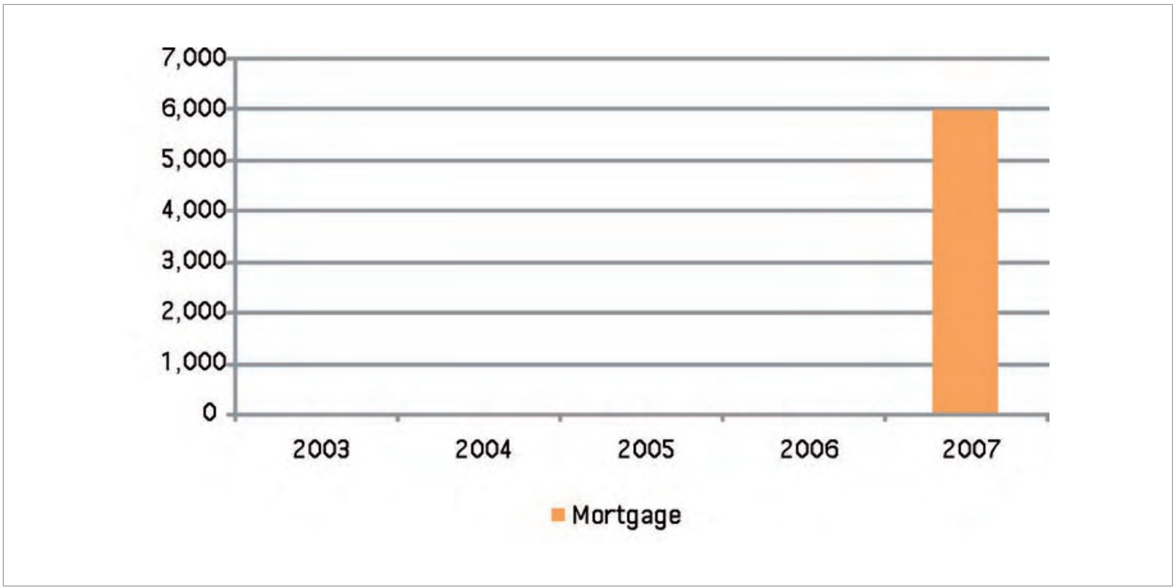
Ratings

All Norwegian covered bonds are rated triple A. According to Moody's, all Norwegian covered bonds benefit from a strong legal framework. Moreover, Norwegian covered bonds benefit from extended refinance periods – which should mitigate refinancing risks – and typically benefit from the lowest so called collateral scores (of around 2%) in the covered bond market. Moreover, in Moody's view, prospects for 2008 in Norway are positive. The level of activity by Norwegian banks in the covered bond segment is expected to increase in 2008 while existing issuers could start to diversify the types of assets in their respective cover pools. In case of Fitch, Norwegian covered bonds typically receive a comparably low Discontinuity Factor of around 10%.

Risk Weighting

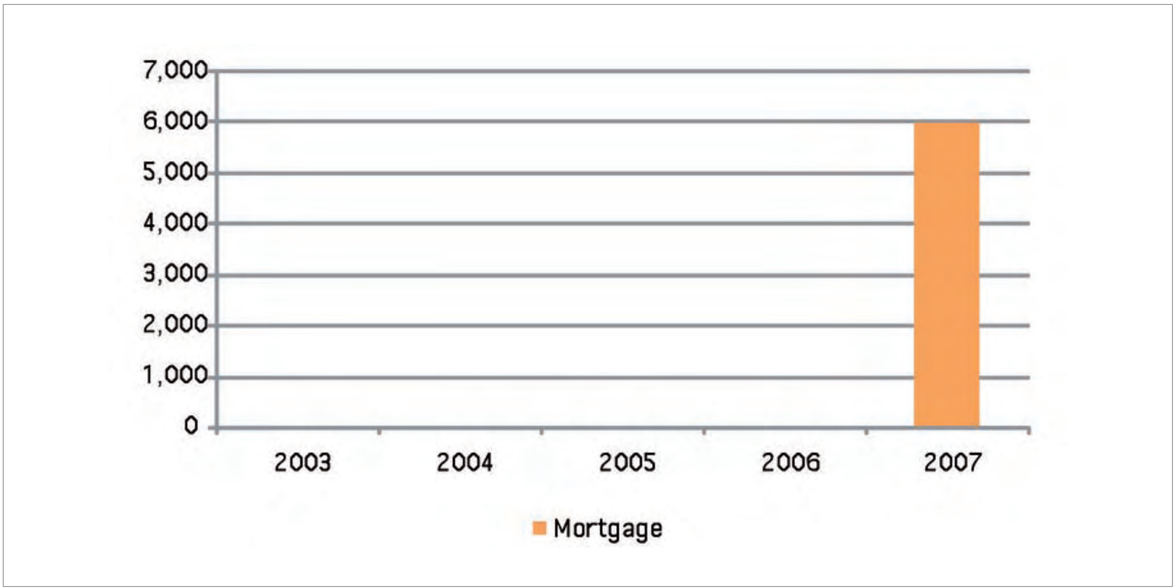
UCITS 22 (4)/CRD is applicable to EEA countries. This is stipulated in article 36 in the contract of the European Economic Area. Besides the UCITS 22 (4), covered bonds have also to fulfill the requirements of CRD to get a privileged risk weighting. In the Norwegian legal framework for covered bonds, 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 1: COVERED BONDS OUTSTANDING 2003-2007, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2007, €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.
1. 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). Currently the process has begun, 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.

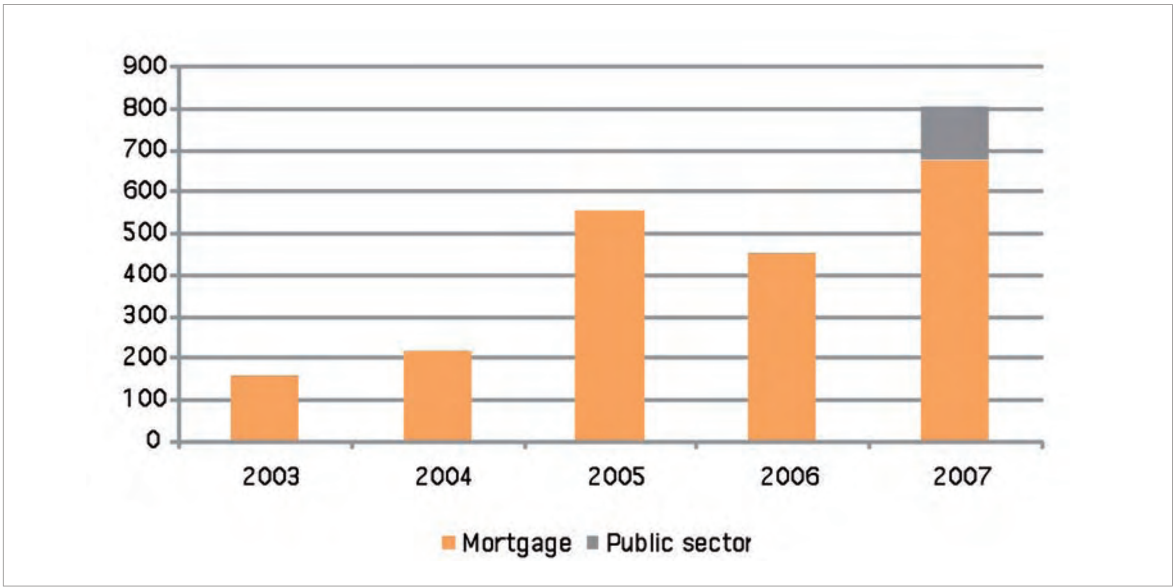
Only the specialised mortgage banks are entitled to the issue of the “list zastawny” (the Polish covered bond). The current “list zastawny” issuers are:

BRE Bank Hipoteczny S.A.

BPH Bank Hipoteczny S.A.

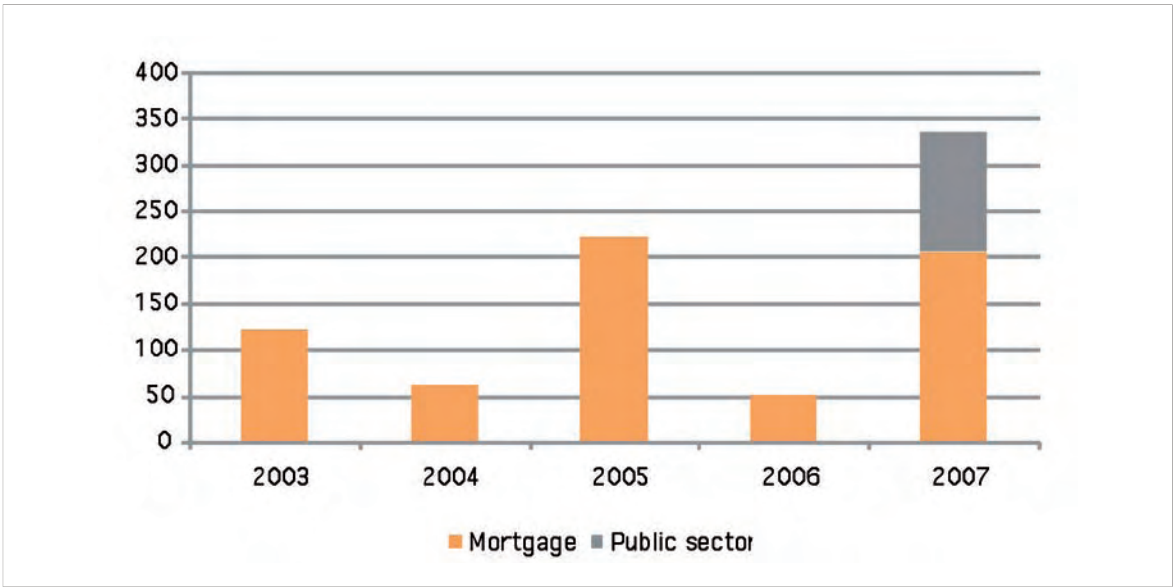
ING Bank Hipoteczny S.A.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2007, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2007, €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[2] 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[3] 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

1 Notice n.º 6/2006
3 Notice n.º 5/2006

estate is placed on sale and that market conditions allow for a regular transmission of the mortgaged asset within an adequate timing.

The property appraisal should be carried out by an independent appraisal specialist, previous to the respective mortgage credits being assigned to the Covered Bond pool.

Appraisals already carried out by a property appraisal expert are also accepted as long as the following conditions have been met:

> Appraisals have been carried out by an expert independently of the credit analysis and decision process of the bank;

> 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[4] determines the application of the following criteria:

> Loans must be accounted according to their outstanding principal, including matured interest;

> Deposits shall be accounted according to their amount including accrued interest;

> Interests eligible for Eurosystem credit transactions shall be accounted according to the value resulting from the rules regarding valuation margins defined by the Eurosystem or, if lower, according to its nominal value, including accrued interest;

> Covered Bonds and public sector Covered Bonds shall be accounted according to the corresponding outstanding principal, including accrued interest.

Interest rate or FX derivatives must be accounted in accordance with their market value and in the event that the corresponding loans and other substitute assets are denominated in different currencies, the issuer must ensure hedging of the relevant currency risk, and the reference exchange rates published by the European Central Bank shall be used for this purpose.

Single name risk is also addressed. The aggregate in risk positions with credit institutions - excluding those with a residual maturity date of 100 days or less - cannot exceed 15% of the aggregate nominal value of the Covered Bonds or public sector Covered Bonds outstanding.

The actual amount of the liabilities arising from the issuance of mortgages Covered Bonds or public sector Covered Bonds cannot be higher than the actual amount of the portfolio allocated to such bonds, taking into 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[5].

In the law, there are no specific rules on the cover pool monitor's responsibility. General rules on civil and contractual responsibility apply. The cover pool monitor will only be liable in case it does not comply with rules applicable to its activity or with its contractual obligations. If the cover pool monitor has complied with all its obligations it will not be liable in case the issuer has not respected the applicable regulation.

4 Notice n.º 6/2006
5 Regulatory Instrument n.º 13/2006

Also, a bondholders' joint representative – common to all mortgages or public bond issues - is to be appointed by the Board of Directors of the issuer in order to represent the interest of the bondholders and supervise the cover pool.

The Bank of Portugal and the Portuguese Securities Commission (CMVM) are responsible for banking and capital markets supervision. The law grants powers to the Bank of Portugal to regulate and supervise the issuers of Covered Bonds, so they must comply with the requirements of the law and all applicable regulations. Non-compliance by the issuer could imply the application of fines and other sanctions and, ultimately (in a worst case scenario) could determine the revocation of the issuer's licence.

Additionally, the Bank of Portugal has been granted powers to control compliance of the applicable rules for as long as the bonds remain outstanding, namely it may:

> 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[6].

The legal effect of registration is to segregate those assets from the insolvent estate over which bondholders will have a special claim in case of insolvency/bankruptcy. In this situation the assets pledged to one or more issues of mortgage bonds will be separated from the insolvent estate for the purpose of its autonomous management until full payments due to the bondholders have been met. Despite this, the law stipulates that timely payments of interest and reimbursements should continue. In that way, cover assets form a separate legal estate, a pool administered in favour of the Covered Bondholders.

In an insolvency situation of the issuer two situations may occur:

> The issuer voluntarily assumes that it is insolvent and will present a project to the Bank of Portugal pursuant to article 35.-A of the Credit Institutions General Regime, containing the identification of the credit institution that will be appointed to manage the cover pool, together with the terms under which those services will be rendered;

> The revocation of the authorisation of the issuer with outstanding Covered Bonds or public sector Covered Bonds takes place, and the Bank of Portugal shall appoint a credit institution[7] to undertake the management of the cover pool.

The cover pool will be managed autonomously by this credit institution, which should prepare, immediately upon initiating its management, an opening balance sheet in relation to each autonomous portfolio and relevant bonds, supplemented by the necessary explanatory notes and should perform all acts and deals necessary for a sound management of the loan portfolio and its guarantees with the aim of ensuring a timely payment on the Covered Bonds, including selling credits, assuring their servicing all administrative procedures pertaining to these credits, the relationship with the debtors, and all modifying and extinguishing acts relating to their guarantees and must carry out and keep updated a registry, in off-balance sheet accounts, the details of the cover pool, in the terms set forth in the Decree-law no. 59/2006.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

According to secondary legislation, stated in the notice of Bank of Portugal[8], 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

6 Notice n.º8/2006
7 Designated Credit Institution
8 Notice n.º7/2006

pool will be 20%. Investment funds can invest a maximum of 25% of their own funds in a single issuer's Covered Bonds.

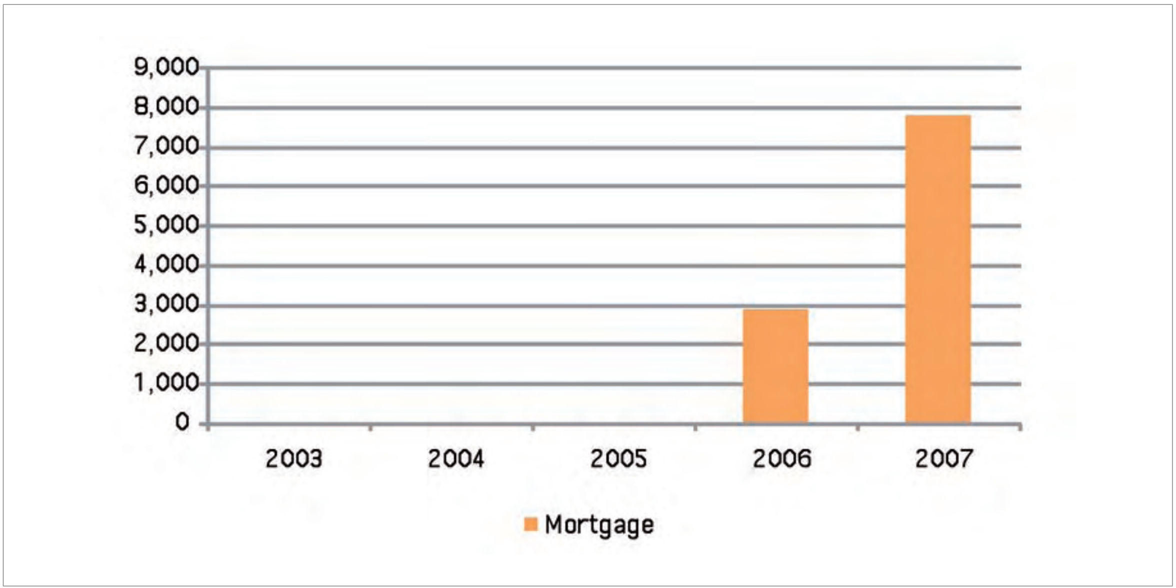
Portuguese Covered Bonds also meet the requirements of the Annex 6 of CRD of June 2006.

DEVELOPMENTS IN THE PORTUGUESE COVERED BOND MARKET

The inaugural issue of Obrigações Hipotecárias - a 10 year benchmark by Caixa Geral de Depósitos - was launched in November 2006 followed by another 10 year issue from Millenium BCP in June 2007, at the same time Caixa returned to the market, this time, with a 5 year Benchmark. Despite the "credit crunch" of August 2007 and the progressive spread widening that followed, the ECBC's "8-to-8" Market-Makers and Issuers Committee interventions in late September helped to stabilise the market and BCP Millenium managed to issue in the 7 years in October 2007. At the end of 2007, the Jumbo market reached an outstanding of 6.5 billion Euros.

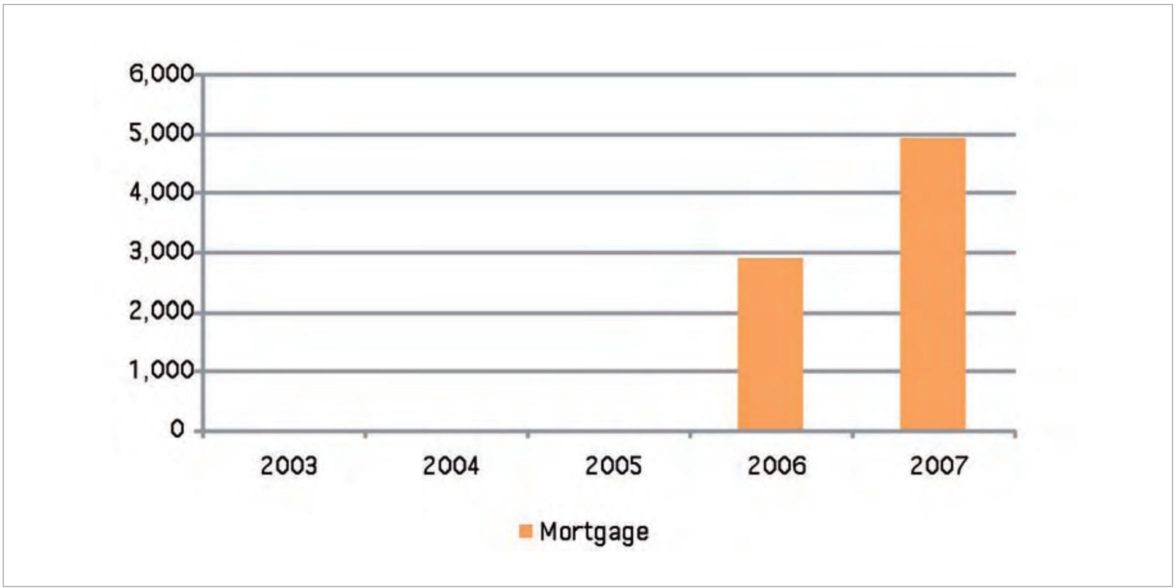
However the liquidity squeeze and volatility that followed led secondary market spreads to excessive widening and further spread dispersion across different issuers and countries, forcing issuers to pay a premium for new issues and secure their funding or wait on the sidelines hoping that levels would narrow again. This diminished the number of new issues and set an extensive new issue pipeline, which again contributed to wide new issue spreads. Nonetheless, Obrigações Hipotecárias have been more resilient than other established jurisdictions. As such, we expect that, both new and repeat issuers will come to the market in 2008.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2007, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2007, €M



Source: EMF/ECBC

3.19 ROMANIA

By Carmen Retegan
Domenia Credit

I. FRAMEWORK

In Romania, the legal basis for Covered Bond issuance is the Mortgage Bond Law and the Assets Securitization Law from March 2006. These laws supersede the general bankruptcy regulation.

II. STRUCTURE OF THE ISSUER

Pursuant to the mortgage bond law, the issuer holds the assets on his balance sheet. To qualify as a mortgage bond, the issuer has to be a credit institution (as defined by Romanian Banking Law which is in line with EU Directive). Therefore, all commercial or mortgage banks may be an issuer and no other special 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 issuer has to comply with all National Bank[1] regulations. The National Bank has not yet issued the set of applicable regulations for mortgage banks.

The mortgage bond issuer holds the ownership title over the portfolio. A direct legal link between single cover assets and mortgage bonds does not exist. All obligations from bonds are obligations of the issuing bank as a whole. However, 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 mortgage bonds it is expressly regulated only in case of issuer's bankruptcy. While not forbidden, in cases other than bankruptcy the precise applicable regulations are not very clear.

In the case of the assets securitisation law, which sets the legal framework for off-balance sheet financing, the assets originator transfers the assets from his balance sheet to a special purpose vehicle (SPV) which becomes the issuer of the mortgage backed securities. The securities issued may be of the type equity or debt. Under this structure, the originator of the assets is not subject to any restriction in terms of object of activity and it is not required to have special authorisation or a supervisory body. The issuer (which is a special purpose vehicle) is not allowed to have its own employees and all of the important decisions have to be undertaken by either the originator of the assets or by a third party servicer, if such a mandate is provided.

In the case of mortgage backed securities, servicing is made by a portfolio management entity (different to the issuer) which is the SPV.

Under both structures (i.e. mortgage bonds and mortgage backed securities) the Covered Bonds are direct and unconditional obligations of the issuer, however the issuer is the originator in case of mortgage bonds and the SPV in case of mortgage backed securities. The claims of the holders of mortgage backed securities and mortgage 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

1 Central Bank being the regulator and the supervisor of the financial market

bankruptcy, the bonds holders in a specific issue will have first priority over the pool of assets dedicated to the specific issue.

III. COVER ASSETS

The Assets Securitisation Law allows any type of asset to be securitised and for mortgage backed securities structured under this law no special eligibility criteria for the underlying assets is set in place. Furthermore, asset (mortgage) backed securities are allowed to be part of the cover pool.

In the case of mortgage bonds structured under the Mortgage Bond Law, two kinds of assets, mortgage loans (i.e. residential or commercial mortgage loans) and other eligible assets, can be included in a cover pool which is to be established by the National Bank Regulation. Such eligible assets 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. Eligible mortgage loans may be underwritten only by financial institutions that are under National Bank supervision.

Concerning the mortgage loans included in the cover pool, several eligibility or performance criteria are imposed by the Mortgage Bonds Law:

a. the pool is homogenous comprising of only one type of mortgage loan according to their 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 is not to 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 is not to exceed, in case of a residential mortgage loan, 80% of the reference value of the immovable asset over which the security interest was created and, in case of a commercial mortgage loan, 70% of the reference value of the immovable asset over which the security interest was created;
g. the amount representing the principal granted through a mortgage loan agreement has been fully disbursed to the beneficiary;
h. the amount granted to a single beneficiary or to a single beneficiary and all affiliated persons of the beneficiary does not exceed 10% of the value of the cover pool;
i. the receivables deriving from the mortgage loans are not subject to a security interest in favor of any other person;
j. the mortgage loan must not register delayed payments exceeding 61 days;

k. the real estate over which a security has been created for the reimbursement of the mortgage loan is insured against all risks for an amount equal with the reference value of the immovable established on the date of the mortgage agreement;

In terms of geographical coverage, the sole restriction imposed under the Mortgage Bonds Law, provides that, in order to be included in the cover pool, the mortgage loans were granted for real estate investments on the territory of Romania or on the territory of member states of the European Union or the European Economic Area.

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 Assets Securitisation Law allows for a dynamic pool, while the mortgage bond 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 in 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.

Both legal frameworks include disclosure requirements. Detailed information concerning the assets included in the cover have to be provided by 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 person. 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. The legal framework does not incorporate any special monitoring requirement. We would also like to emphasize the idea that in countries (like Romania) where we do not have a long history of real estate transactions, or the market has been heavily distorted by certain events (e.g. political or other types) the mortgage lending value may not be measured/estimated. Therefore, the level of discount from the market value is, and has to be, a credit risk decision and not a valuers one.

The Mortgage Bond Law stipulates limits for LTV on both commercial and residential loans at 70% and 80%, respectively. This LTV is not a relative limit; partial mortgage loans may not be included in the pool. The Assets Securitisation Law does not impose any limit to the LTV, but includes full disclosure on the principles

V. ASSET - LIABILITY MANAGEMENT

The Mortgage Bond 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 is not required to provide any overcollateralisation.

If any of these limits is breached the bondholders may request that the bonds are immediately repaid, unless the breach is remedied within 30 days.

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. As far as mortgage backed securities are concerned, under the Securitisation Law special supervision is carried out by the Securities Commission. Supervision by the National Bank is limited to credit institutions acting as the portfolio management companies of the mortgage backed securities issues. The respective roles of the Securities Commissions and the National Bank are clearly segregated; the Securities Commission authorises and supervises the public offering, while the National Bank of Romania authorises and supervises the issuer and portfolio manager.

For mortgage bonds, the law provides for the mandatory appointment of an agent. For mortgage backed securities, the appointment of an agent is optional. The agents have to be authorised jointly by the Securities Commission and by the National Bank. Initially, the agent shall be appointed by the issuer (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-fulfillment 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).

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 i mortgage bond or mortgage backed security 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 also provides the legal means for the bondholders (through the agent) and for the supervising authority (National Bank of Romania) to check compliance by the issuer of all requirements under the law with respect to the structure of the portfolio, net asset value coverage etc.

The cover register is kept by the issuer and subject to checks by the agent and supervision by the National Bank of Romania.

Under the Securitisation Law, the cover register is kept by the portfolio management company which is obliged obligation to send a copy of the cover register to the SPV manager on a monthly basis. The SPV manager also sends information received from the portfolio management company to the National Securities Commission. The holders of asset-backed securities or the agent, as the case may be, may request a copy of the cover register from the portfolio management company on a monthly basis.

Asset segregation

The segregation of the cover assets from the insolvent's estate is a consequence of the operation of the law - the asset pool is not included in the bankrupt estate. After the launching of the insolvency proceedings, a special cover 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 shareholders.

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 Covered Bond issues continue to be administrated until full realisation of the receivables in the respective portfolio. In the event that the bankrupt issuer pays in full all the amounts due to the bondholders, the bondholders have the option to decide in the general meeting of bondholders to accept payment in advance with a vote of 25% of the total number of bonds in the respective issue.

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 insolvent issuer's estate on the other.

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 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.

Access to liquidity in case of insolvency

With the appointment of the cover pool management company, the right to manage and dispose of the recorded assets is transferred to him by law. Thus, the cover pool manager first has access to the cover assets and collects the cash flows according to their contractual maturity.

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. Full disclosure in the prospectus with respect to the voluntary overcollateralisation is advisable as a potential means to mitigate the risk of voluntary overcollateralisation being claimed by the insolvent issuer's creditors.

Sale and transfer of mortgage assets to other issuers

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

For substitution or overcollateralisation purposes, (but only up to 20%) other types of assets (but only up to 20%) with at least the same risk level as the eligible loans of the pool may be included in the cover pool. The types of such assets and their risk-weighting are to be defined by the National Bank of Romania at a later stage.

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 issued under the Mortgage Bond Law also comply with the CRD Directive Annex VI, Part 1, Paragraph 68 a) to f), with the exception of Paragraph 68(e), according to which, in the case of commercial real estate cover pools, the LTV ratio may exceed 60% only provided the following two conditions are met: the value of the total assets pledged as collateral for the Covered Bonds should exceed the nominal amount outstanding on the Covered Bonds by at least 10%, and the bondholders' claims should meet a number of certainty criteria. While the certainty criteria are met, the Romanian Mortgage Bonds Law does not stipulate overcollateralisation (the updated value of mortgage loans securing an issue of mortgage bonds has to be at least equal to the updated value of the payment obligations of the issuer towards the holders of mortgage bonds of the issue secured with the respective pool).It nevertheless requires an LTV ratio of 70% for commercial mortgages.

3.20 RUSSIA

By Tim Lassen, Eurohypo AG

I. FRAMEWORK

In Russia, the legal basis for Covered Bonds is the Federal law "On mortgage securities" ("Ob ipotechnykh cennykh bumagakh") No 152-FZ[1], dated 11 November 2003.[2] This law is supported by rules in the laws "On mortgage (real estate pledge)" [3], "On insolvency (bankruptcy)"[4], "On insolvency (bankruptcy) of credit organisations"[5] and "On securities market"[6].

In addition the Central Bank of Russia[7] issued the "Instruction of mandatory requirements for credit organisations, issuing securities with mortgage cover" No 112-I, dated 31 March 2004.[8] The Federal Financial Markets Service (FFMS)[9] released the Order "On confirmation of the Decree on the method of determination of the mortgage cover" No 05-59/pz-n, dated 1 November 2005[10] and the Order "On confirmation of the Decree on the activity of the special depositor for the mortgage cover and the Rules of the maintenance of the register of the mortgage cover" No 05-60/pz-n, dated 1 November 2005[11].

II.STRUCTURE OF THE ISSUER

The Russian Covered bond law foresees three types of securities:

- Two types of "mortgage obligations"[12] (obligation issues (i) by a credit organisation or (ii) by a SPV ("mortgage agent"), art. 7 sec 1[13]), her in the following: "Covered bonds"[14]. Covered bonds have to bear interest (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 "Pfandbrief" 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.[15]

As a general rule mortgage obligations are secured by static cover pools (other as for example dynamic cover pools under German or Austrian law). Even if the Russian Covered bond law allows several issues

1 Following: Covered bond law. See also: Information letter of the High Arbitrazh Court of the Russian Federation of 28 December 2003 No S5-7/UZ-1391 "On the Federal law "On mortgage securities".
2 Amended by the Federal laws dated 29 December 2004 No 193-FZ and 27 July 2006 No 141-FZ.
3 Federal law dated 16 July 1998 No 102-FZ, following: "Mortgage law". In art 20 sec 4.1; 22 sec 1.1 the mortgage law includes regulations only for mortgage participation certificates.
4 Federal law dated 26 October 2002 No 127-FZ, following: "Bankruptcy law".
5 Federal law dated 25 February 1999 No 40-FZ, following: "Credit organizations bankruptcy law".
6 Federal law dated 22 April 1996 No 39-FZ. Art 8 sec 4 contains rules for mortgage share certificates, art 27.3 general rules for securities, secured by a pledge.
7 www.cbr.ru.
8 Published Vestnik Banka Rossii No 30 (754) as of 19 May 2004, amended by Direction No 1550-U dated 18 February 2005 (Vestnik Banka Rossii No 19 (817) as of 13 April 2005).
9 www.fcsm.ru.
10 Amended by the Order of the FFMS No 06-138/pz-n, dated 30 November 2006.
11 Amended by the Order of the FFMS No 06-142/pz-n, dated 5 December 2006.
12 Language of the law: "Obligations with mortgage cover".
13 Law citations without link are citations of the Covered bond law.
14 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).
15 Knowing, that in fact MBS are no covered bonds!

from one cover pool, the cover for every issue is static and can be modified only in some cases, stipulated by the law.

1. Credit institution (art 7 sec 2)

A credit organisation has to comply with the law "On Banking and banking activities"[16] and the rules, set up by the Central bank for covered bond issuing credit organisations.

By the "Instruction of mandatory requirements for credit organisations, issuing securities with mortgage cover" No 112-I, dated 31 March 2004 the Central Bank has set up special regulations for (art 7 sec 2 para 1 and 2[17]):

- Minimal ratio between the cover pool and the equity of the credit organisation: 10% (pt 2.3 of Instruction No 112-I),
- Minimal ratio between the volume of the cover pool and the volume of the issued covered bonds: 100 % (pt 2.4 of Instruction No 112-I),[18]
- Maximum ratio of all claims against the credit organisation, privileged before the covered bond holders[19] and the equity: 50% (pt 2.5 of Instruction No 112-I),
- Ratio of sufficient equity (capital): 14% (pt 2.1 of Instruction No 112-I),
- Ratio of general liquidity: 20% (pt 2.2 of Instruction No 112-I),[20]

A credit organization has to fulfill at least one of this ratios to issue covered bonds (art 7 sec 1 para 4).

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't be changed or amended later (art 8 sec 1 para 4).

In the founding documents of the mortgage agent has to be stipulated the number of covered bond issues, this agent is founded for. After this issuance(s) 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 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).

16 Federal law dated 2 December 1990 No 395-I.
17 The Central Bank hasn't used its right to set a limit special limit for covered bond issuers of the interest and foreign exchange risk.
18 Restrictions by art 102 sec 2 Civil code, art 33 sec 3 of the law "On joint stock companies" (dated 26 December 1995 No 208-FZ) and art 31 sec 2 of the law "On limited liabilities companies" (dated 08 February 1998 No 14-FZ) do not apply for the issuance of covered bonds.
19 Before introducing the separation of the cover pool from the bankruptcy estate in the law, mainly claims of physical depositors were privileged before covered bond holders (art 50.36 sec 3 Credit organizations bankruptcy law). After introducing the separation principle in the amendment to the Covered bond law in 2004 it is not clear, which claims may be privileged.
20 The ratios of sufficient equity (capital) and of liquidity are amending the general rules for credit organizations of the Instruction "On mandatory requirements for banks" No 110-I, dated 16 January 2004 (published: Vestnik of the Central Bank of the Russian Federation No 11 (735) of 11 February 2004, last amendment Direction No 1991-U of 31 March 2008). The general requirements for banks are:
- Sufficient Equity (capital) ratio (pt 2.2 Instruction No 110-I):
  . Banks with equity up to 5 m EUR: 10%.
  . Banks with equity higher than 5 m EUR: 11%.
- Liquidity ratio (pt 3.2, 3.3 and 3.4 Instruction No 110-I):
  . Momentary liquidity: 15%.
  . Floating liquidity: 50%.
  Long term liquidity: 120%.

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 FFMS may apply for liquidation of the mortgage agent (art 8 sec 3).

The FFMS 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 potkrytie"), mortgage agent ("ipotechnyj agent") and "mortgage specialized organisation" ("ipotechnaya spezializirovannaya organisatsiya")[21] may be used only for the purposes of the Covered bond law.

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)[22] 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 don't exceed the LTV limit of 70% (art 3 sec 2 para 2).

One asset may only be used for one cover pool. A mortgage participation certificate cannot 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 law "On securities market" (art 37 para 1; 40 sec 1) an important information is an account report on performance of the cover assets (art 40 sec 4 pt 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 FFMS

21 "Mortgage specialized organization" is another allowed name for "mortgage agent" (art 8 sec 1 para 5).
22 A mortgage certificate is only eligible, if it is not pledged of another purpose (art 3 sec 3 para 1).

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).

Credit organisations issuing covered bonds have special reporting duties to the Central bank (art 7 sc 1 para 3; pt 3.1 – 3.5 Instruction No 112-I).

IV. VALUATION AND LTV CRITERIA

Due to art 3 sec 2 para 2 the LTV limit is 70% of the market value of the property. The valuation has to be made by an independent valuer.[23]

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 FFMS.[24] The following claims shall not be encountered by summing up the mortgage cover:

- No payment made on the claim for more than six month;
- Loss of the mortgage object, including if the mortgage was declared void by a court;
- Secured obligation declared void by a court;
- Bankruptcy of the debtor; and
- No insurance of the mortgage object for more than 6 month.

Only in this 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). 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).[25]

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

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23 The valuers profession is regulated in the law „On valuation activity in the Russian Federation" of 29 July 1998 No 135-FZ.

24 Order "On confirmation of the Decree on the method of determination of the mortgage cover" No 05-59/pz-n.

25 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.

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 has to be mortgage secured claims. If this ratio is lower than 80% within three months the issuer has to increase the share of mortgage secured claims. This can be done by obtaining new mortgage secured claims and/or by prepayment of outstanding covered bonds (art 13 sec 1 para 2).

Money received from the repayment of the mortgage secured claims has to be included into the cover pool as far as this is necessary to fulfil the legal stipulations on the volume of the cover pool (art 13 sec 4).

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; and
- other reasons stipulated by the decision on issuing covered bonds.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

Cover Pool Monitor

Cover assets have to be registered in a "register of mortgage cover"[26] (art 5 Covered bond law).

The register of mortgage cover is maintained by a cover monitor (the "specialised depositor of the mortgage cover"[27]), art 33 sec 1. The cover monitor has to be a commercial organisation[28], licensed for depositary activities for investment funds, non-state pension funds and on the securities market (art 32 para 2). The FFMS has published a special Order "On confirmation of the Decree on the activity of the special depositor for the mortgage cover and the Rules of the maintenance of the register of mortgage cover" No 05-60/pz-n, dated 1 November 2005[29].

The specialised depositor is acting on the bases of a contract with the issuer (pt 1.3 Order No 05-60/pz-n).

26 In Russian "reestr ipotechnogo pokrytiya".
27 In Russian "spetsializirovannyj depositariy ipotechnogo pokrytiya".
28 Not affiliated with the issuer (art 33 sec 3 para 2).
29 Amended by the Order of the FFMS No 06-142/pz-n, dated 5 December 2006.

One cover pool may be only administrated by one monitor (art 33 sec 3 para 1 Covered bond law). The monitor is acting solely in the interests of the holders of mortgage securities (art 35 para 1). He is obliged to inform the FFMS on breaches of the covered bond law (art 35 para 3).

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). 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).[30]

The cover monitor is obliged to (art 35 sec 2):

- Safekeeping of the documents confirming the mortgage secured claim;
- giving of consents for the disposal of cover assets;
- submission of accounting information to the FFMS; and
- information of the covered bond holders of their right to prepayment of the covered bonds according to art 16.

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 cover pool monitor is controlled by the FFMS (art 43 sec 1 pt 7, sec 2 para 1).

The monitor may insure his responsibility in front of the covered bond holder on his own account (art 36).

Supervision

State regulation of issuing covered bonds is done by the FFMS 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 FFMS (art 43 sec 2).

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.

30 In case of non-fulfillment of this tasks the cover monitor has a shared responsibility with the issuer in front of the covered bond holders (art 34 sec 2).

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 hasn't 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 (rt 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 realisation 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[31], Annex VI, Part 1, Paragraph 68 a) to f).

IX. COVERED BOND STATISTICS AND ISSUERS

Some banks and institutions in Russia are focusing on mortgage lending (mainly housing finance), e. g. Moscow Mortgage Agency[32], Delta Credit[33], Gorodskoy Mortgage Bank[34], federal Agency for mortgage housing lending[35] (AIZhK) and regional mortgage agencies.

The AIZhK has issued covered bonds twice by using mortgage agents. The Moscow Mortgage Agency and the Irkutsk Regional Mortgage Agency[36] have issued mortgage secured bonds on-balance, but by using other structures than the Covered bond law.

No covered bonds under the Covered bond law have been issued by credit organisations so far.

IX. OUTLOOK

In the State Duma amendments to the Covered bond law are under discussion. Aim is, to enhance the legislation for covered bond, issued by credit organisations and to implement a clearer differentiation between covered bonds, issued by credit organisations and issued by mortgage agents.

31 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.

32 www.mia.ru

33 www.deltacredit.ru

34 www.gorodskoi.ru

35 www.rosipoteka.ru

36 www.ipoteka.irk.ru

3.21 SLOVAK REPUBLIC

By Viktória Múčková and Eva Horvátová University of Economics in Bratislava,
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FRAMEWORK

According to §§14-17 of the Act on Bonds, a mortgage bond 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 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 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 indicated in the criteria above, in order to be distinguishable from the insolvency estate of the bank, the mortgage loans serving as collateral for mortgage covered bonds, just as all other items serving as substitute collateral, have to be recorded in separate mortgage (coverage) register by the issuing bank.

With respect to the general approach to covered bonds the model, applied by Slovakian lawmakers is similar to common practice in Germany and Spain.

However, what is significantly different is the introductory period. In order to allow for a smooth start of the covered bond business after a covered bond issuing license has been granted, the Slovakian covered bond law defines the conception of temporary mortgage bonds.

Within eighteen months following the effective date of mortgage business license, a bank may issue, upon a decision taken by its general meeting, temporary mortgage bonds in form of bearer securities with a total nominal value not exceeding 50% of the bank's basic capital. The bank is obliged to exchange 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.

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 currency and bonds might be placed more with international investors.

STRUCTURE OF THE ISSUER

The mortgage bonds issuers are universal credit institutions. In accordance with Act on Banks, No. 483/2001, amendments, and with relevant decree the minimum requirements to obtain and keep the special licence are as follows:

- the minimum amount of cash contribution to the bank equity capital, is SKK 1,000,000,000[1], 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.

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 an uncompleted construction, which is at least to the amount of 90% financed by the issue and sale of mortgage bonds by a mortgage bank pursuant to the Slovak covered bond regulation. 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.

1 1,000,000,000/32,91 = 32,910,349 EUR.

In order to be eligible for collateral 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, no entries are made in the register of mortgages. 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.

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.

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.

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.

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

Although the Slovakian lawmakers enacted a detailed insolvency and restructuring regulation in 2000 (Nr. 238/2000), which was amended in December 2004 (7/2005 and 353/2005), the role of holders of Slovak

Covered Bonds is not explicitly laid out. It is generally accepted to see holders of hypotekárne založné listy as creditors according to §8 of the law. Should this be the case, investors in Slovak Covered Bonds would participate in the general insolvency procedure but would be satisfied from funds stemming from the assets held in a separate estate (§69). Prerequisite for this special treatment, however, would be that the holders of hypotekárne založné listy raise their secured claim within a period of 45 days starting from the day of declared insolvency. Hence, Covered bond holders enjoy limited preferential treatment.

RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Slovak "Hypotekárny záložný list" comply with the requirements of Art. 22 par. 4 UCITS Directive conditionally (preferential treatment is limited).

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,
- pension funds up to 15 % of their assets in HZL.

ANNEX: DEVELOPMENT OF MORTGAGE LOANS IN BANKING SECTOR

Since inception of the law, a license has been granted to nine banks.

Slovakian Covered bond Issuers

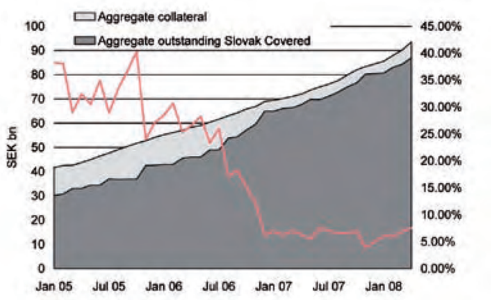
Name	Web Page	Bloomberg Equity Ticker	Bloomberg Debt Ticker	Ownership situation
Istrobanka	www.istrobanka.sk	1015Z SK	ISTROB	KBC Groep NV
Slovenská Sporitelna	www.slsp.sk	SPO SK	SLOSPO	Erste Bank der Österreichischen Sparkassen
Tatra Banka	www.tatrabanka.sk	TAT SK	TAT	72% Raiffeisen International; 14% Tatra Holding
UniCredit Bank	www.unicreditbank.sk	333232Z SK	HVBBNK	Bank Austria Creditanstalt
Všeobecná Úverová Banka	www.vub.sk	VUB SK	VUB	Intesa Sanpaolo

Source: UniCredit Global Research

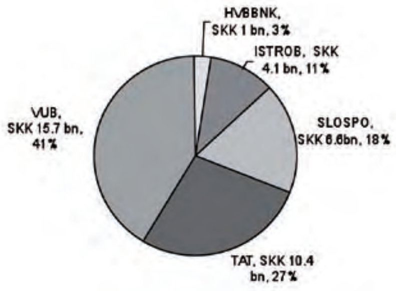
Market size and development

Figure 1: Covered Bonds Outstanding 2003-2007, €m

Total Market Size



Market Shares of publicly placed paper



Source: UniCredit Global Research

The fact that the market for Slovakian Covered Bonds has become quite mature meanwhile can be seen from the evolution of various issuance styles. The two graphs above show that the market for publicly placed hypotekárne založné listy is only a fraction of the total market – almost comparable to the situation of the Pfandbrief market. Publicly placed paper account for only 47% of the total market.

A similar picture holds true for the coupon styles offered to the market. Although the majority of hypotekárne založné listy pays a fixed coupon, with a market share of almost 30%, floating rate hypotekárne založné listy also play a significant role. What has not been touched yet – at least in the publicly placed part of the market are – putable, callable, extendible, etc. features. The market is still a pure hard bullet market.

In terms of currencies, international terrain has been explored but not yet populated. In the publically placed segment, there are two non-SKK denominated issues, in reasonable size though. The TAT 3m EUR+17.5 2008 denominated in EUR (size EUR 130 mn – equiv. SKK 3.95 bn) is the largest publicly placed bond in the entire market and the VUB 6m PR+50 2012 (CZK 1 bn - equiv. SKK 1.3 bn) also ranks among the larger hypotekárne založné listy publicly placed. The average size of publicly placed Slovakian Covered Bonds is just above SKK 800 mn.

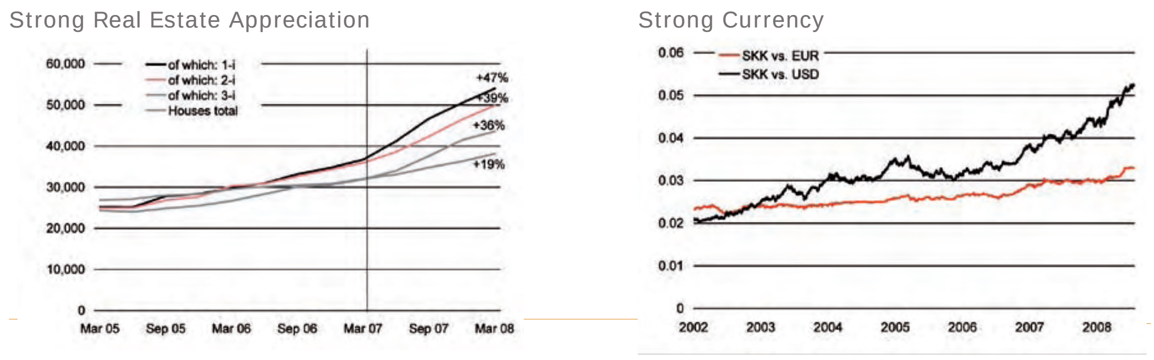
Mortgage Market Basics

House price increases in Slovakia have been significant in the recent past, however, this happened on the back of an overall booming economy. Residential real estate appreciated 32.5% (28% in real terms) in 2007. In 2006, prices increased by 17.5% (12.9% in real terms).

Rapid economic growth is the main driver for rising house prices. Slovakia's economy grew by an impressive 14.1% in Q4 2007, pushing the 2007 GDP growth rate to 10.4%. Average GDP growth from 2002 to 2006 was around 6%. In addition, house prices received a further boost from the announcement that Slovakia will adopt the euro in 2009. This is expected to push house prices up strongly in 2008. In Q1 2008, the average residential property price was SKK 44,463 (€1,450) per sq. m., up 34.5% from the same quarter last year.

In particular for foreign investors the significant appreciation in property prices has even been spurred by the strong performance of the koruna (displayed in the graph below). The koruna has risen from 0.025 EUR per SKK in mid-2006 to 0.033 EUR per SKK as of mid 2008. The appreciation against the USD was even stronger, starting from 0.033 USD per SKK and peaking at 0.052 USD per SKK in mid-2008.

Figure 1: Covered Bonds Outstanding 2003-2007, €m



Source: UniCredit Global Research

Demand for Slovakian real estate is strongly biased to the domestic side. Although foreign buying interest has been strong since the country allowed foreign purchases in 2004, the high ownership ratio in Slovakia speaks for itself. Owner-occupancy rate increased substantially from 49.7% in 1990 to 75.9% in 2001, while public rentals diminished from 27.2% to 3.7%. Cooperative housing still plays a significant role although the market share slightly decreased from 22.3% to 14.9%, over the same period as mentioned above. However, in the period between 2001 and 2004, the owner-occupancy rate increased to 85%, but in this period at the expense of co-operative housing, which became marginal with 7% market share.

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 transfered 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 Juan Garcia Muñoz, Spanish Mortgage Association

I. FRAMEWORK

The legal framework for Spanish Covered Bonds --“Cédulas Hipotecarias” (CHs) -- is determined by the Law 2/1981, of 25th of 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 (hereinafeter Law “41/2007”) and the Royal Decree 685/1982, of 17th of March, (which will be modified shortly in order to be adapted to the redrafted Law 2/1981) that further clarifies certain matters of the Law 2/1981 (hereinafter, “RD 685/1982).

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).

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 establishes that in case of insolvency of credit institutions their specific legislation, specifically article 14 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, Cooperative Banks and Financial Credit Institutions and the Spanish Confederation of Savings Banks (CECA)

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 and 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.

As a general practice, the issuer has its own employees. 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 status, 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, being a common practice that different series of bonds are covered by different portfolios of CHs, thus, the risk of one series will not affect the other series.

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-collateralization of 43%.

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 establishes 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.

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 redemption of their principal amount or the modification of the market value of the mortgaged properties the values do not exceed said LTV, initial or reviewed.

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 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.

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, as it will be determined by the regulations, the essential details of said register (art. 12 Law 2/1981)

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*.

If at any time for any reason the value of the mortgaged real estate has fallen by an amount in excess of 20% of the value, the issuer may, pursuant article 26 and 29 of the RD 685/1982 Art. 5 Law 2/1981, request the relevant debtor, to the extent legally required, to: a) extend the mortgage to other assets that provide sufficient cover and meet required LTV; or b) return all the mortgaged credits or such portion of the relevant mortgage loans as may be in excess as a result of the application of the current appraisal to the percentage used to initially determine its amount.

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 an administered 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 Cover 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:

- The floating rates of the CH and the Assets have to be stated as a fixed margin plus an interest rate of reference.
- The average floating rate of the CH shall not exceed the average interest rate of the Cover Assets with a floating interest rate.
- In addition and without prejudice to the limit of the 80% of the aggregated outstanding principal of the eligible assets, it is compulsory to stipulate a limit or cap on the eventual variation of floating rate of the CH based on the foreseen yield of the Cover Assets.

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 11% 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.

The role of the rating agencies shall be decided by the issuer on a case-by-case basis, either for commercial or market reasons.

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 (modified by the 19th final Provision of the Insolvency Law) 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 84.2.7º 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)

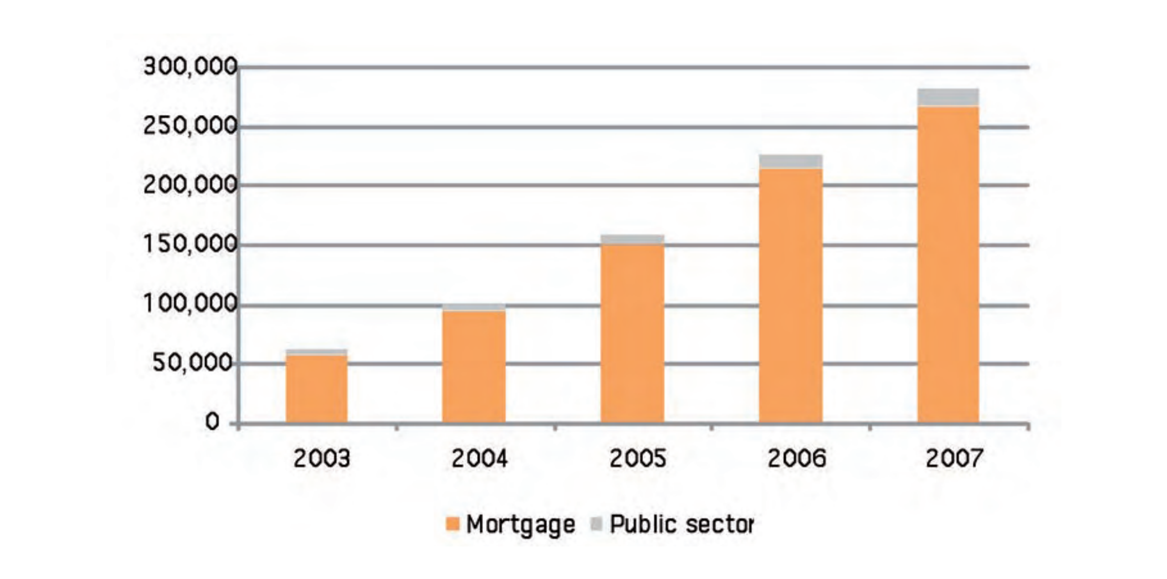
The CHs listed on a recognised secondary market (as AIAF) are eligible for investing the assets of the UCITS up to 25% of its net worth.

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.

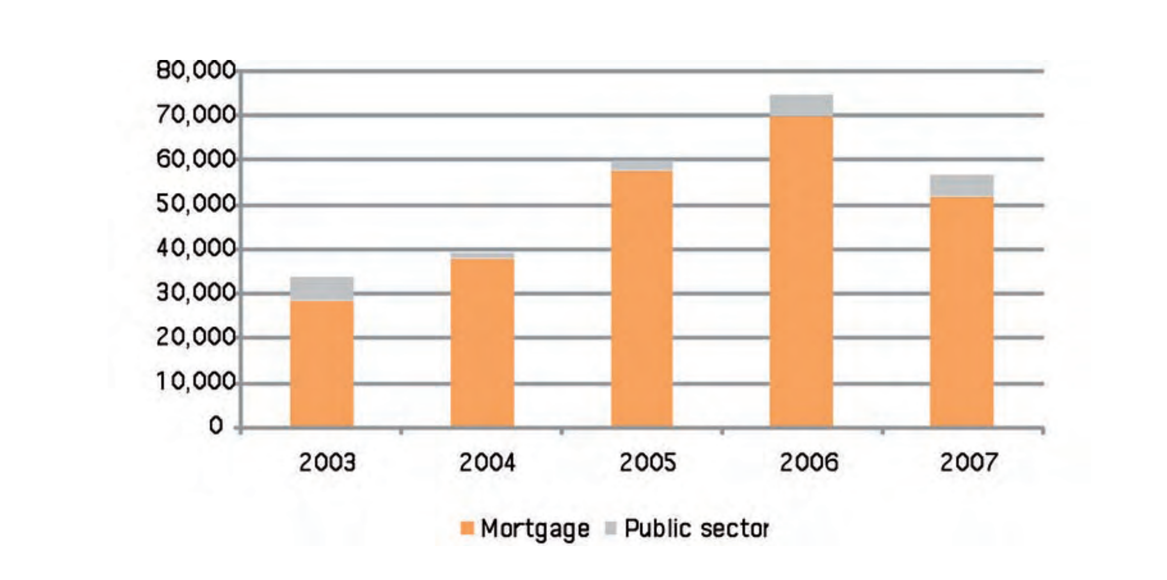
Finally, the CHs upon being listed or applied for listing are eligible for: i) investment by insurance companies of their technical provisions obligations; ii) the investment by mutual guarantee companies; iii) investment by Pensions Funds.

Figure 1: Covered Bonds Outstanding 2003-2007, €m



Source: EMF/ECBC

Figure 2: Covered Bonds Issuance, 2003-2007, €m



Source: EMF/ECBC

3.24 SWEDEN

By Tomas Tetzell, Swedish Bankers' Association

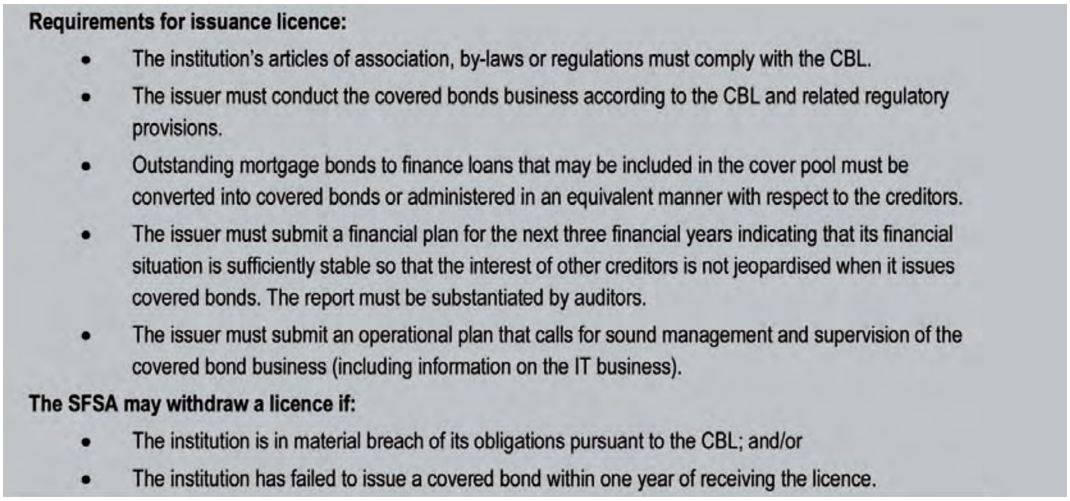
I. FRAMEWORK

In Sweden, the issuance of Covered Bonds is governed by the Swedish Covered Bond Law, which came into force on 1 July 2004 (Lag 2003:1223 om utgivning av säkerställda obligationer, hereinafter the 'CBL')[1]. The CBL supersedes the general bankruptcy regulation and grants Covered Bond investors a priority claim on eligible cover assets (CBL: 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 CBL 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 (CBL: 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 CBL. The SFSA has the right to withdraw the licence should the institution be in material breach of the CBL or have failed to issue Covered Bonds within one year of receiving the licence (Table 1). If the SFSA withdraws a licence, it must determine a plan to wind down the operation.

Table 1: Licence needed to issue Covered Bonds



Requirements for issuance licence:

- The institution's articles of association, by-laws or regulations must comply with the CBL.
- The issuer must conduct the covered bonds business according to the CBL and related regulatory provisions.
- Outstanding mortgage bonds to finance loans that may be included in the cover pool must be converted into covered bonds or administered in an equivalent manner with respect to the creditors.
- The issuer must submit a financial plan for the next three financial years indicating that its financial situation is sufficiently stable so that the interest of other creditors is not jeopardised when it issues covered bonds. The report must be substantiated by auditors.
- The issuer must submit an operational plan that calls for sound management and supervision of the covered bond business (including information on the IT business).

The SFSA may withdraw a licence if:

- The institution is in material breach of its obligations pursuant to the CBL; and/or
- The institution has failed to issue a covered bond within one year of receiving the licence.

Source: Lag 2003:1223, FFFS 2004:11

1 Lag 2003:1223 om utgivning av säkerställda obligationer [Law Concerning the Issuance of Covered Bonds].
2 FFFS 2004:11 Finansinspektionen's Regulations and General Guidelines Governing Covered Bonds.

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 CBL, 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. Within a banking group, outsourcing of the business activities to the parent is possible, as the issuer does not need to have its own employees, except for a board and a managing director. An outsourcing agreement between the issuer and the parent would regulate the terms of credit decisions, risk management and reporting standards. However, it would not be permissible for an issuer to outsource its core business to a third company.

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 (CBL: Chapter 3, Section 1). The CBL does specify separate cover pools for mortgage and public sector cover assets. Both asset classes are mixed in one cover pool. However, it is reasonable to expect that 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 CBL 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 CBL and the CBR (see page 3).

Eligible public-sector assets are defined as securities and other claims[4]:

- issued by or guaranteed by the Swedish state, Swedish municipality or comparable public body;

3 Countries belonging to the European Economic Area are the 25 EU countries plus Norway, Iceland, Liechtenstein.
4 As defined in the Swedish Act [1994:2004] on Capital Adequacy and Large Exposures for Credit Institutions and Securities Companies, Chapter 3, Section 1, first paragraph, A 2-6.

- 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[5];
- 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 CBL (CBR: Chapter 3, 4§).

Derivative contracts

The CBL 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[6]. These assets qualify for a 0% risk weighting. The SFSA has the discretion to extend the universe to eligible substitute assets (CBL: Chapter 3, Section 2).[7]

IV. VALUATION AND LTV CRITERIA

The CBL defines valuation principles for properties that act as collateral for mortgages in the cover pool (CBL: Chapter 3, Section 4). The valuation relating to residential properties may be based on general price levels. The valuation of any other eligible property class must be based on the market price, which must be determined by individual appraisal by qualified professionals. The market value should reflect the price achievable through a commercial sale, without time pressure and excluding any speculative or temporary elements. Issuers must monitor the market value of the property regularly, and in the case of serious decline must review the valuation, and ensure that the loan to value (LTV) of the related mortgage loan remains within the defined maximum limit (CBR: Chapter 3, 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 (CBL: Chapter 3, Section 3):

5 The law does not provide for any explicit geographic restriction.
6 These assets are congruent with Chapter 3, first paragraph, A of the Capital Adequacy and Large Exposure Act (SFS 1994:2004).
7 The SFSA can extend the universe to include assets as defined in Chapter 3, first paragraph, B of the Capital Adequacy and Large Exposure Act (SFS 1994:2004). These assets currently qualify for a 20% risk weighting.

- 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 CBL 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 (CBL: 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 CBL 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 CBL protects any OC in the cover pool in the event of issuer insolvency (page 6).

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 (CBL: 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 CBL 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 (CBL: 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 CBL. 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 (CBL: 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 (CBL: 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 (CBL: 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 CBL, notwithstanding the existence of 'only temporary, minor deviations' (CBL: Chapter 4, Section 2).[8] 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 CBL. 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.[9]

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.

8 According to preparatory works to the Act, this would be, for example, "temporary liquidity constraints".

9 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.

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 CBL 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.[10] 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; nor is the receiver allowed to take out bridge financing against the cover pool to ensure timely payment, which would rank pari passu with Covered Bond investors. 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.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Swedish Covered Bonds comply with the criteria of UCITS 22 (4) and with the Covered Bond criteria defi ned in the EU CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f). The Swedish Covered Bond law explicitly lists mortgages against property for agricultural purposes, and mortgages against the pledging of tenant-owner rights as eligible cover assets, while the EU CRD does not. However, general opinion of the parties involved is that the EU CRD's term "commercial real estate" should be interpreted in a broader sense, including agricultural property. In addition, issuers can impose self restrictions to ensure that their Covered Bond issues comply with EU CRD.

Swedish Covered Bonds are eligible for repo transactions with the Swedish Central Bank. Moreover, Swedish Covered Bonds denominated in euros are likely to qualify as Tier 1 assets with the ECB.[11]

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).

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10 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.

11 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).

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 (before 1 April 2008 the maximum was 10 %).

Swedish legislation on investment funds (Lag 1990:1114 om Värdepappersfonder) 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.

The Riksbank (The Swedish Central Bank) decided on 13 December 2007 on changes in collateral requirements for credits in RIX (the Riksbank's system for the settlement of payments),and monetary policy instruments. The Riksbank allows with regard to covered bonds an exception from the ban on securities issued by Swedish banks or foreign credit institutions domiciled in the same country as the counterparty.

In addition, the Riksbank allows an exception for covered bonds from the ban on securities issued by the counterparty or by an institution with close links to the counterparty. An extra haircut is applied with regard to these securities. For the time being a special routine will apply for pledging covered bonds issued by the counterparty or by an institution with close links to the counterparty. This means that a special pledge account shall be used, which in turn requires a special grant of pledge. A counterparty who intends to use this type of security must contact the Riksbank immediately.

In addition, with regard to secured bonds for which an exception as above is applied, a limit in the collateral value (the adjusted market value) from a single issuer or group of closely-related issuers is introduced. The limit has been set at 25 per cent of the collateral value of all of the counterparty's collateral. The limit does not apply if the total collateral value is less than SEK 250 million.

IX. ISSUING AND TRADING OF SWEDISH 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 eight 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 mortgage bonds. The market for government and mortgage 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 VPC (the Swedish CSD part of the NCSD-group). In general, Swedish bonds are domestically settled via the VPC. 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 mortgage 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 Stockholm Stock Exchange. 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.

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 lots shall typically exceed SEK 50 million.

The obligations of a market maker is 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.

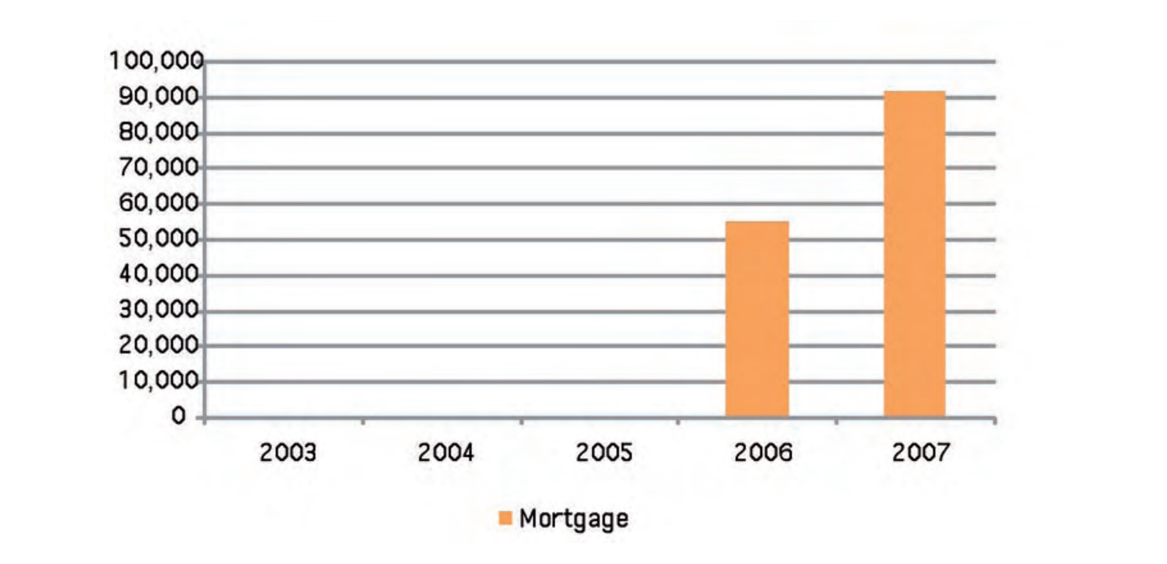
If so, the market marker shall notify the issuer and may withdraw from the duties wholly or in part for a shorter or longer time.

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.

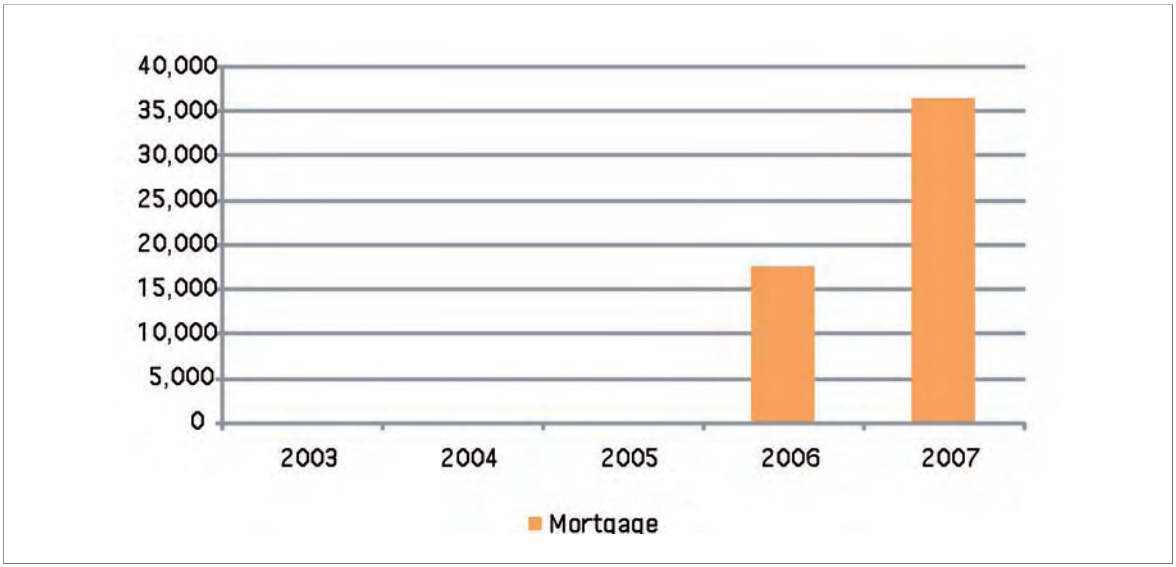
> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2007



Source: EMF/ECBC

Notes: The first covered bonds were issued in 2006, even though the Swedish covered bonds act applies from 2004. 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 also been converted into covered bonds in 2006. The figures include both the converted bonds and the new bonds issued during the year.

> FIGURE 2: COVERED BONDS ISSUANCE 2003-2007



Source: EMF/ECBC

Issuers

The Swedish covered bonds market in 2007 consists of six issuers and from 2008 seven issuers: Stadshypotek, Swedbank Hypotek (from April 2008), Nordea Hypotek, SBAB, 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.

3.25 SWITZERLAND

By Michael Bloch, Pfandbriefzentrale der Schweizerischen Kantonalbanken
& Joerg Schmid, Pfandbriefbank Schweizerischer Hypothekarinstitute

I. FRAMEWORK

The issuance of Swiss covered bonds - or '*Pfandbriefe'*, a term protected by law - is governed by the *Pfandbriefgesetz* (PfG) of 25 June 1930, in the version of 1st April 1996. The PfG is complemented by the *Pfandbriefverordnung* (PfV), which dates back to 23 January 1931. The PfV regulates in further detail the issuance and redemption of Pfandbriefe, the form and content of the cover register ('*Pfandregister'*), as well as the content and periodicity of the issuers' financial reporting. The PfG supersedes general bankruptcy regulations and is complemented by the Law on Banks and Savings Banks (*BankG*) and the Swiss Liability Law ('*Obligationenrecht', OR*).

II. STRUCTURE OF THE ISSUER

The PfG grants only two institutions the right to issue Pfandbriefe. One institution is the central covered bond issuing vehicle of the Swiss cantonal banks, called 'Pfandbriefzentrale der schweizerischen Kantonalbanken' hereinafter PBZ. Cantonal banks are public-sector banks majority-owned by the canton (Swiss region) in which they are incorporated. Moreover, the majority of cantonal banks benefit from a deficiency guarantee extended by their canton.[1] The other institution is called 'Pfandbriefbank schweizerischer Hypothekarinstitute' (hereinafter PBB) and operates as the Pfandbrief-issuing vehicle for Swiss banks other than cantonal banks. The PfG grants these two institutions the right to merge (PfG Art. 1).

The two institutions need to be authorised by the government ('Bundesrat') to issue Pfandbriefe (PfG Art 2) and are supervised by the Swiss banking regulator ('Eidgenössische Bankenkommission' hereinafter EBK). The authorisation is subject to the following requirements:

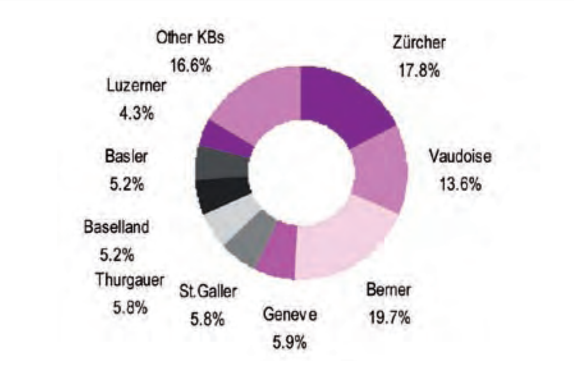
- The institution must be established as a joint-stock company or cooperative.
- The institution must have at least five members.
- The institution must have at least a minimum paid-in capital of CHF 5 million.
- The government ('*Bundesrat'*) must approve the institution's Articles of Association or by-laws.

PBZ was founded as a joint-stock company 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, which manages PBZ under a management contract.

PBB was also established as a joint-stock company in 1931. Any Swiss bank can 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 PfG allows PBB to waive the second condition. PBB has amended its by-laws accordingly (PBB-BL Art. 4) and accepts as members Swiss banks whose mortgage loans account for at least 10% of their balance sheet. The supervisory board has the power to grant further exceptions.

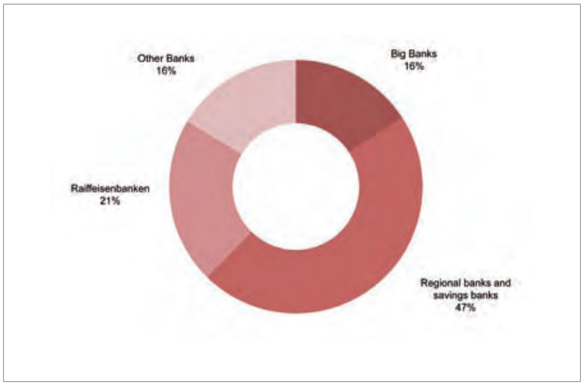
1 Two of PBZ's member banks do not benefit from a cantonal guarantee, namely Banque Cantonale de Genève (BCG) and Banque Cantonale Vaudoise.

Chart 1: Shareholders of PBZ



Source: PBZ, as per 31.3.2007

Chart 2: Shareholders of PBB



Source: PBB, as per 31.3.2007

Neither institution has a general banking licence, and the PfG strictly limits their business activities to the following areas ('specialised banking principle') (PfG Art. 5):

> to the issuance of Pfandbriefe;

> to use the proceeds and grant loans to their member banks at a stable and low interest rate. These loans must be backed by eligible mortgage collateral on real estate situated in Switzerland. PBB and PBZ are also entitled to grant loans to non-member banks. In this case, more conservative collateral requirements apply than for member banks;

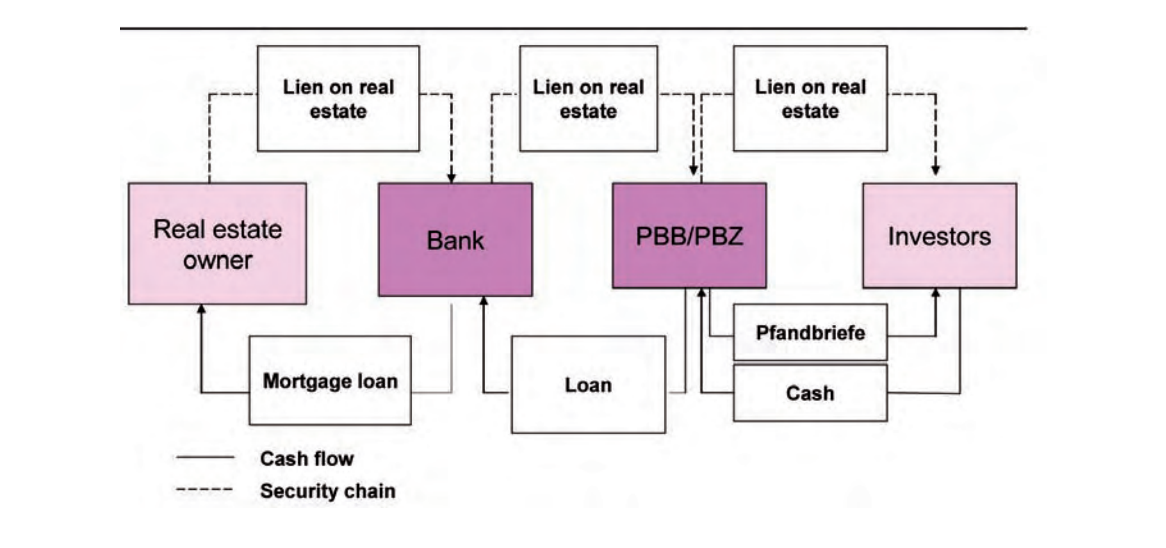
> to manage and invest its own funds in asset classes deemed to be safe, such as loans secured by liens on real property up to 2/3 of the fair market value ('Verkehrswert'), securities eligible for repo transactions with the Swiss central bank, own Pfandbriefe, and in office buildings for own use;

> to conduct any short-term banking activity to support the activities listed above.

Pfandbriefe issued by PBB and PBZ are direct unconditional obligations of the respective institution. PBB and PBZ use the proceeds raised through Pfandbrief issuance and pass them on by extending loans to their member banks (and non-member banks). In return, PBB and PBZ receive a lien on eligible cover assets – equivalent to mortgages on real estate originated in Switzerland – which remain on the balance sheet of the member banks. In turn, the mortgage loan granted by the member banks to the mortgagee is secured by property collateral (Chart 3).[2]

2 The mortgage extended to the mortgagee by a member bank generally does not reflect the same terms and conditions as the loans extended to the member bank by PBB or PBZ. Likewise, the PBB and PBZ define the maximum loan to value ratio for eligible mortgage loans that can be refinanced with Pfandbriefe. These LTVs are not required to match the LTVs granted by the member bank to the mortgagee.

Chart 3: The Swiss Pfandbrief Model



Source: UBS

There is a direct link between the loans extended to the member banks and the Pfandbriefe issued by PBB and PBZ. First, Pfandbriefe are issued in series and must exhibit the same repayment and tenor profile as the particular loan series (PfG Art. 12 Abs. 1). Second, member banks can prepay a loan series to PBB or PBZ.[3] They must buy back in the market and surrender to the issuer the underlying Pfandbriefe corresponding to the particular loan series and refund unamortized issue cost. However, in the unlikely event of issuer insolvency, Pfandbriefholders have a direct priority claim on the entire universe of registered cover assets ranking pari passu among themselves (PfG, Art. 29) (page 6).

Finally, the PfG restricts the total Pfandbrief issuance volume of each institution, in that the total amount of outstanding liabilities (including Pfandbriefe) cannot exceed 50x the issuer's own funds ('circulation limit') (PfG, Art. 10).

III. COVER ASSETS

The PfG defines as eligible cover assets mortgages on any kind of real property and land, excluding property whose value would diminish with exploitation (eg, mines, quarries). Pfandbriefe secured on such eligible assets also qualify as cover (PfG Art. 19, Art. 36). Asset-backed or mortgage-backed securities do not qualify as cover assets, nor do public sector assets. Hence, public sector Pfandbriefe do not exist in Switzerland.

The organisational rules of the issuers require that member banks replace nonperforming cover assets with performing ones (PBB-REG, Art. 15, PBZ-REG, Art. 25).

Derivative contracts

The law does not provide for the use of derivatives in the cover pool to hedge interest and/or currency risk, but this is not required in any case. Pfandbriefe are issued in individual series that must match

3 According to the organisational rules of PBZ and PBB, member banks can only prepay their loans at a coupon date and must give the issuers three months' prior notice.

the tenor and repayment profile of the loans to member banks they refinance, eliminating interest rate risk for PBB and PBZ. Currency risk does not exist either, as both the loans to member banks and the Pfandbriefe are issued in CHF.

Substitute assets

The PfG allows the use of substitute assets, which are defined as cash or marketable securities of the Swiss central government ('Eidgenossen'), regional governments (cantons) or municipalities. Marketable securities must be valued at 95% of their actual quoted price (PfG, Art. 25). There is no explicit limit with regard to the use of substitute assets, though the organisational rules of both issuers stipulate that they can be used only temporarily.

IV. VALUATION AND LTV CRITERIA

The PfG defines valuation principles for real estate that acts as mortgage collateral (PfG, Art. 32 to 36), which must be implemented as valuation regulations by the issuers and be approved by the 'Bundesrat'. The valuation must assess the fair market value ('Verkehrswert'), taking into account only permanent features of the real estate. In the case of real estate for agricultural or forestry use, the valuation must be based on the average profitability of the property ('durchschnittlicher Ertragswert') (PfG, Art 33). The Swiss valuation concepts are conservative in a European context; valuation must be carried out by the member banks systematically and periodically, applying uniformly the respective valuation principles of the PBB or PBZ. The valuation is monitored by an independent legal auditor approved by the EBK. The EBK can ask for a reassessment of the collateral if its market value or other economic conditions have deteriorated substantially (PfG, Art. 32).

The PfG defines the following maximum loan-to-value ratios for different mortgage types (PfG, Art. 34, 35):

> 5/6 of the average profitability value or, if lower, 2/3 of the fair market value on real estate for agricultural or forestry purposes;

> 2/3 of the fair market value for all other real estate;

> less than 2/3 of the fair market value for land ready for construction, and industrial and commercial real estate. LTVs for each asset class are defined in the valuation principles of the issuers (PfG Art. 32).

Table 1 lists in detail the LTV criteria defined by the valuation regulations of the two issuers.

TABLE 1: MAXIMUM LTV RATIOS DEFINED BY THE ISSUERS

Maximum LTV limits	PBB/ PBZ
2/3	of the fair market value for single-family homes, apartment houses, and real estate with share of trade less than 30%
50%	of the fair market value for weekend and holiday houses, real estate with a trade share above 30%, and land ready for construction
1/3	of the fair market value for apartments in holiday resorts, apartments in trade real estate, hotels and restaurants, and other commercial real estate.

Source: Valuation regulations of the PBB and PBZ.

V. ASSET - LIABILITY MANAGEMENT

Cover principles

The PfG stipulates that the principal amount and interest payments of outstanding Pfandbriefe be covered at all times by an equivalent amount of loans to the respective member banks (PfG Art.14). Likewise, the loans granted by PBB or PBZ to their member banks must be collateralised by equivalent liens on eligible real property (PfG Art.19). The issuers must confirm prior to any Pfandbrief issuance that the legal cover exists (PfG Art. 9). PBB and PBZ are also entitled to grant loans to non-member banks. In this case, the law requires that non-member banks pledge eligible cover assets of at least 105% of the nominal loan value to the issuers (PfG Art. 11, Art. 26).

If the issuers or the member banks are in breach of these cover principles, they must remedy the situation by increasing the cover accordingly (PfG Art. 15, Art. 20). If eligible cover assets are not immediately available or insufficient to meet the cover principles, eligible substitute assets must be used (PfG Art. 25) on a temporary basis and replaced with ordinary cover at a later stage.[4]

Interest and currency risk

PfG Art. 12 eliminates interest rate risk by demanding that a particular loan series extended by PBB or PBZ to their member banks exhibit the same repayment profile (coupon and tenor) as the respective Pfandbriefe series issued to fund these loans.[5] Member banks have the option to prepay their loans to PBB or PBZ on a coupon date, giving three months' notice. The risk of negative carry for PBB or PBZ is passed on to the member banks. They must buy back an equivalent amount of the corresponding Pfandbrief series in the market, surrender the Pfandbriefe to the issuer, and refund any unamortized issue cost.

Cover assets and Pfandbriefe can be issued only in CHF, eliminating any currency risk.

Overcollateralisation

Apart from the nominal cover principles between the outstanding Pfandbriefe and member loans, both issuers have committed themselves to maintain a certain level of overcollateralisation (OC) (Table 2).

Table 2: Minimum OC levels of the issuers

The PfG	PBB	PBZ
The principal amount and interest payments of outstanding Pfandbriefe must be covered at all times by an equivalent amount of loans to the respective member banks. Likewise, the loans granted by the institutions to their member banks must be collateralised by equivalent liens on eligible real property by the member banks against the mortgagee. Non-member banks must pledge eligible cover assets of at least 105% of the amount of member loans to the issuers.	Eligible cover mortgages must exceed the amount of member loans granted by PBB by 3%. The interest on cover mortgages must exceed the interest charged on member loans by 3%.	Eligible cover mortgages must exceed the amount of member loans granted by PBZ by 10%. The interest rate on cover mortgages must exceed the interest charged on member loans by 10%. At present, a temporary adjustment to PBZ's OC guidelines is in place, reducing the minimum OC to 5% from 10%. This amendment must be re-approved at the end of 2010. For non-member banks, a minimum OC level of 10% applies. The OC requirement can be raised to 20% if warranted.

Source: PBB and PBZ-REG

4 PBZ allows the use of substitute assets for only six months (PBZ-REG Art. 22), while the PBB requires a "possible early exchange" of substitute assets with ordinary assets (PBB-REG Art. 20).

5 PBZ-REG allows the application of an interest margin to loans extended to the member banks to cover administrative costs (PBZ-REG, Art. 16 Abs. 1). In general, non-member banks must pay an administrative fee that is higher than that for member banks.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

PBB and PBZ require the authorisation of the Swiss government ('Bundesrat') to issue Pfandbriefe, which is linked to certain criteria (PfG Art. 2 Abs.1, Art. 2 Abs.2). The operations of PBB and PBZ fall under the supervision of the Swiss banking regulator ('EBK'), which audits the issuers' annual reports and the compliance of their cover registers with the PfG (PfG Art. 39 Abs.1, Art. 42). If PBB and PBZ are in breach with the PfG, and resist or oppose corrective directives of the EBK, the latter has the power to withdraw the institutions' right to issue Pfandbriefe (PfG Art. 41).

The PfG requires that cover pools maintained by the member institutions be audited regularly, but at least once a year by external auditors approved by the EBK (PfG Art.43). The auditors must report their findings to the EBK and the respective issuers (PBB or PBZ). Moreover, PBB and PBZ receive a cover pool report by the member banks at least once a year, and have access to the details of member banks' cover pool at any time if required (PfG Art. 24).

VII. SEGREGATION OF COVER ASSETS & INSOLVENCY

Cover register

PBB and PBZ must register eligible mortgage loans, substitute assets and related real estate collateral in a cover register (PfG Art. 16), which must be kept (physically) separate from other assets (PfG Art. 17). Likewise, the member banks are required to keep a register of eligible mortgage loans and real estate collateral pledged against these loans, and substitute assets (PfG Art. 21). The registered assets must also be kept (physically) separate from the bank's other assets (PfG Art. 22). The PfV sets out further regulations with regard to the form and the content for the cover registers (PfV Art. 11 – 14). In this context, PBB and PBZ are not required to register the loans granted to the member banks, as their normal balance sheet accounting is sufficient to form part of the cover pool (PfV Art. 13). PBB maintains its register electronically. This allows the issuer to monitor the pool on a daily basis and to decide proactively whether it accepts the collateral registered by the member banks.

The legal result of the registration is that outstanding claims of Pfandbriefe and loans to member banks have a direct lien on the eligible real estate collateral registered in the cover pool of the issuers (PBB/PBZ) or the member banks in the event of insolvency of the issuers or one of the member banks (PfG Art. 18, 23).

Insolvency scenarios

In the event of the insolvency of a member bank, Pfandbrief investors and the Pfandbrief issuers would have a direct priority claim on the interest and principal of the registered collateral (PfG Art. 23) (including registered overcollateralisation). The mere opening of bankruptcy proceedings cannot delay payments on mortgaged-backed claims in the cover pool (whether interest or principal) backing Pfandbriefe (BankG Art. 26, Abs. 1, h). Moreover, the Swiss banking regulator can demand the transfer of the collateral pool under its control, whereupon it would then act as fiduciary ('Treuhänder') (PfG Art. 40) or arrange for a sale of the cover assets to other banks.[6] Furthermore, PBB/PBZ have a certain amount of flexibility with regard to ensuring timely payment on Pfandbriefe, even if one or several member banks default. First, the issuers collect the interest on the member loans on a semi-annual basis, while coupon payments on Pfandbriefe are annual. Second, both PBB and PBZ dispose of own funds and maintain a portfolio of

6 In the early 1990s, Spar- und Leihkasse Thun, a member bank of PBB, no longer met regulatory capital requirements and was closed by the EBK. Cover pool mortgages were sold to other banks and the proceeds were used to amortise the loans granted by PBB.

liquid investments, providing an equity buffer for investors and ensuring sufficient liquidity to cover for the next coupon and principal of maturing Pfandbrief series.

Should a non-member bank became insolvent or ignore late-payment reminders, the PBB/ PBZ can sell the pledged collateral to amortise outstanding claims (PfG Art. 31).

The insolvency of PBB/PBZ is highly unlikely, as it would occur only if several member banks defaulted at the same time, combined with a severe deterioration of the respective registered mortgage collateral on the member bank's balance sheet. However, in theory, the insolvency of PBB/PBZ would not trigger the acceleration of outstanding Pfandbriefe as long as the cover principles between the Pfandbriefe and mortgage collateral are met. Again, the EBK has the power to assume control of the respective cover pool and to act as fiduciary. If the cover pool were insufficient to meet all outstanding obligations, Pfandbriefe would accelerate and Pfandbrief investors would rank pari passu among themselves on the proceeds of the asset sale (PfG Art. 29).

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The Swiss Pfandbrief law meets the requirements of UCITS Art. 22 (4). However, under the current capital regulations the EBK assigns Swiss Pfandbriefe a risk weighting of 25% (BankV Art. 12a Abs.2.5).

Covered bonds issued by foreign OECD banks enjoy the same risk weighting as senior unsecured debt securities or interest receivables of such counterparties in Switzerland. Hence, covered bonds have a risk weighting of:

> 25%, with a residual maturity is ≤ 1 year

> 50% with a residual maturity > 1 year ≤ 3 years

> 75% with a residual maturity > 3 years.

Switzerland will implement Basel II into national law and modify it to account for national specifics (Basel II EBK). Switzerland will not implement the special regulatory treatment for covered bonds of the European Capital Requirement Directive (EU CRD, Annex VI Art. 65 to 68). Basel II EBK has three approaches: the Swiss standard approach, the international standard approach and the internal ratings-based approach. Under the Swiss standard approach, domestic Pfandbriefe continue to enjoy a 25% risk weighting, while under the international one they have a risk weighting of 20%. Taking into account the multiplier of 1.1, the final risk weighting will be 22% under the international approach. Basel II EBK will treat covered bonds issued by foreign banks as senior debt securities and interest receivables of bank counterparties.

The Swiss Pfandbriefe are eligible for repo transactions with the Swiss National Bank.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2007, €M

Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2007, €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 posses 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 EU financial services screening report on Turkey, published in April 2007, not only states that the respective Turkish laws and regulations are "largely in line" with EU standards, but also highlights that Turkey will align its legislation to the CRD in the course of 2008.

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 nonresidential 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.

3.28 UNITED KINGDOM

By Fritz Engelhard, Barclays Capital
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I. FRAMEWORK

The UK Regulated Covered Bonds Regulations (the Regulations) came into force on 6 March 2008. Under the Regulations, issuers will be permitted (but not required) to submit their covered bond programmes to the UK Financial Services Authority (the FSA) for recognition. The application process is comprehensive, as described in Section VI below. Those issuers who satisfy the FSA that their programmes meet all of the criteria set out in the Regulations are granted "Regulated Covered Bond" status. The Regulations will only apply to Regulated Covered Bonds.

Regulated Covered Bonds will be 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 bonds sector in the United Kingdom ..." in the exercise of its functions under the Regulations. Regulated Covered Bonds will comply with the requirements of Article 22(4) of the EU Directive on Undertakings for Collective Investment in Transferable Securities (the UCITS Directive).

Key elements of the Regulated Covered Bond structure will continue to be governed by contract: the cover assets will be continue to be ring-fenced by means of a "true sale" to a special purpose entity, for example, and the various cover pool sufficiency tests will be set out in the programme documents. However, there will be a number of key differences. First, the FSA will have a veto over any material amendments to these contracts, and will have broad powers to enforce their provisions. Secondly, the priority of claims against the cover pool in a winding up scenario will be as set out in the Regulations: no counterparty will have any claim against the cover pool in priority to that of the Regulated Covered Bondholders. This approach is intended to accommodate innovation whilst preserving legal certainty and robust bondholder protection. Existing FSA-imposed limits on covered bond issuance by deposit-taking institutions will continue to apply.

The FSA set a deadline of 30 April 2008 for the first wave applications, and its decisions on all applications submitted before this deadline will be announced simultaneously. The FSA has held follow-up meetings with a number of applicants since then. However, at time of writing, no UK programme has yet been recognised under the Regulations. The following programmes were in existence as of 30 April 2008:

- *Expected to be eligible under both the Regulations and the CRD:* Abbey National, Alliance & Leicester, Barclays, BOS (residential mortgage programme), Bradford & Bingley, HSBC, Nationwide, Northern Rock, Yorkshire
- *Expected to be eligible under the Regulations only:* BOS (social housing programme)
- *Not expected to be eligible under the Regulations:* Anglo Irish

The discussion that follows refers to those programmes which are expected to comply with both the Regulations and the CRD. The Anglo Irish and BOS social housing programmes have certain distinct features which are treated separately at the end of this chapter.

II. STRUCTURE OF THE ISSUER

The Regulations require the issuer to be a credit institution authorised in the UK to carry out regulated activities. It must also have a registered office in the UK and meet certain additional requirements set by the FSA. These additional requirements mainly include the registration and notification duties, which will allow the FSA to ensure that issuers comply with the specific requirements imposed upon covered bond issuers. The Regulations do not include any additional restrictions on the business activities of the issuer beyond those set out in existing financial institution regulations.

The 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 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' assignment; however, the mortgage borrowers must be notified of the assignment (which perfects legal title in favour of the LLP) following the occurrence of certain trigger events, such as the downgrade of the issuer below investment grade. The programmes can be increased in size by transferring more mortgages to the LLP and issuing more bonds against them, subject to meeting stringent tests.

The LLP guarantees the issuer's obligations on 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 (which is permitted to sell the mortgages) uses either the mortgage cash flows and/or the mortgage sale proceeds to pay the Covered Bond investors. There is no direct legal link between the mortgages and the Covered Bonds.

III. COVER ASSETS

The Regulations generally allow those assets which are listed in Annex VI, Part 1, Section 12, Paragraph 68 a) to f) of the EU Capital Requirements Directive (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 reputation of Regulated Covered Bonds.

Cover assets must be situated in EEA states, Switzerland, the US, Japan, Canada, Australia, New Zealand, the Channel Islands or the Isle of Man. Issuers need to get confirmation that the law of the respective jurisdiction would not adversely affect the claims on non-UK assets.

In all of the programmes to date, the cover pool eligibility criteria are narrower than required under the Regulations, allowing only UK residential mortgages and the substitution assets described below. Mortgage LTV criteria are 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 are valued using UK mortgage market accepted practice. Normally, this is a UK surveyor and the process is completed upon the granting of the loan. Residential property values are indexed to a reputable real estate price index on a monthly 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 will therefore be 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, and so on. The FSA will have the power to order an issuer to transfer additional assets to its cover pools if it believes the collateral in the pool is insufficient.

Issuers must carry out a dynamic Asset Coverage Test (**ACT**) on a monthly basis to ensure that minimum OC requirements are satisfied. The ACT requires the balance of the mortgages in the cover pool to exceed the outstanding covered bonds by a specified amount, equal to the sum of the following:

- A base level, as set out in figure 1. This level may be increased from time to time if the credit quality of the mortgages in the cover pool decreases, as determined by a quarterly WAFF / WALS[1] test.
- Additional OC 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

1 WAFF = weighted average frequency of foreclosure; WALS = weighted average loss severity

covered bonds as originally scheduled under the guarantee, as described further in Section VII below. The issuer may also become liable to enforcement action by the FSA.

An amortisation test is run on each calculation date after the delivery of a notice to pay. 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 (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 currency and interest rate of the bonds and the cover assets. In addition, downgrade triggers for swap counterparties, the pre-maturity test, the ACT, maturity extension rules and the amortisation test all ensure cash-flow adequacy.

Most UK covered bond transactions have a soft-bullet maturity. Following the service of a notice to pay, the LLP may not have sufficient proceeds for a timely repayment of covered bonds. In this case, the legal final maturity will be extended by 12 months in order to allow the realisation of the cover assets.

In the case of the programmes of HBOS and HSBC[2], a pre-maturity test is designed to ensure that the LLP has sufficient cash available to repay the bonds, in full, on the original maturity date in the event of the issuer's insolvency. If, in the six months before a maturity date, the issuer's short-term ratings fall below A-1+ (S&P), F1+ (Fitch) or P-2 (Moody's) (or, in case of HBOS, the issuer's long-term Moody's rating falls to A2 or below), 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 UK 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 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. Issuers must satisfy the FSA that their programmes comply with the criteria set out in the Regulations and provide, amongst other things:

- details concerning the programme structure, such as the cover pool eligibility criteria, the formulae used to calculate compliance with minimum OC requirements and ratings triggers;
- details concerning asset and liability management, audit and controls;

2 Within the HSBC programme, only Covered Bonds which are issued as "hard bullet Covered Bonds" are subject to the pre-maturity test. The programme also allows for the specification of an extended final maturity.

- arrangements for the replacement of key counterparties;
- cover pool data; and
- legal and audit opinions.

The issuer is responsible for the 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. They also monitor the amount of OC required to maintain the triple-A ratings.

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 sold to a special purpose entity 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 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 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 will does cause the acceleration of payments by the LLP to covered bondholders and their redemption at the early redemption amount relevant to that particular covered bond.

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

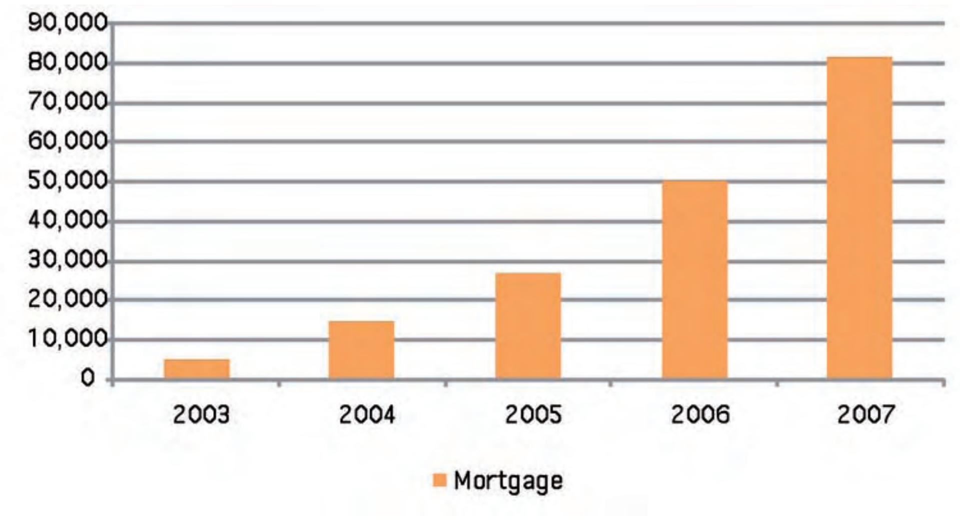
The list of eligible assets under the Regulations is in some respects narrower than that set out in the CRD. Residential mortgage backed securities (**RMBS**), for example, are severely restricted. However, certain assets which are excluded from the CRD – such as loans to UK housing associations – are 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. All other Regulated Covered Bonds will benefit from the same preferential treatment as Covered Bonds from other EU jurisdictions.

> FIGURE 1: OVERVIEW –UK COVERED BOND PROGRAMMES EXPECTED TO BE CRD-COMPLIANT

	HBOS	Northern Rock	Bradford & Bingley	Abbey National	Nation-wide	York-shire	HSBC	Alliance & Leicester
Programme Volume in € bn	60	10	15	12	35	7.5	15	10
LTV cap	60%	75%	75%	75%	75%	75%	75%	75%
House price index	Halifax	Halifax	Halifax	Halifax	Nationwide	Avg. of Halifax & Nationwide	Halifax	Halifax
Maximum asset percentage applied in ACT	92.5%	90.0%	91.0%	91.0%	93.0%	93.5%	92.5%	91.0%
Minimum Over-collateralisation	108.1%	111.1%	109.9%	109.9%	107.5%	107.0%	108.1%	109.9%
Current asset percentage applied in ACT	92.5%	88.5%	83.3%	90.7%	93.0%	92.1%	92.5%	91.0%
Current over-collateralisation	108.1%	113.0%	120.0%	110.3%	107.5%	108.6%	108.1%	109.9%
In arrears accounting	No recognition	Max. 40% or repurchase	Max. 40% 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 repurchase	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 repurchase
Hard bullet	Yes; pre-maturity test	No; 12 month maturity extension	No; 12 month maturity extension	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	KPMG	PWC	KPMG	D & T	PWC	PWC	KPMG	D & T

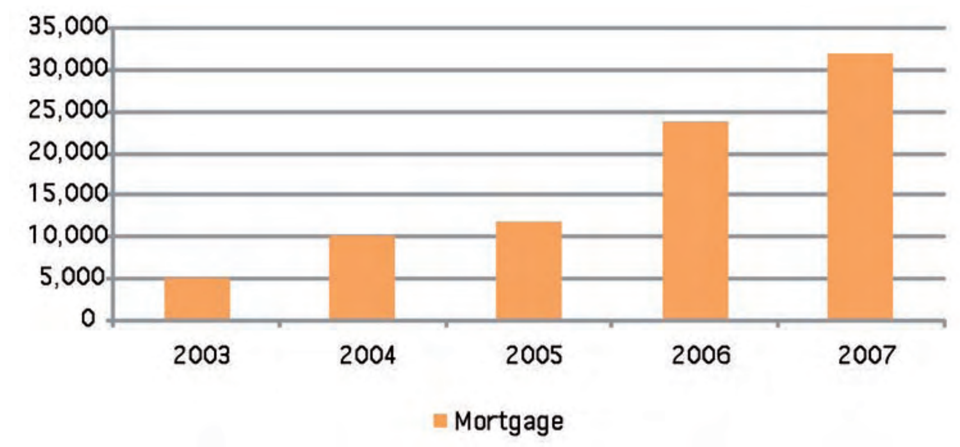
Note: *for designated series only. Source: Transaction documents.

> FIGURE 2: COVERED BONDS OUTSTANDING 2003-2007, €M



Source: EMF/ECBC

> FIGURE 3: COVERED BONDS ISSUANCE, 2003-2007, €M



Source: EMF/ECBC

BOS Social Housing Covered Bond Programme

In 2004, BoS established a £3 billion equivalent Covered Bond programme backed by loans to multiple UK housing associations (registered social landlords). All loans are secured by mortgages on residential properties. The cashflows that housing associations use to service the loans largely derive from the payments of housing benefit that they receive from the central government, as well as capital grants. This programme is eligible for recognition under the Regulations, although it would not qualify for preferential risk weights under the CRD.

The cover assets are transferred to the LLP by way of “silent assignment”. Each new loan sold to the LLP is subject to a minimum loan asset cover covenant of 100% (subject to the weighted average loan asset cover covenant in the cover pool being no lower than 110%). Property values are calculated assuming either continuous re-letting by a social landlord or the sale of vacant units to a commercial landlord. This basis of valuation is generally expected to be lower than the open market value of the property, due to the voluntary control on rents imposed by the Housing Corporation as regulator.

The ACT gives zero credit to loans which are in arrears for two months or more. Maturities are extendable by up to two years in the event of the issuer’s insolvency to allow the LLP to liquidate the cover assets.

To date, three £500 million benchmark transactions have been issued off the programme, which is rated AAA/Aaa by S&P and Moody’s.

Anglo Irish Bank Corporation plc Covered Bond Programme

Anglo Irish Bank Corporation plc operates a covered bond issuance programme through its UK branch. This programme falls outside of the scope of the UK RCB legislation by virtue of the fact that Anglo Irish Bank does not have its registered office in the UK; the programme structure and collateral would otherwise have been eligible to be considered for recognition.

Collateral for the Anglo Irish UK Covered Bond Programme consists of a pool of UK commercial mortgage loans originated by Anglo Irish or a member of its group. The loans are transferred to the LLP by means of a declaration of trust. The legal title of the mortgage loans remains with the originator and the LLP is entitled to act in the name of the originator to enforce the mortgage loans in a stress scenario.

The programme limits loans to 60% LTV for the purposes of the ACT and there is an additional requirement that the weighted average original LTV of the portfolio must not exceed 80%. Property values are not indexed, however if Anglo Irish’s ratings fall below A3 (Moody’s) they must be revalued annually or semi-annually. The minimum level of overcollateralisation is 117%. The maximum loan size is £150m and the maximum single tenant exposure must not exceed 5% of the total cover pool. Substitution assets are permitted, subject to a cap of 15% of the cover pool. There is no reserve fund requirement. Maturities are extendable by up to 18 months in the event of the issuer’s insolvency to allow the LLP to liquidate the cover assets.

The programme is rated ‘Aaa’ by Moodys Investor Services and currently has approximately €5bn of covered bonds outstanding.

The UK Government has indicated that it will consider allowing UK branches of EEA incorporated credit institutions to apply to be recognised covered bond issuers from Spring 2009.

3.29 UNITED STATES

By Sabine Winkler, Merrill Lynch

I. FRAMEWORK

Formation of a unique US covered bond regime

For many years covered bonds were a widely used and broadly accepted funding instrument in Europe, but not in the US. However, as the US authorities have wrestled with the fallout from the sub-prime debacle and the current housing correction, one priority has been to find ways to stabilise the mortgage finance market by increasing the availability of affordable mortgage financing. Both, the US Department of the Treasury ('US Treasury') and the Federal Deposit Insurance Corporation ('FDIC') have called for expansion of the available range of funding techniques, which suggests the inclusion of covered bonds.

On 29 July 2008, covered bonds leapt to the forefront of discussion with the US Treasury's release of '***Best Practices for Residential Covered Bonds***' ('**Best Practices Guide**') with the support of the FDIC, the Federal Reserve, the Office of Thrift Supervision ('OTS'), the Office of the Comptroller of the Currency ('OCC'), and the Securities and Exchange Commission ('SEC'). In fact, however, the wheels have been turning in the US for some time. On 9 July 2008, the FDIC approved the ***final Covered Bond Policy Statement***, clarifying the FDIC's position on qualifying covered bond transactions and their treatment in a conservatorship or receivership of an insured depository institution ('IDI', 'sponsor bank'). The Best Practices Guide represents a second major step in that it provides a common template to promote the development of a standardised covered bond market in the US.

Consider that the final Covered Bond Policy Statement reduces risk facing the US product by providing guidance on the availability of access to collateral pledged for qualifying covered bond transactions in a receivership or conservatorship of an IDI upon the FDIC's decision to affirm or repudiate qualifying covered bond transactions, as we discuss below. Together, the Best Practices Guide and the final Covered Bond Policy Statement help to better understand the application of US legislation and regulations to qualifying covered bond transactions. We believe that the new standards are meant to bolster acceptance of this product among the various stakeholders in the nascent covered bond market in the US and that they have been designed to make covered bonds especially appealing to domestic investors.

Alongside the release of the Best Practices Guide, several supportive measures, including ***industry initiatives***, have been announced to speed up the growth of a covered bond market in the US. For example, the US Treasury intends to update its collateral acceptability policy, Securities Industry and Financial Markets Association ('SIFMA') has announced the formation of a US Covered Bond Traders Committee and potential creation of a US Covered Bond Council, Bank of New York Mellon has announced that it plans to designate the product as eligible collateral for its tri-party repo programme, and Bloomberg and Tradeweb have pledged to create an online marketplace in the US for covered bonds.

The release of the Best Practices Guide and the final Covered Bond Policy Statement are likely to herald important changes in the US mortgage market, with the US authorities suggesting that covered bonds may be suitable and cost-effective alternatives to funding residential mortgage loans via the government-sponsored enterprises and especially private-label securitisation. The US authorities' active engagement in the development of this market significantly increases the likelihood of a breakthrough of covered bonds in the US. The series of US authorities' measures and industry initiatives suggest, however, the formation of a unique US covered bond model.

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 Federal Deposit Insurance Act ('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 extra costs to the US covered bond structure. For covered bond transactions 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 collateral pledged for qualifying covered bonds*** is likely to support their use, since it makes them a more cost-effective funding alternative. The reduced economic friction should facilitate the development of a covered bond market in the US. However, to be accorded the shorter stay, the bonds have to meet the following requirements:

- they need to 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;
- the assets referred to may be eligible mortgages, triple-A rated mortgage-backed securities secured by eligible mortgages, and substitution collateral; the share of eligible mortgage-backed securities must not exceed 10% of the collateral for any bond issue or series; substitution collateral, including US Treasury and agency securities, and cash, can only be used as necessary to prudently manage the cover pool;
- eligible mortgages are defined as performing first-lien mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and with documented income. They need to be in line with the existing supervisory guidance on the underwriting of residential mortgage;
- they must be issued with the consent of the IDI's primary federal regulator and only if, after issue, the bank's total obligation under such bonds accounts for not more than 4% of total liabilities and only so long as the assets backing the bond obligation are eligible ones.

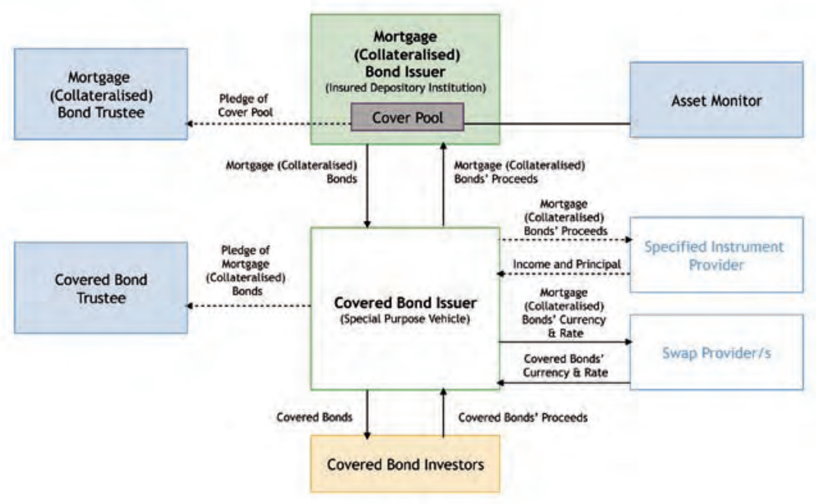
By urging issuers of bonds structured in accordance with the final Covered Bond Policy Statement to disclose loan-to-value ratios for loans in the cover pool, the FDIC intends to improve transparency. The final Covered Bond Policy Statement does not suggest a loan-to-value limit. The FDIC can revise 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 launched before repeal, but in compliance with the final Covered Bond Policy Statement, will be grandfathered. The 4% issuance threshold may be subject to potential upward revision in due course. This restriction reflects the FDIC's concerns about the encumbrance of prime assets of an IDI resulting in structural subordination of the unsecured creditors, including depositors, and reducing the ability of the FDIC to wholly recover potential depositor losses.

Consider that the final Covered Bond Policy Statement must not be construed as waiving, limiting or otherwise affecting the rights and powers of the FDIC. 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 bond transactions from the risk of insolvency of an IDI.

The US Treasury's *Best Practices for Residential Covered Bonds*

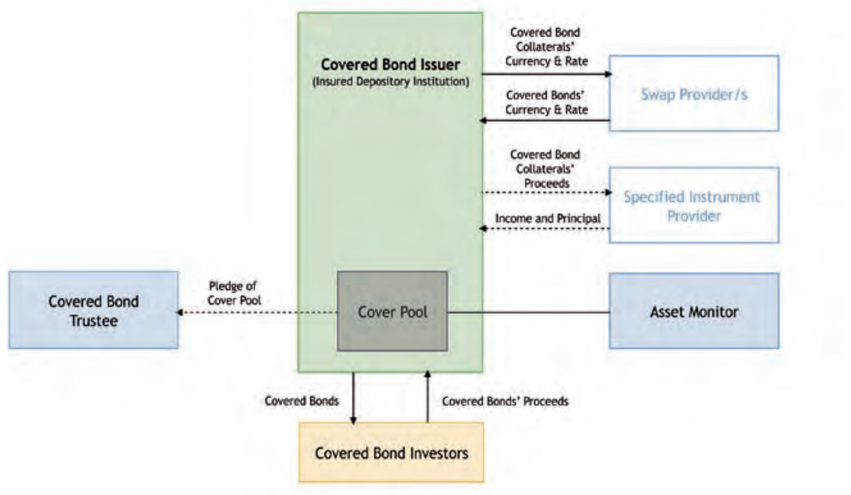
The Best Practices Guide outlines ***two issuance structures***: (1) the 'SPV Structure' (the covered bond issuer is a bankruptcy-remote special purpose vehicle ('SPV'); and (2) the 'Direct Issuance Structure' (the covered bond issuer is an IDI and / or a wholly-owned subsidiary of an IDI). The first refers to the structure currently used by Bank of America and Washington Mutual Bank, as we discuss later.

Chart 1



According to the Best Practices Guide, multiple covered bond issuances of an issuer can be backed by a common cover pool. Obligations under the bonds need to be secured by a first perfected security interest on the respective collateral for the benefit of the bondholders. Covered bonds must be issued with the consent of the primary federal regulator of an IDI and only if, after issuance, the institution's total obligation under the bonds accounts for not more than 4% of total liabilities. Moreover, the Best Practices Guide clearly specifies that only well-capitalised institutions should launch covered bonds.

Chart 2



- No uniform structure, but compliance with Best Practices Guide: The US Treasury does not impose a uniform template for the issuance of covered bonds. It is left to the discretion of the IDI to develop other issuance structures consistent with the Best Practices Guide. In future, structures may thus deviate from the current structure.
- Dynamic cover pool on an IDI's balance sheet: Irrespective of the applied structure, the IDI must own and hold the collateral in the cover pool – ie, the cover pool must remain on an IDI's balance sheet. The IDI has to clearly identify the collateral in the cover pool in its books and records and actively manage the cover pool to meet certain requirements.
- 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.
- Fixed or floating, registered or non-registered, maturity profile: Fixed-rate and 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 bond transactions, but also repeats and expands on the standards for those transactions prescribed by the FDIC under the final Covered Bond Policy Statement. In addition, it introduces new standards relating to a number of key areas, including eligibility criteria, asset-liability matching, over-collateralisation, disclosure of information to investors, supervision, and insolvency procedures.

- Eligibility criteria to ensure collateral quality: The cover pool can consist of a portfolio of performing loans secured by first-lien mortgages on one-to-four family residential properties, underwritten at the fully-indexed rate and with documented income. They must be compliant with the existing supervisory guidance on the underwriting of residential mortgages. Negative amortisation loans and loans over 60 days in arrears are not eligible for the cover pool. Non-performing and prepaid mortgage loans must be replaced. The mortgage loans must not be burdened by other liens. At the time a loan is to be included in the cover pool, the loan-to-value must not exceed 80%. Quarterly, loan-to-values are required to be updated by adjusting the original valuation of the property with the nationally-recognized, regional housing price index or other comparable measurement. There is a concentration limit regarding the cover pool in terms of regions: a single Metro Statistical Area cannot account for over 20% of the cover pool. Substitution 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 may be adjusted with the growth of the market in the US and thus the cover pool may deviate from the above characteristics and may include other asset classes.
- Asset Coverage Test to ensure adequate collateralisation: A monthly Asset Coverage Test ('ACT') run by an IDI ensures collateral quality and a minimum over-collateralisation level of 5% of the outstanding principal balance of the covered bonds. Loans can be financed via covered bonds up to an 80% limit of their outstanding balance. If an IDI fails the ACT, no further covered bond series can be issued 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 may terminate the specific covered bond programme. In this case, principal and accrued interest needs to be paid to investors.
- Swap agreements with financially sound counterparties: At the time of issuance of a covered bond series, an IDI has to enter swaps or similar agreements for each series to hedge interest and currency risks and risks related to timing discrepancies between the dates on which proceeds from the relevant collateral are received and the date on which interest and principal is payable on the specific covered bond series. Swap providers are required to temporarily cover limited amounts of interest in the event of IDI insolvency. Swap agreements must be with financially sound counterparties and their identity must be disclosed to investors.
- Specified investment to prevent bond acceleration: At the time of issuance of a covered bond series, an IDI has to enter into a specified investment (guaranteed investment contract or other arrangement) for this series with financially sound specified instrument provider/s. In the event of IDI insolvency, proceeds from the collateral in the cover pool need to be invested in the specified investment. Upon a payment default by the IDI or should the FDIC as conservator or receiver repudiate the bonds, ongoing scheduled interest and principal payments are paid out of the specified investment as long as the specified investment provider/s receive/s proceeds from the collateral in the cover pool in an amount at least equal to the due amount under the covered bonds. If those proceeds are insufficient to meet the payments due under the outstanding covered bonds, the bonds would accelerate – ie, would become immediately due and payable.
- Disclosure of cover pool information to investors: The outcomes of the Asset Coverage Test and of any reviews by the asset monitor must be made available to investors. Given over 10% or 20% of the collateral in a cover pool is substituted in any month or quarter, respectively, an IDI has to disclose updated information in relation to the collateral in the cover pool to investors. An IDI and an SPV (if applicable) needs to disclose information regarding its 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 to evaluate compliance with the principles: An IDI's controls and risk management processes are supervised by the respective primary federal regulator. This regulator is now also charged with reviewing proposed covered bond programmes using its standard method of evaluating the IDI's activities as part of its ongoing supervisory efforts. The review is likely to include an analysis of the steps taken by an IDI to conform to the principles imposed under the new policies. According to the Best Practices Guide, an IDI must also designate an independent asset monitor and an independent trustee. The trustee has to act on behalf of, and represent the interests of, bondholders and enforce their rights in the collateral in the event of IDI insolvency. The asset monitor has to frequently determine compliance with the ACT.
- Insolvency procedures: The FDIC as receiver or conservator of an IDI can: (1) affirm the qualifying covered bond transactions of an IDI and continue to meet payments under the bonds when due; or (2) repudiate those transactions. If the FDIC repudiates transactions, the bonds become due and payable. The FDIC can either pay off the bonds OR provide access to the collateral to the relevant first priority perfected security interest holder to enforce its security interest and exercise self-help remedies including liquidation of the collateral in the cover pool to pay off the bonds. Note that an amount equal to *actual direct compensatory damages*[3] has to be paid in full up to the value of the collateral in the cover pool. Provided the value of the collateral in the cover pool exceeds the *actual direct compensatory damages*, the excess amount has to be returned to the FDIC as conservator or receiver. Thus, the cash flow to bondholders is limited to the *actual direct compensatory damages*. If insufficient collateral is pledged to cover the *actual direct compensatory damages*, bondholders would have an unsecured claim in the receivership for any amounts remaining outstanding after the collateral in the cover pool has been depleted. Note that in the event of default, investors in covered bond series with a common cover pool share losses pro rata. If the funds arising from the collateral in the cover pool are insufficient to meet all their claims and the shortfall is not covered by their unsecured claim in the receivership, the bondholders may experience a loss.

Note that 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 Uniform Commercial Code ('UCC'), the FDIA, and the Securities Act. So far, the US authorities have shown no intention of implementing a more rigorous legal covered bond framework providing, for example, for a high level of legal protection of the covered bond investors' claims in the event of issuer insolvency and supportive capital treatment. But, the US Treasury expects the structure and collateral in the cover pool and other key terms of qualifying covered bond transactions to evolve with the growth of this market in the US. The current principles are thus likely to be adjusted to promote the development of a deep covered bond market in the US populated by domestic and international investors.

3 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 conservator or receiver.

II. EXISTING US COVERED BONDS PROGRAMMES

The issuance of covered bonds in the US is not governed by dedicated legislation outlining clearly and unambiguously the interests of covered bond investors in the event of IDI insolvency. In the absence of a uniform covered bond law, Washington Mutual Bank and Bank of America have employed structured finance elements to replicate recognised European covered bond characteristics to set up their covered bond programmes. Their contractual arrangements are governed by the laws of the State of New York and the State of Delaware. Other US legislation and regulations are implemented, such as the UCC, the FDIA, Regulation S under the Securities Act, and Rule 144A under the Securities Act.

The UCC provides, in particular, the legal basis to pledge eligible collateral via creation of a first priority perfected security interest. Such security interest is obtained through the use of a 'contractual grant' by an institution that clearly identifies the pledged collateral in its books and records. As there is no sale or conveyance of ownership, the pledged collateral remains on the balance sheet of the institution, which grants the first priority perfected security interest.

Note that the two banks with established covered bond programmes announced their intention to align their specific tailor-made covered bond programmes in accordance with the standards under the final Covered Bond Policy Statement and the Best Practices Guide, while Citigroup, JPMorgan Chase and Wells Fargo have shown interest in setting up covered bond programmes using the new guidelines. At the moment, Bank of America and Washington Mutual Bank use an SPV Structure.

Washington Mutual Bank and Bank of America use the SPV Structure

The SPV Structure operates a ***two-tier approach***: the covered bonds are not launched by an IDI, but by an SPV in the form of a Delaware statutory trust. They are collateralised by a related series of mortgage (collateralised) bonds launched by an IDI. The mortgage (collateralised) bonds are, in turn, backed by a cover pool that remains on the IDI's balance sheet. The SPV has to be a 'separate' entity that is neither controlled by nor affiliated to the IDI. Only a 'separate' SPV is not consolidated for bankruptcy purposes in respect of the relevant IDI's assets. If an SPV is not 'separate' there is the risk that the FDIC seeks to consolidate assets and liabilities of the SPV with those of the sponsor bank.

- The sponsor bank, ie, Bank of America or Washington Mutual 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. The mortgage (collateralised) bonds are backed by a pool of eligible collateral ('cover pool'), which remains on the sponsor bank's balance sheet. The cover pool is dynamic meaning that the sponsor bank can add and remove collateral including qualifying mortgage loans and substitution assets 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 Mortgage Bond Indenture Trustee ('MBIT') for the benefit of the mortgage (collateralised) bond investor, which is in this case the US covered bond issuer or SPV.
- The sole purpose of the SPV is to issue a related series of covered bonds and to use the proceeds to purchase the corresponding mortgage (collateralised) bond series. The SPV grants a first priority perfected security interest in the covered bond collateral, mainly mortgage (collateralised) bonds, to a Covered Bond Indenture Trustee ('CBIT') for the benefit of the covered bondholders. The

covered bonds are limited recourse obligations of the SPV ranking pro rata and without priority among themselves. If the proceeds from the enforcement of the first priority perfected security interest in the covered bond collateral are insufficient to meet their claims, the covered bondholders have no further claim against the SPV or the sponsor bank.

Eligibility of collateral for the cover pool

The tailor-made covered bond programmes provide Bank of America and Washington Mutual Bank with considerable flexibility with regard to the composition of the cover pool because 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 covered bonds outstanding. Consequently, the cover pool may not only consist of a portfolio of currently eligible collateral; in future, it may also include other mortgage products and asset classes. So far, 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.

- Bank of America's cover pool may consist of first-lien or second-lien residential mortgage loans or home equity lines of credit or a combination thereof originated or acquired by Bank of America. The loans must not be delinquent.
- Washington Mutual Bank's cover pool may include first-lien residential mortgage loans originated or acquired by the bank. Loans in arrears for more than 60 days no longer qualify as collateral and have to be excluded from the ACT calculation and be removed from the cover pool.

The mortgaged property has to be a single-family or multi-family residence. Of each mortgage loan only an amount equal to a maximum loan-to-value of 75% of the mortgaged property's value can be funded via mortgage (collateralised) bonds. The real estate value is the most recent value given to a mortgaged property by the relevant sponsor bank adjusted by changes of the Office of Federal Housing Enterprise Oversight House Price Index ('OFHEO HPI'). The Office of Federal Housing Enterprise Oversight is an independent office within the Department of Housing and Urban Development. Its House Price Index is a broad measure of the movement of single-family house prices and updated quarterly. 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.

According to the respective contractual terms for covered bonds, substitution assets are eligible to be included in the cover pool. Substitution assets may be, for example, debt issued by or guaranteed by 0% risk-weighted central or regional governments, central banks, public sector entities, local authorities and international organisations. Eligible are also exposures to 10% or 20% risk-weighted institutions and triple-A rated, liquid residential mortgage-backed securities ('RMBS') that are US$-denominated. Such exposures must not account for more than 10% of the total principal amount of the outstanding covered bonds. Substitution assets are limited to a maximum of 10% of the cover pool.

Asset-liability management

The mismatch between the yield on the collateral in the cover pool and the coupon on the mortgage (collateralised) bonds outstanding is unhedged. However, the individual contractual terms for covered bonds require nominal interest and currency matching between the covered bonds and their related mortgage (collateralised) bonds. Each covered bond series needs to match the principal amount and core issue terms of the relevant mortgage (collateralised) bond series.

The SPV has to enter swap agreements with qualifying swap provider/s to address risks from interest and currency mismatches between a mortgage (collateralised) bond series and the corresponding covered bond series, and risks related to timing discrepancies between the dates on which mortgage (collateralised) bond proceeds are received by the SPV and the date on which interest and principal is payable on a covered bond series.

The swap provider/s are required to make swap payments to the SPV if and to the extent they receive due payments from the SPV. If the SPV fails to pay any amounts due to swap providers if the FDIC as receiver or conservator does not authorise continued interest payments on the mortgage (collateralised) bonds, swap providers are required to cover limited amounts of interest for up to 90 days (stay period if the FDIC is appointed as receiver). For covered bond transactions structured in accordance with the FDIC's final Covered Bond Policy Statement the stay can be reduced to a period of 10 days. Deferred amounts of the swap provider/s are subordinated to interest and principal payments on covered bonds.

As long as mortgage (collateralised) bonds remain outstanding, the sponsor bank performs an Asset Coverage Test and ensures that the adjusted aggregate loan amount is at least equal to the aggregate principal amount of all mortgage (collateralised) bonds outstanding. The adjusted aggregate loan amount (excluding the principal balance of any substitution assets and any collections of principal of the collateral in the cover pool during a preset period of time) is multiplied by an asset percentage that is at least 96% for Bank of America and 93% for Washington Mutual Bank. This refers to a contractually-committed minimum over-collateralisation ('OC') of 4.2% and 7.5%, respectively. However, in order to assign a target rating, the rating agencies ask for an OC that is not necessarily the same as the contractually-committed minimum OC level. At the time of writing, the applied asset percentage was 93% for Bank of America and 86.6% for Washington Mutual Bank. This, in turn, refers to an OC of 7.5% and 15.5%, respectively. The ACT is conducted monthly on each determination date and on any date on that collateral is removed from the cover pool. An asset monitor has to frequently test the arithmetic accuracy of the calculation. If the ACT is failed, the sponsor bank has to add additional eligible collateral to the cover pool to ensure that the ACT is passed again at the next determination date. If the ACT is failed and were it not to be remedied at the next determination date, this would constitute a trigger event of a sponsor bank event of default.

Depending on the final terms of a series, covered bonds are repaid in full on their maturity date or, in the event that the SPV fails to redeem the final amount in full on the maturity date, the payment of the final redemption amount can be deferred. According to the respective contractual terms for covered bonds, such deferral can be up to 60 days. A deferral of payments does not constitute an SPV event of default, but it increases the likelihood that payments will be settled at the extended due for payment date. The extended due for payment date is designed to give an MBIT additional time to enforce its first priority perfected security interest in the cover pool.

Asset monitor and banking supervision

Bank of America is supervised by the OCC and Washington Mutual Bank by the OTS. The OCC and the OTS are bureaus of the US Department of Treasury. The former charters, regulates and supervises national banks and the latter is the primary regulator of all federal and many state-chartered thrift institutions, including savings banks and savings and loan associations.

According to the terms of the relevant Asset Monitor Agreement, The Bank of New York was appointed independent asset monitor to assess the arithmetic accuracy of ACT calculations of Bank of America and

Deutsche Bank Trust Company Americas to test the calculations of Washington Mutual Bank. Under this agreement, the asset monitor has to verify the arithmetic accuracy of the ACT calculation once a year. If the sponsor bank was downgraded to or below BBB- by S&P, Baa3 by Moody's or BBB- by Fitch an asset monitor has to test the ACT calculation monthly until the required credit ratings have been reinstated. In addition, rating agencies analyse the cover pool quarterly. Upon review of a cover pool, rating agencies confirm or adjust the relevant asset percentage to maintain a target rating.

Upon a sponsor bank event of default

If a sponsor bank becomes insolvent, is in an unsound condition or engages in certain violations of law or regulations, or if other similar circumstances occur, the respective bureaus of the US Department of Treasury can appoint the FDIC as conservator or receiver of the sponsor bank. In the event of sponsor bank default, the MBIT declares all mortgage (collateralised) bonds outstanding immediately due and payable and enforces its first priority perfected security interest in the cover pool against the FDIC as receiver or conservator of the sponsor bank on behalf of the SPV.

If one mortgage (collateralised) bond series defaults, all mortgage (collateralised) bond series default. The cover pool securing mortgage (collateralised) bond series outstanding is not segregated from the insolvency estate of the sponsor bank. Upon a sponsor bank event of default all outstanding mortgage (collateralised) bonds 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, or proceeds of, the cover pool based on their entitlements to proceeds from the related mortgage (collateralised) bond series. Under the FDIA, the FDIC as receiver or conservator of the sponsor bank can:

- affirm the covered bond transactions and continue to meet the scheduled payments under the mortgage (collateralised) bonds when due and / or seek to transfer any of the IDI's assets and liabilities including the mortgage (collateralised) bonds to a new obligor; or
- repudiate the covered bond transactions. 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 remains in default for a defined period (stay period), or if the FDIC as conservator or receiver of the sponsor bank repudiates the contract, but does not pay the *actual direct compensatory damages* to the first priority perfected security interest holder – such as the MBIT for the benefit of the SPV – within the stay, the first priority perfected security interest holder can exercise self-help remedies and enforce its security interest in the cover pool. The exercise of self-help remedies is, however, 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 bond transactions 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 collateral pledged for mortgage (collateralised) bonds that are not structured in accordance with the final Covered Bond Policy Statement, prior to the expiry of the 45-day (as conservator) or 90-day (as receiver) period on a case-by-case basis. Within the relevant stay period the FDIC needs to either (1) pay off the mortgage (collateralised) bonds, OR (2) provide access to the collateral in the cover pool to the respective first priority perfected security interest holder to enforce its security interest and exercise self-help remedies to pay off the mortgage (collateralised) bonds.

Note that an amount equal to *actual direct compensatory damages* has 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 prescribed under the FDIC's final Covered Bond Policy Statement as the par value of mortgage (collateralised) bonds plus interest accrued up to the date of appointment of the FDIC as conservator or receiver. Provided the value of the collateral in the cover pool exceeds the *actual direct compensatory damages*, the excess amount has to be returned to the FDIC as conservator or receiver. If insufficient collateral is pledged to cover the *actual direct compensatory damages*, the bondholders would have an unsecured claim in the receivership for any amounts remaining outstanding after the collateral in the cover pool has been depleted.

Following 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 in the cover pool into a particular specified instrument for each covered bond series. In the case of Bank of America's structure, this can be a guaranteed investment contract ('GIC') account, a forward contract, or deposit account with a qualifying bank, while in the case of Washington Mutual Bank's structure it is a GIC account. Reserves on each specified instrument have to be swapped to provide the funds needed to meet payments due under the relevant covered bond series. The funds on each specified instrument must not be commingled with a sponsor bank's other funds and assets. As long as the reserves on each specified instrument are sufficient to meet payments due under each covered bond series, the bonds do not accelerate. If the cover pool is insufficient to fully secure 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 with regard to the portion of such claim that is unsecured.

Following a mortgage (collateralised) bond acceleration but prior to an SPV event of default, the CBIT performs a Proceeds Compliance Test ('PCT') on each determination date. The CBIT assesses whether the sum of (1) the total amounts deposited in, or credited to, the specified instrument for each covered bond series less any accrued interest and (2) the total unpaid principal amounts of each corresponding mortgage (collateralised) bond series is at least equal to the total principal amount of all covered bonds outstanding.

Upon an SPV event of default

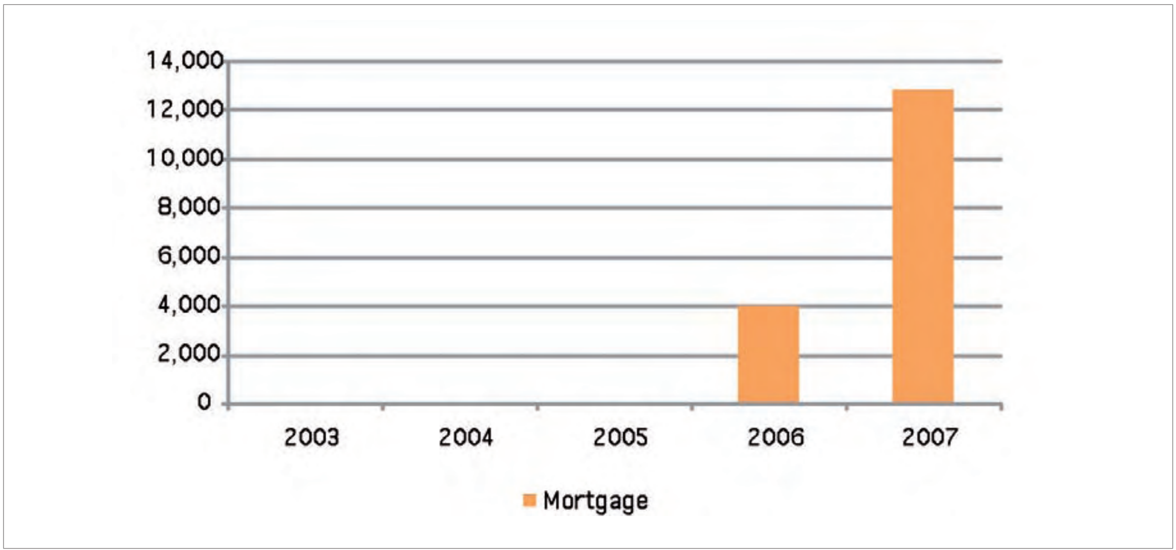
Any failure to meet the PCT, for example, constitutes an event of default of the SPV and entitles the CBIT to declare all covered bond series outstanding immediately due and payable at their early redemption amount plus accrued interest. In this case, the CBIT enforces its first priority perfected security interest over the covered bond collateral, liquidates it and exchanges the proceeds with the covered bond swap provider/s to prepay the accelerating covered bond series. The CBIT acts on behalf of the covered bondholders. No covered bond investor can proceed directly against the 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 insufficient to meet the claims of the covered bond investors in full, no other assets will be available for the payment of the deficiency. The rights of holders of such covered bond series will be extinguished.

III. RISK WEIGHTING & ECB ELIGIBILITY

Since none of the existing US covered bond issuers 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 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 weighting.

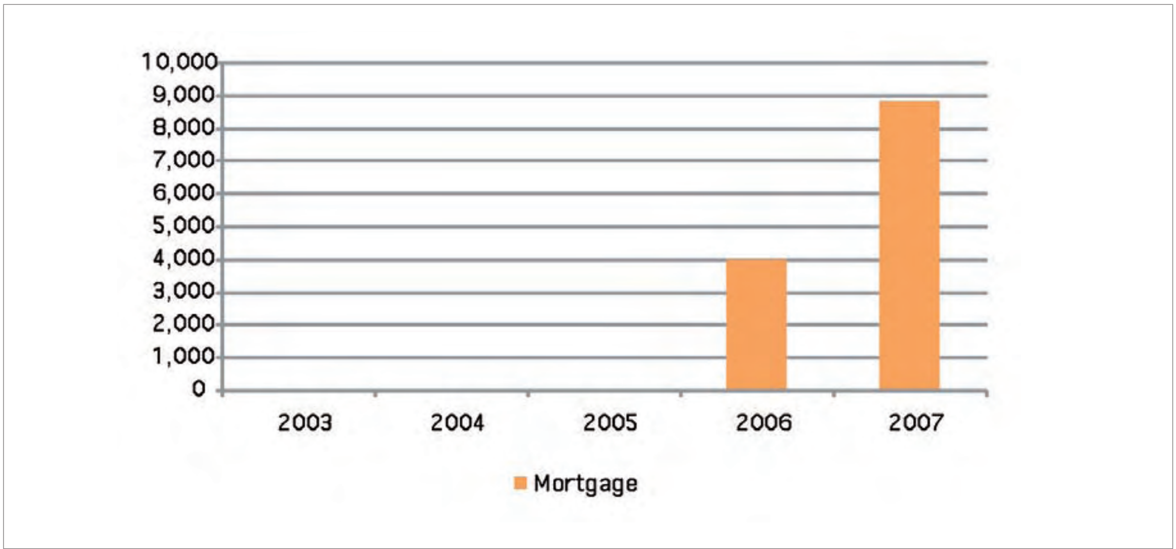
Within the scope of its liquidity-providing operations, the European Central Bank ('ECB') accepts certain assets, also known as marketable assets, as collateral for lending operations. The ECB follows the definition of covered bonds as set out in UCITS 22(4). As US covered bonds fall outside the UCITS definition, they are not classed as covered bank bonds, but as credit institution debt instruments (liquidity category III) by the ECB for repo purposes and not as asset-backed securities (liquidity category IV).

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2007, €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE 2003-2007, €M



Source: EMF/ECBC

CHAPTER 4 - RATING AGENCIES & METHODOLOGY

4.1 INTRODUCTION

By Bernd Volk
Deutsche Bank

I. RATINGS OF COVERED BONDS – AN ONGOING TOPIC OF DISCUSSION

Since Berlin Hannover Hypothekenbank's mortgage Pfandbriefe received a Aa1 rating from Moody's in October 2006, all outstanding Jumbo covered bonds have at least one rating. With more than 90% of European Jumbo covered bonds rated triple A, the market is almost exclusively a triple A asset class. Inaugural Jumbo issuers are typically rated triple-A. However, the fact that Aaa rated Spanish Cedulas (by Moody's) have to pay a significant spread pick-up versus German mortgage Pfandbriefe, e.g. Bayerische Hypovereinsbank, rated Aa1 by Moody's (and AAA by S&P), raises some question marks. Moreover, with Moody's downgrading its ratings of Washington Mutual covered bonds to Aa1 in March 2008 and by a further four notches to A2 in May 2008, investors were reminded that a triple A is never set in stone. Moreover, with Fitch assigning an expected B+ rating to the mortgage covered bonds of Ukrainian Bank Khreschatyk, a sub investment grade covered bond market (in the non-Jumbo Eastern European market segment) has started to emerge. Independent from the current ratings of covered bonds, the methods rating agencies use in their assessment has always been at the centre of investors' interest.

With the financial market crisis that started in 2007, rating agencies have come under massive pressure and had to adjust their rating methodologies in a number of different sectors. In this context, there have been concerns that covered bonds will be categorized as structured finance products by rating agencies and may consequently see significant changes in rating methodologies. We understand that this discussion is off the tables and rating agencies will continue to treat covered bonds (as an on balance sheet funding tool) differently from true-sale structured products.

Moody's (which introduced its joint default approach in 2005) and Fitch (which first published a methodology for rating Pfandbriefe in 1998) adjusted their rating approach for covered bonds recently. In contrast to Moody's, Fitch does not rely on an analysis of the joint probability of default of the issuer and the cover pool (and therefore the correlation between the two). This is due to the lack of historical data on the defaults of both financial institutions and covered bonds, which makes assessing the correlations between the two variables difficult.

S&P seems to have the most constant rating methodology, starting to rate covered bonds in the mid-1990, making only slight adjustments since then. Whereas Moody's focuses on the expected loss for covered bond investors, S&P focuses on timely payment, and Fitch ratings primarily reflect probability of default, but also incorporate an element of recoveries given default (up to 2 notches). All three rating agencies massively increased transparency recently by regularly publishing detailed new issue reports, including much more cover pool data than in the past. Fitch introduced a separate section on its website publishing the cover pool data on which the rating is based (if the issuers allow Fitch to do so) and Moody's has a separate section on its website for covered bonds and will start publishing performance reviews from Q3 2008.

Whereas details of the rating methodologies are different, all three - S&P, Moody's and Fitch - have to face the specific characteristic of covered bonds as bank bonds with an additional claim on a dynamic cover pool. As a complete delinkage of the rating of covered bonds from the rating of the issuer is almost excluded, one of the main interests of investors is typically the sensitivity of the covered bond rating to changes in the senior debt rating of the respective issuer bank. So far, Moody's and Fitch have not assessed any structure as being fully delinked form the issuer. Also S&P seems to place more emphasis on the corporate review of the issuer.

S&P applies the structured finance approach if it is comfortable that, even in a stress scenario, covered bond investors will get "timely and full payment of interest and repayment of principal, according to the original terms and conditions of the bonds". If S&P sees the risk of a moratorium, an acceleration, liquidity shortfall or debt restructuring, S&P will apply the "well secured debt approach" allowing a maximum upgrade of two notches (six in case of Cedulas since April 2006). Hence, S&P makes a rather binary decision by either applying the structured finance approach or the well secured debt approach. In February 2006, S&P introduced the Covered Bond Monitor modelling the cash flows of cover pool assets. Moreover, in March 2006 S&P announced a modest widening in its revised counterparty and supporting party criteria for structured finance transactions.

Fitch and Moody's adjusted their covered bond rating approaches in 2006 and 2008 respectively. Fitch by introducing the so called Discontinuity Factor and Moody's by introducing the so called Timely Payment Indicator. Both indicators measure the degree of delinkage of the covered bond rating from the senior unsecured rating of the issuer. In addition, Moody's changed its assumptions regarding refinancing margins of cover pool assets in case of issuer insolvency in February 2008. Given the current market environment, Moody's justifiably assumes that the discount at which funds can be raised by selling cover pool asset has increased materially. Moreover, Moody's usually communicates the collateral score, an indicator for the credit quality of the cover pool, which was already introduced with the new rating approach in 2005.

While S&P and Fitch usually give indications regarding the cover pool credit quality in their covered bonds reports, Moody's collateral score enables comparisons of the cover pool quality of different countries and issuers. The collateral score is more or less the part of the cover pool that Moody's is expecting to be written off (due to non performing loans) in case of issuer insolvency. Technically the collateral score gives the percentage of subordination that would be needed to get a Aaa rating for a hypothetical senior tranche of the cover pool. In the current highly sensitive credit environment, the fact that Moody's is giving an opinion regarding the collateral quality is a positive step towards rating transparency. With an average collateral score of Spanish Cedulas of around 18% and UK covered bonds of around 8% versus Norwegian covered bonds of around 2.5% and Swedish covered bonds of around 3%, Moody's is giving a clear hint about its views on the cover pools of different issuers. Interestingly, Moody's indications are broadly in line with the tiering of the different covered bond sectors in the market.

By using the structured finance approach, S&P's covered bond ratings are not linked to the senior unsecured rating of the issuer. Hence, whereas Moody's already made multi-notch downgrades in case of a few covered bonds, in case of S&P (and Fitch) almost all covered bonds are still rated triple-A. While we expect some upcoming adjustments from rating agencies to take into account the significantly changed environment in the market for whole loans, i.e. the massively reduced liquidity, rating consequences for covered bonds might be limited. It seems more likely that rating agencies will pressure issuers to enhance their cover pools or covered bond programmes to protect their rating. Obviously issuers have a strong interest to retain a triple-A. Higher costs to protect ratings may be lower than higher funding costs which would be the result of the loss of the triple A rating. On the other hand, the fact that even some triple A issuers struggle to gain market access shows that investors do not completely rely on ratings and that rating agencies may be lagging. In our view, the biggest risk for covered bond ratings at this stage continues to be the potential downgrade of senior bank ratings. Rating upside on this front is currently limited to a very few exceptional cases. In the current environment, investors will continue to keep a close eye on senior ratings even if the covered bond market remains rated triple-A.

4.2 FITCH COVERED BONDS RATING METHODOLOGY

By Hélène M. Heberlein
Fitch Ratings

Fitch introduced its covered bond rating criteria in February 2007. Under this methodology, covered bond ratings assigned by the agency are a function of the covered bonds' probability of default and their recovery given default. While the latter aspect deals with the treatment of recoveries following general principles already used by Fitch in its debt Recovery Ratings, the definition of the covered bonds' likelihood of default was an innovation. To determine how far the covered bonds probability of default can differ from that of the financial institution acting as main debtor of recourse, Fitch invented the concept of Discontinuity Factor, which is further explained below.

Covered Bonds' Probability of Default

Three inputs come into play when determining the covered bonds' probability of default: the relevant Issuer Default Rating (IDR), the applicable Discontinuity Factor and the stress-testing of cover assets, compared to outstanding covered bonds in a given rating scenario.

- 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 worst, the covered bonds' probability of default will be equal to that of the institution acting as main debtor of recourse – in general the covered bond issuer. At best, it 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 Factor expresses the likelihood of an interruption in the payments due to covered bond holders caused by the transition from the main debtor of recourse to the cover pool as the source of payment on the covered bonds. It takes systemic and cover pool as well as issuer-specific aspects into account.

  On the systemic side, Fitch investigates the strength of the asset segregation mechanism, notably to see whether it also places overcollateralisation beyond the reach of unsecured creditors until all covered bonds have been repaid in full. The agency relies on external lawyers to provide opinions about the immunity the legal framework offers against leakage from the cover pool assets or cash flows – related, for example, to claw back risk of the assets set aside for the covered bonds investors, commingling risk with the issuer's other cash flows, borrowers' set-off rights or the bankruptcy remoteness of any foreign assets included in the cover pool. The attitude of the domestic banking authorities towards the instrument is another systemic component of Fitch's Discontinuity Factor. Indeed, the agency recognises that regulators may exercise a positive influence on covered bonds if they control their risk profile through specific guidelines, especially if the covered bond market accounts for a substantial part of domestic banks' funding.

  Two further areas form part of Fitch Discontinuity Factor, and have both system-driven and individual components. First, 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. In addition, the operational on-site review carried out by the Fitch analysts indicates 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. Second, even assuming the speediest appointment of the most capable substitute manager at a very well organised issuer, it could still prove impossible to repay maturing covered bonds in time if the scheduled cash flows from the cover pool did not exactly match the payments owed to the covered bond investors. In most cases, the alternative manager in charge will need to find another source of liquidity to complement the scheduled cash flows from the cover pool, which could take some time. Therefore, the liquidity gaps component of the Fitch Discontinuity Factor considers the mitigants against any delay, which range from features that extend the maturity of the covered bonds to the availability of liquid assets that could be sold in the immediate aftermath of an issuer default. In addition, the agency assesses the tradability of the regular assets included in the cover pool, or the feasibility of borrowing against the cover pool assets.

The Fitch Discontinuity Factor is expressed as a percentage between 0% (best) and 100% (worst), which represents the average of the scores for each of the four sub-sections, weighted as follows:

Asset Segregation:	50%
Liquidity Gaps:	30%
Alternative Management:	15%
Covered Bonds Oversight:	5%

– The combination of the likelihood of default associated with the relevant IDR and the Discontinuity Factor indicates the maximum rating that can be assigned to the covered bonds on the basis of their probability of default, provided overcollateralisation between the cover assets and the covered bonds is commensurate with this targeted rating. The table below show these achievable ratings for a few Discontinuity Factors.

COVERED BONDS PROBABILITY OF DEFAULT MATRIX

Issuer Default Rating	Discontinuity Factor											
	100%	90%	80%	70%	60%	50%	40%	30%	20%	10%	5%	0%
AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
AA+	AA+	AA+	AA+	AA+	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
AA	AA	AA	AA	AA+	AA+	AA+	AA+	AAA	AAA	AAA	AAA	AAA
AA-	AA-	AA-	AA	AA	AA	AA+	AA+	AA+	AAA	AAA	AAA	AAA
A+	A+	A+	A+	AA-	AA-	AA-	AA	AA	AA+	AAA	AAA	AAA
A	A+	A+	A+	A+	AA-	AA-	AA	AA	AA+	AAA	AAA	AAA
A-	A-	A-	A	A	A+	A+	AA-	AA-	AA	AA+	AAA	AAA
BBB+	BBB+	BBB+	A-	A-	A	A+	A+	AA-	AA	AA+	AAA	AAA
BBB	BBB	BBB	BBB+	BBB+	BBB+	A-	A	A+	AA-	AA	AA+	AAA
BBB-	BBB-	BBB-	BBB-	BBB	BBB	BBB	BBB	BBB+	A	AA-	AA	AAA
BB+	BB+	BB+	BBB-	BBB-	BBB-	BBB-	BBB	BBB	BBB+	A	AA-	AAA
BB	BB	BB	BB+	BB+	BB+	BBB-	BBB-	BBB	BBB	A-	AA-	AAA

Issuer Default Rating	Discontinuity Factor										
	100%	90%	80%	70%	60%	50%	40%	30%	20%	10%	5%	0%
BB-	BB-	BB-	BB	BB	BB	BB+	BB+	BBB-	BBB	BBB+	A	AAA
B+	B+	B+	BB-	BB-	BB	BB	BB+	BB+	BBB-	BBB	A-	AAA
B	B	B	B+	B+	BB-	BB-	BB	BB+	BBB-	BBB	BBB+	AAA
B-	B-	B-	B	B	B+	BB-	BB-	BB	BB+	BBB-	BBB+	AAA
CCC+/CCC	CCC+// CCC	CCC	B-	B-	B	B+	BB-	BB-	BB	BBB-	BBB	AAA

Source: Fitch

– The last step before the agency can reach a conclusion about the covered bonds' probability of default is to simulate a wind-down scenario that assumes management by a third party, verifying whether the overcollateralisation accounted for by the agency would be sufficient to withstand the stress scenario corresponding to the rating indicated in the above matrix and to enable the cover assets to meet payments to privileged creditors on their due date. Fitch will not always give full credit to overcollateralisation available at the last reporting date: in the absence of any contractual commitment or public statement, the agency considers the lowest overcollateralisation observed in the preceding 12 months if the issuer is rated 'F2' or above. Below this rating threshold, and barring any public commitment from the issuer, it considers only the legal minimum overcollateralisation. 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.

Exposure Draft on Covered Bonds Swap Criteria

In June 2008, Fitch published an exposure draft on criteria for swaps used in covered bonds programmes, so called 'privileged' because they benefit from preferential rights against the cover pool. They are designed to survive an issuer's insolvency and continue protecting investors in a wind-down situation. One of the key drivers of the Fitch criteria stems from investors' reliance on the issuer to manage interest rate and currency discrepancies between the cover pool and the covered bonds. This reflects the dual recourse nature of covered bonds and leads to a fundamental difference compared to the agency's structured finance swap criteria. Whereas the latter focuses on the impact of swap counterparties credit risk, the covered bonds criteria also considers the issuer rating in determining whether the exposure is compatible with the covered bonds rating. The agency has opened a consultation period during which it is gathering market participants' comments on its guidelines for the posting of collateral depending on counterparty and issuer ratings. Fitch is also seeking feedback on its proposed treatment of swaps which do not meet the criteria. Cash flows due by and owed to privileged counterparties are taken into account irrespective of whether the swap contracts comply or not. However, to mitigate the effect of non-compliance, Fitch may disregard in its analysis, a portion of the overcollateralisation which would otherwise have been given credit to. Also, the Discontinuity Factor can be adjusted where the likelihood of counterparty replacement is reduced.

If the simulated overcollateralisation 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 overcollateralisation without leading to a covered bond default. However, it is worth noting that no stress scenario will be modelled at a rating scenario equal to the IDR, which serves as a floor for the covered bond rating on a probability-of-default basis.

Once the covered bonds' probability-of-default rating is established, the agency adjusts it according to the percentage of stressed recoveries obtained in the event of the covered bonds' default. Naturally, if the covered bonds' rating is already 'AAA' on a probability-of-default basis, no uplift can be awarded.

Recoveries given Default

Fitch's covered bond ratings do not fully reflect an 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. Furthermore, Fitch's calculations are not comparable to the loss-given-default assumption needed to calculate the covered bonds' capital charges for solvency purposes, since these are based on the stressed rather than the expected losses potentially suffered if a liquidation of the residual assets in the cover pool ever became necessary. Finally 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.

> FIGURE 2

Recovery Ratings	Recovery Prospects	Recovery Range (%)	Maximum Notching	
			Investment Grade	Non Investment 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 Ratings

Examples of Fitch Covered Bond Ratings

The IDR, Discontinuity Factor, overcollateralisation and the benefit from recoveries are therefore the cornerstones upon which Fitch builds its covered bond ratings. The table below details these building blocks for a few examples of covered bonds rated by Fitch. This shows that not all 'AAA' ratings assigned by Fitch to covered bonds are based on a probability of default for the covered bonds equivalent to a 'AAA' rating. Indeed, some are equivalent to a 'AA' rating from a probability-of-default point of view, but assumptions about recoveries given default enable the agency to grant a 'AAA' issue rating to the covered bonds. It also demonstrates that the Discontinuity Factor may constrain the covered bonds' probability of default in comparison with that of the issuing institution to an extent that cannot be cured by even the most generous overcollateralisation levels. However, issuers may improve their Discontinuity Factor over time, for instance by taking measures to reduce the liquidity gaps or improve their systems.

> FIGURE 3

Issuer	Banco Comercial Portugues	Bayerische Landesbank	Caixa Catalunya	Coreal Credit	Northern Rock	Wuestenrot Bank Pfandbriefbank
Country of the Issuer	Portugal	Germany	Spain	Germany	UK	Germany
Type of Covered Bonds	Legislative	Legislative	Legislative	Legislative	Contractual	Legislative
Nature of Cover Assets	Mortgages	Mortgages	Mortgages	Mortgages	Mortgages	Mortgages
Applicable Issuer Default Rating	A+	A+	A	BBB-	A- (RWP)	A-
Discontinuity Factor	7,8%	11,7%	31,6%	11,7%	8,8%	14,9%
Nominal Overcol-lateralisation	8,6%	26,7%	242,2%	17,8%	14,7%	7,8%
Maximum Rating on a Probability of Default Basis	AAA	AAA	AA	A+	AA+	AA+
Rating on a Probability of Default Basis	AAA	AAA	AA	A+	AA+	AA
Covered Bonds Rating	AAA	AAA	AAA	AA	AAA	AAA

Source: Fitch Ratings Covered Bonds SMART, June 2008

RWP: Rating Watch Positive

The Discontinuity Factors publicly assigned by the agency to date in the developed world range from 6% to 38.4%. Their distribution by asset types supports the conclusion that public sector cover pools can lead to a wider gap between the rating of the covered bonds and that of the issuer. This holds true, in particular, if the cover pool consists mainly of large exposures in the form of bonds, or if the assets were purchased on the secondary market – which will improve their liquidity profile. Equally, a small number of assets in the cover pool will ease the transition to an alternative manager in case of need.

Unlike legislative covered bonds, covered bonds issued under contractual arrangements are penalised in their Discontinuity Factors for the lack of any dedicated covered bond oversight. In the case of contractual covered bond issuers who are experienced securitisation issuers, this can be partly mitigated by good pre-existing reporting facilities for the sub-pools managed by the institution and assigned to third parties. In theory, provisions that minimise liquidity gaps, such as extendible maturities, should benefit contractual covered bonds, although this advantage is now shared by legislative covered bonds, some of which are also using such provisions.

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 overcollateralisation as of each reporting date. It graphically compares 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.fitchresearch.com.

4.3 MOODY'S COVERED BOND RATING METHOD

By Juan Pablo Soriano, Nicholas Lindstrom and Jörg Homey,
Moody's

SUMMARY

Moody's rating approach for covered bonds is based on the so-called 'joint-default analysis' method. This takes into account not only the credit strength of the issuer but also, upon "Issuer Default" (i.e. the removal of support from the issuer group), the value of the cover pool.

A Moody's covered bond rating is primarily determined by its expected loss. Moody's Expected Loss Covered Bond Rating Model ("Moody's EL Model") first assesses whether the issuer is still performing. If the issuer is performing, there should be no loss to covered bondholders. It is only following Issuer Default that Moody's EL Model switches to the analysis of the value of the cover pool, which is typically the more important driver of a final Covered Bond rating. 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 at the time of Issuer Default; and

> Any interest or currency rate risks to which the cover pool is exposed.

Each of these factors should be taken into account in the stressful environment that is expected to follow an Issuer Default.

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. In addition, while the issuer performs, it will also typically manage the cover pool – for example, by replacing defaulted assets with performing assets if required. For this reason, Moody's sees the role of the issuer as more important than that of a simple guarantor – in most cases, the issuer is actively managing the cover pool to the benefit of the covered bondholders.

CREDIT QUALITY OF THE COVER POOL

The credit quality of the cover pool is measured by its "Collateral Score". In Moody's EL Model, the Collateral Score determines the loss due to the credit deterioration on the assets in the cover pool that would be expected to be incurred following Issuer Default. The higher the credit quality of the cover pool, the lower the collateral score and hence the lower the level of losses that will impact the cover pool at the time of Issuer Default.

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 "natural amortisation" of the assets in the cover pool is unlikely to be sufficient to repay the bullet principal payments that are due under most covered bonds. The question to ask is: at what discount to the notional value of the cover pool will these funds be raised? Recent events have highlighted the potential volatility of this risk – it is refinance risk that is arguably one of the defining features of the current "credit crunch".

In February 2008, Moody's updated some of the refinance stresses applied in covered bonds, and also published some of the "discounts" that it applies for this risk. The average loss modelled into Moody's EL Model for refinance risk is around 5% for cover pools backed by residential and commercial mortgage collateral. For individual deals, these losses vary from approximately 2% to over 15%. These losses are over and above those resulting from the credit quality of the cover pool.

MARKET (INTEREST AND CURRENCY) RISKS IN THE COVER POOL

The value of the cover pool may also be impacted by interest and currency rate risks. For example, Moody's EL Model looks separately at the impact of increasing and decreasing interest rates on the expected loss of the covered bonds, and takes the path of interest rates that leads to the more severe result on the expected loss on the covered bonds. Furthermore, Moody's EL Model can make the following assumptions: (i) that these risks are largely unhedged at the point of Issuer Default; (ii) that if suitable hedges are in place that survive Issuer Default, low levels of risk will be attributed to any such hedged risks/mismatches; or (iii) that some other level of hedging is in place.

TIMELY PAYMENT INDICATORS ("TPIS")

As explained above, a Moody's covered bond rating is primarily determined by its expected loss. However, the timeliness of payment on a covered bond – or "linkage" to the underlying issuer – may constrain a rating outcome where the risk of a late payment following Issuer Default is considered to be too high. To date Moody's has not assessed any structure as being fully delinked from the issuer, and reasons for this include:

- Refinance risk where covered bonds are structured as bullets. The potential problems of raising funding from a pool of assets in an environment following an Issuer Default are being seen in the current market.
- Discretion enjoyed by issuers - for example, assets in the cover pool may revolve and new (in particular, hedging) contracts may be entered that change the refinancing and hedging profile of a programme.
- Operational and legal risks faced by an administrator, in particular where an administrator is servicing multiple pari-passu bullet bonds with different maturities after an Issuer Default.

To add transparency to its approach, in March 2008 Moody's published timely payment indicators (TPIs) for all covered bond programmes in which the issuer was publicly rated. These TPIs are Moody's assessment of the likelihood that a timely payment would be made to covered bondholders following Issuer Default. The TPI determines the maximum rating that a covered bond programme can achieve with its current structure while allowing for the addition of a reasonable amount of over-collateralisation.

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4.4 STANDARD & POOR'S

By Karen Naylor, Karlo Fuchs and Sabrina Miehs
Standard & Poor's

The analytical approach Standard & Poor's Ratings Services applies when evaluating mortgage and public sector covered bonds is based on a regular review of the quality and structure of the individual cover pools and the adequacy of the cash flows under a stressed scenario to determine whether they are sufficient to service the outstanding covered bonds in a timely manner. In addition, our ratings also reflect our opinion of an issuer's willingness and ability to maintain an overcollateralisation that is at a level sufficient (typically over and above the regulatory minimum requirement) to cover prevailing risks for the target rating (usually 'AAA') of its covered bonds.

A dedicated team of our covered bond analysts across Europe continuously analyse and monitor covered bonds. Ongoing monitoring of the issuer as well as markets allows us to incorporate relevant market developments into our covered bond rating assumptions.

Transparency with regard to potential risks in covered bonds has already prompted legislators in Europe to introduce mandatory transparency measures but we are of the opinion that current transparency still has room for improvement. To provide transparency with regards to our covered bond rating analysis, we aim to provide jurisdiction- and asset-specific assumptions for our credit and cash flow risk analysis. Further, we provide investors with our view of the respective covered bond structures and their development by publishing presale report and transaction update reports. Market participants, in particular issuers of legislation enabled covered bonds, can also rerun our cash flow analysis or to estimate the effects of changes in composition of their cover pools on the required level of overcollateralisation by using our quantitative covered bond model (Standard & Poor's Covered Bond Monitor; CBM - further information can be found at www.coveredbondmonitor@standardandpoors.com).

In our covered bond analysis we focus on four core areas:

1 We review the legal framework or structures to assess whether in the event of the issuing bank's default, covered bond investors would be able to receive timely payment of interest and repayment of principal in accordance with the original terms and conditions of the bond. Only if we are of the opinion that this would be the case in the event of the insolvency of the issuing bank, can we assign a covered bond rating that is based predominantly on the strength of the structure and the cover pool and which only has limited recourse to the rating of the bank.

2 We conduct an ongoing analysis of the quality and structure of the collateral registered in the cover pools to determine the probability as well as the expected loss in the event of default (interest and repayment of principal) of the cover pool assets. Based on a thorough review of the respective cover pools and of the operational features of the issuer's credit management, we apply stress scenarios that are calibrated to the rating being sought (for example 'AAA') for an individual portfolio.

3 We analyze the effect on the cash flows resulting from credit losses, maturity and currency mismatches, liquidity, and interest rate risks as well as payment delays and servicing costs. For most legislation-enabled covered bonds, we use the CBM to evaluate the cash flow structures of the assets and the covered bonds to determine whether, under stress scenarios tailored to the desired rating level (for example, 'AAA'), the cash flows generated by the assets are sufficient to meet the debt service

payments in a timely manner. Cash flows for covered bonds based on contractual laws have to be able to withstand similar stresses to legislation-enabled covered bonds but we perform the analysis with different models to allow us to assess additional structural elements.

4 We review the ongoing adequacy of covenants, in particular those regarding overcollateralisation or liquidity provided by the issuer. The adequacy is dependent on the covered bonds' target rating and is determined by assessing their quantity, quality and expected permanency, which is typically over and above the regulatory requirements. Dependent on the counterparty credit rating on the issuer and its business strategy, we expect varying strength and permanency of such covenants.

Investors should be aware that, in the absence of a clearly communicated covenant strategy, covered bond ratings of a particular issuer could demonstrate a lower long-term rating stability compared with typical securitizations at the same rating level. This reflects that potential risk migrations in legislation-enabled covered bonds are less restricted and a static minimum regulatory overcollateralisation is typically not sufficient to mitigate all potential permutations of risks.

Certain factors can reduce potential rating volatility: A clearly communicated strategy with regard to expected credit risks and diversification of the cover pool, tolerance levels for interest rates, currency rate risks, and liquidity risks, as well as the willingness to provide a cushion over and above the minimum regulatory requirements. While contractually agreed covenants are the strongest form of a communication strategy, we may also take into account non-legally binding covenants into our analysis.

Independent of the quantitative and qualitative assessment of the covered bond structure, regular and issuer-specific monitoring further helps us gain comfort that the issuing bank is willing and able to maintain the appropriate level of overcollateralisation required for the prevailing rating level.

Such monitoring includes that all covered bond issuers we rate undergo a rating process by Standard & Poor's Financial Services Group. The rating assigned to the issuer largely determines the acceptable monitoring and covenant standards.

If a covered bond issuer addresses the above criteria, we are usually in a position to assign a rating to the covered bonds that is considerably higher than the issuing bank's individual credit rating, even as high as 'AAA'.

CHAPTER 5 - COVERED BOND STATISTICS

5.1 INTRODUCTION

By Johannes Rudolph, HSBC Trinkaus and
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I. DESCRIPTIVE REVIEW OF THE COVERED BOND STATISTICS

The ECBC Statistics and Data Working Group collects and provides information as regards the annual gross supply and volume outstanding of covered bonds at year-end. Its aim is to provide complete and up-to-date statistics on all covered bond markets. The statistics covered 27 jurisdictions at the end of 2007.[1] The collection of these statistics is possible thanks to the cooperation of the Working Group members with covered bond issuers.

Even though there is a significant amount of covered bond data readily available, it is often difficult to evaluate its coverage and completeness. This should be taken into account when reading the statistics. In addition, for certain countries, national specifics should be considered.

> **Denmark**: at year-end, new bonds issued to refinance particular bullet bonds and the refinanced bullet bonds are in *ultimo figures*. Thus, the reported total outstanding amount exceeds the actual total outstanding amount.

> **Sweden**: Sweden's covered bond statistics include only converted *bostadsobligationer* (mortgage bonds) and *säkerställda obligationer* (covered bonds).[2]

> **Spain**: Spain's covered bond statistics only consider *cédulas* with an official listing in Spain's AIAF (Asociaciòn de Intermediarios de Activos Financieros).

> **France**: Compagnie de Financement Foncier runs a mixed pool of assets, using mortgage loans, public sector assets and senior tranches of RMBS as collateral. In addition, Crédit Foncier et Communal d'Alsace et Lorraine – Société de Crédit Foncier's cover pool consists of mortgage loans and loans to public sector entities. Thus, their covered bonds are not classed as mortgage covered bonds and public covered bonds, but are grouped together into one category.

> **Austria**: since the Österreichische Nationalbank stopped the publication of Pfandbrief-related data in 2004, consistent statistics are no longer available.

The statistics distinguish between covered bonds backed by public debt, mortgage loans, ship loans and a mix thereof. In contrast to the non-Jumbos, Jumbos usually have a minimum volume of €1bn, a fixed coupon payable once a year in arrears, and bullet redemption, and they are supported by the commitment of at least five market makers to quote continuous two-way prices throughout 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 this is not the euro), and those in a foreign currency other than the euro and the domestic currency. The exchange rate used to convert non-euro issues is the end-of-year exchange rate published by the European Central Bank at the end of every year. A distinction is also made between fixed-rate and

1 These were Austria, Canada, Czech Republic, Denmark, Finland, France, Germany, Hungary, Iceland, Ireland, Italy, Latvia, Luxembourg, Norway, Poland, Portugal, Spain, Sweden, Switzerland, Ukraine, the Netherlands, the UK and the US. The statistics also cover Czech hypotéční zástavní listy (mortgage bonds). Slovenia introduced a specific covered bond law in 2006, Romania in 2007. But, so far no *obligaţiuni ipotecare* (Romanian covered bonds) and *hipotekarni in komunalni obveznici* (Slovenian covered bonds) have been issued.

2 The first säkerställda obligationer were issued in 2006. Prior to this, bostadsobligationer were launched. At the end of 2005, the outstanding bostadsobligationer volume exceeded €90bn. To qualify for a licence to engage in säkerställda obligationer business, mortgage bond issuers were forced by the Swedish banking supervisor to either convert outstanding mortgage bonds or to treat their holders in the same way as covered bond-holders. One issuer converted outstanding bostadsobligationer into säkerställda obligationer in 2005, two in 2006, three in 2007 and one in 2008.

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 covered bonds outstanding from one country.

II. COVERED BOND MARKET DEVELOPMENTS

Over the past decade, the covered bond market has expanded enormously in terms of volume and geographical reach. By the end of 2007, there were active covered bond markets in over 20 European jurisdictions. The covered bond market is likely to continue to grow, driven by the rising number of markets and issuers and increased use of the product by existing issuers. Danish banks started to issue covered bonds (under the new legislation) in 2008 after new laws came into effect in 2007, and Italian and Greek institutions may follow suit in 2008. The market could also see the first Slovenian and Romanian covered bond in 2008. Canada, Norway and Ukraine joined the covered bond market last year, while Lithuania exited it after the last outstanding covered bond was repaid.

At the end of May 2008, nearly 250 issuing entities (circa 230 at the end of last year) were competing for investor attention. In 2007, circa 20 institutions joined the market and five left, mainly due to mergers. With 68 Spanish cédula issuers, 66 German and 22 Austrian covered bond issuers, the three jurisdictions together represented almost 70% of the issuers in the overall covered bond market.

The total volume outstanding of European covered bonds was almost €2,100bn at the end of 2007. Considering the covered bonds issued by Canadian and US issuers, the overall covered bond market accounted for circa €2,110bn compared with roughly €1,920bn at the end of 2006. This translates into an annual growth rate of 10%. Even though the importance of German Pfandbriefe is falling in both relative and absolute terms, with an outstanding volume of approximately €889bn at the end of last year, Germany remains the largest covered bond market, followed by Denmark (circa €345bn) and Spain (circa €283bn). At the end of 2007, the average volume outstanding of covered bonds per issuer was €9bn. Note that these statistics are skewed by country specifics (see above), exchange rate fluctuations and some banks' refunding activities. In 2007, total covered bond gross supply set a new record with a total volume of circa €526bn.

In 2007, covered bonds backed by mortgage loans dominated the market, accounting for two thirds of the yearly gross supply compared with circa 28% for covered bonds secured by public debt. Mortgage covered bonds accounted for over half of the overall volume outstanding at the end of 2007.Even though several covered bond laws allow for a mixed cover pool, only Compagnie de Financement Foncier and Crédit Foncier et Communal d'Alsace et Lorraine – Société de Crédit Foncier run a mixed pool of assets. Last year's gross supply of covered bonds secured by a mixed pool of assets was €24bn.

Covered bonds are endowed with a variety of features in terms of currencies, coupons and denominations. At the end of 2007, of the total volume of covered bonds outstanding, 26% were not €-denominated and 12% were floating rate notes. The other important currencies are DKK and SEK, followed by USD, CHF and GBP. Many covered bond issuers use their domestic currency. Moreover, the practice of targeting the traditional continental European investor base has left its mark, because the vast majority of the UK covered bonds are €-denominated, while their collateral is £-denominated. At the end of 2007, around €230bn (11%) of the total volume of covered bonds outstanding was denominated in a non-domestic currency. More than 28% (€523bn)[3] of the total volume of covered bonds outstanding was placed privately.

3 The figure includes assumptions for privately placed French *obligations foncières*.

In 2007, the market share of privately placed covered bonds increased slightly by 0.6%, however, private placements gained importance in H1 2008.

The market distinguishes between special law based framework covered bonds and general law based framework covered bonds (structured covered bonds). The first have a legal framework behind them, i.e., a specific covered bond law safeguards the interests of the bondholders. Up to 2006, structured covered bonds were issued only out of countries where no specific covered bond law existed. However, in the past two years several French banks as well as one German bank have established covered bond programmes outside the specific national covered bond law. At the end of 2007, covered bonds outstanding that were issued outside a specific covered bond law in Canada, France, Iceland, the Netherlands, the UK, and the US amounted to €127bn (6% of the overall covered bond market). Spanish pooled cédulas and Italian covered bonds launched by Cassa Depositi e Prestiti accounted for another €124bn (6%). In 2007, total structured covered bond gross supply was €94bn (20% of the overall gross supply). Taking into account also pooled cédulas, the figure rises by circa €27bn. Enforcement of the covered bond laws in the UK and the Netherlands should see the share of special law based framework covered bonds in the 2008 gross supply and outstanding volume rise.

III. COVERED BOND MARKET OUTLOOK

The covered bond market has proved more resilient than the securitisation market, but it has not escaped unscathed from the turbulence in the financial markets, witnessing a sharp decline in liquidity and widening spreads. In the midst of this turbulence, buyers have shown reluctance to absorb new covered bond issues or engage in the secondary market. This is especially the case if there are economic concerns surrounding certain countries that have benefited from a booming housing market over recent years and/or credit concerns regarding individual banks.

The 2008 Jumbo gross supply up to the end of June was subdued, with 53 new Jumbos with a total volume of €66bn having been issued, compared with €70bn for the same period in 2007. Over 65% of the new, 2008 Jumbos are mortgage covered bonds, and the remainder public covered bonds, except two: one backed by a mixed pool of assets, and the other secured by ship mortgage loans.

Over the course of this year, issuers have had no option but to take the market as it is. Soft-sounding and private placements have been in vogue to diminish execution risk in public markets. The covered bond market has remained open to issuers with superior credit histories prepared to pay prevailing spread levels to inspire investor confidence. Investor demand often dictates an issuer's choice of maturity and size. Shorter-term issues have been more popular this year since it has been difficult to secure favourable pricing for longer-term issues. The turmoil in the financial markets has also shown that investor appetite for mortgage covered bonds and structured covered bonds is suppressed.

5.2 STATISTICS

5.2.1 TOTAL

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector	869.714	858.645	869.924	884.038	858.642
Outstanding Covered Bonds backed by Mortgage	606.008	677.426	784.968	964.303	1.158.222
Outstanding Covered Bonds backed by Ships	10.087	9.542	10.585	11.341	13.136
Outstanding Covered Bonds backed by Mixed Assets	34.530	41.350	50.040	61.930	80.097
Total Outstanding	1.520.393	1.586.964	1.715.518	1.921.612	2.110.096
Outstanding Jumbo	704.140	779.485	878.416	1.008.206	1.117.848
Outstanding non-Jumbo	805.503	796.728	837.101	913.406	992.249
Total Outstanding	1.520.393	1.586.963	1.715.517	1.921.612	2.110.097
Total Outstanding Public Placement	1.022.384	1.020.452	1.172.882	1.251.327	1.534.507
Total Outstanding Private Placement	391.063	446.870	453.948	486.288	538.049
Total Outstanding	1.520.393	1.586.964	1.715.518	1.921.612	2.110.095
Outstanding denominated in EURO	1.212.927	1.252.336	1.336.404	1.327.249	1.562.127
Outstanding denominated in domestic currency (in m EUR)	252.256	276.308	316.935	382.578	434.597
Outstanding denominated in other currencies (in m EUR)	44.461	47.568	62.178	57.181	104.844
Total Outstanding	1.520.394	1.586.962	1.715.517	1.921.611	2.110.094
Outstanding fixed bullet	1.263.772	1.294.042	1.418.904	1.541.257	1.804.743
Outstanding floating bullet	155.423	177.148	176.749	201.187	242.523
Outstanding others	24.577	25.313	27.224	20.565	41.445
Total Outstanding	1.520.393	1.586.214	1.715.517	1.921.611	2.110.097
Maturity of bonds					
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector	182.740	162.683	179.978	171.978	150.960
New Issues of Covered Bonds backed by Mortgage	204.849	197.529	272.657	305.222	347.479
New Issues of Covered Bonds backed by Ships	2.421	1.785	3.579	3.334	3.911
New Issues of Covered Bonds backed by Mixed Assets	9.600	11.150	13.150	17.263	23.682
Total Issuance	399.610	373.147	469.364	497.796	526.031
Issuance Jumbo	109.327	112.300	136.847	194.422	177.633
Issuance non-Jumbo	277.852	249.697	315.561	303.375	348.398
Total Issuance	387.179	361.997	452.409	497.796	526.031
Total Issuance Public Placement	316.354	293.225	374.298	379.392	407.831
Total Issuance Private Placement	80.296	79.922	91.260	118.404	118.200
Total Issuance	396.650	373.147	465.559	497.796	526.031
Issuance denominated in EURO	283.572	270.698	284.273	343.067	327.696
Issuance denominated in domestic currency (in m EUR)	98.614	93.282	152.339	125.788	168.192
Issuance denominated in other currencies (in m EUR)	14.593	9.167	28.946	28.942	30.143
Total Issuance	399.610	373.146	469.363	497.797	526.031
Issuance fixed bullet	319.406	309.045	375.873	391.016	423.850
Issuance floating bullet	50.741	44.735	66.569	54.451	87.886
Issuance others	10.403	10.765	14.047	6.295	5.435
Total Issuance	399.610	373.146	469.364	497.796	526.031
Maturity of bonds					

5.2.2 AUSTRIA (ESTIMATE)

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector	6.750	6.750	13.038	15.615	15.200
Outstanding Covered Bonds backed by Mortgage	4.000	4.000	4.000	3.880	4.125
Outstanding Covered Bonds backed by Ships				0	0
Outstanding Covered Bonds backed by Mixed Assets				0	0
Total Outstanding	10.750	10.750	17.038	19.495	19.325
Outstanding Jumbo			6.000	6.000	7.000
Outstanding non-Jumbo			11.038	13.495	12.325
Total Outstanding	10.750	10.750	17.038	19.495	19.325
Total Outstanding Public Placement				10.235	10.987
Total Outstanding Private Placement				9.260	8.338
Total Outstanding	10.750	10.750	17.038	19.495	19.325
Outstanding denominated in EURO			15.691	17.703	17.304
Outstanding denominated in domestic currency (in m EUR)				0	0
Outstanding denominated in other currencies (in m EUR)			1.347	1.792	2.021
Total Outstanding	10.750	10.750	17.038	19.495	19.325
Outstanding fixed bullet			13.497	17.207	18.111
Outstanding floating bullet			3.324	2.062	1.029
Outstanding others			217	226	185
Total Outstanding	10.750	10.750	17.038	19.495	19.325
Maturity of bonds					
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector	1.802		3.591	3.110	3.131
New Issues of Covered Bonds backed by Mortgage	1.029		214	2.176	1.959
New Issues of Covered Bonds backed by Ships				0	0
New Issues of Covered Bonds backed by Mixed Assets				0	0
Total Issuance	2.831		3.805	5.286	5.090
Issuance Jumbo				1.000	1.000
Issuance non-Jumbo				4.286	4.090
Total Issuance	2.831		3.805	5.286	5.090
Total Issuance Public Placement				1.677	1.531
Total Issuance Private Placement				3.609	3.559
Total Issuance	2.831		3.805	5.286	5.090
Issuance denominated in EURO				4.899	4.861
Issuance denominated in domestic currency (in m EUR)				0	0
Issuance denominated in other currencies (in m EUR)				387	229
Total Issuance	2.831		3.805	5.286	5.090
Issuance fixed bullet				3.807	4.577
Issuance floating bullet				1.478	490
Issuance others				0	23
Total Issuance	2.831		3.805	5.286	5.090
Maturity of bonds					

Notes: Data is tentative.

5.2.3 CANADA

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector					0
Outstanding Covered Bonds backed by Mortgage					2 000
Outstanding Covered Bonds backed by Ships					0
Outstanding Covered Bonds backed by Mixed Assets					0
Total Outstanding					2 000
Outstanding Jumbo					2 000
Outstanding non-Jumbo					0
Total Outstanding					2 000
Total Outstanding Public Placement					2 000
Total Outstanding Private Placement					0
Total Outstanding					2 000
Outstanding denominated in EURO					2 000
Outstanding denominated in domestic currency (in m EUR)					0
Outstanding denominated in other currencies (in m EUR)					0
Total Outstanding					2 000
Outstanding fixed bullet					2 000
Outstanding floating bullet					0
Outstanding others					0
Total Outstanding					2 000
Maturity of bonds					5,0
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector					0
New Issues of Covered Bonds backed by Mortgage					2 000
New Issues of Covered Bonds backed by Ships					0
New Issues of Covered Bonds backed by Mixed Assets					0
Total Issuance					2 000
Issuance Jumbo					2 000
Issuance non-Jumbo					0
Total Issuance					2 000
Total Issuance Public Placement					2 000
Total Issuance Private Placement					0
Total Issuance					2 000
Issuance denominated in EURO					2 000
Issuance denominated in domestic currency (in m EUR)					
Issuance denominated in other currencies (in m EUR)					
Total Issuance					2 000
Issuance fixed bullet					2 000
Issuance floating bullet					0
Issuance others					0
Total Issuance					2 000
Maturity of bonds					5,0

5.2.4 CZECH REPUBLIC

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector	0	0	0	0	
Outstanding Covered Bonds backed by Mortgage	1.638	1.956	4.452	5.543	7.850
Outstanding Covered Bonds backed by Ships	0	0	0	0	
Outstanding Covered Bonds backed by Mixed Assets	0	0	0	0	
Total Outstanding	1.638	1.956	4.452	5.543	7.850
Outstanding Jumbo	0	0	0	0	
Outstanding non-Jumbo	1.638	1.956	4.452	5.543	7.850
Total Outstanding	1.638	1.956	4.452	5.543	7.850
Total Outstanding Public Placement	1.537	1.721	3.710	4.682	
Total Outstanding Private Placement	100	235	742	861	
Total Outstanding	1.638	1.956	4.452	5.543	7.850
Outstanding denominated in EURO	0	0	0	42	
Outstanding denominated in domestic currency (in m EUR)	1.638	1.956	4.452	5.501	
Outstanding denominated in other currencies (in m EUR)	0	0	0	0	
Total Outstanding	1.638	1.956	4.452	5.543	7.850
Outstanding fixed bullet	1.572	1.796	3.619	4.615	
Outstanding floating bullet	66	160	833	928	
Outstanding others	0	0	0	0	
Total Outstanding	1.638	1.956	4.452	5.543	7.850
Maturity of bonds	3,2	3,7	8,4	7,2	
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector	0	0	0	0	
New Issues of Covered Bonds backed by Mortgage	666	744	2.558	956	
New Issues of Covered Bonds backed by Ships	0	0	0	0	
New Issues of Covered Bonds backed by Mixed Assets	0	0	0	0	
Total Issuance	666	744	2.558	956	
Issuance Jumbo	0	0	0	0	
Issuance non-Jumbo	666	744	2.558	956	
Total Issuance	666	744	2.558	956	
Total Issuance Public Placement	565	610	2.068	875	
Total Issuance Private Placement	100	135	490	81	
Total Issuance	666	744	2.558	956	
Issuance denominated in EURO	0	0	0	42	
Issuance denominated in domestic currency (in m EUR)	666	744	2.558	914	
Issuance denominated in other currencies (in m EUR)	0	0	0	0	
Total Issuance	666	744	2.558	956	
Issuance fixed bullet	666	650	1.897	903	
Issuance floating bullet	0	94	661	53	
Issuance others	0	0	0	0	
Total Issuance	666	744	2.558	956	
Maturity of bonds	5,0	4,5	12,3	5,5	

Notes: 2007 data - estimate

5.2.5 DENMARK

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector	0	0	0	0	0
Outstanding Covered Bonds backed by Mortgage	226.695	250.133	286.411	300.367	335.849
Outstanding Covered Bonds backed by Ships	6.915	6.330	6.915	6.672	8.723
Outstanding Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Outstanding	226.695	250.133	286.411	300.367	344.572
Outstanding Jumbo	143.595	170.427	199.504	220.463	257.780
Outstanding non-Jumbo	83.099	79.704	86.906	79.904	86.792
Total Outstanding	226.695	250.132	286.410	300.367	344.572
Total Outstanding Public Placement	226.695	250.133	286.411	300.367	342.309
Total Outstanding Private Placement	0	0	0	0	2.262
Total Outstanding	226.695	250.133	286.411	300.367	344.571
Outstanding denominated in EURO	17.457	18.315	18.432	18.743	26.309
Outstanding denominated in domestic currency (in m EUR)	209.239	231.817	267.979	281.623	315.999
Outstanding denominated in other currencies (in m EUR)	0	0	0	0	2.262
Total Outstanding	226.696	250.132	286.410	300.366	344.570
Outstanding fixed bullet	208.662	230.606	242.752	241.951	266.403
Outstanding floating bullet	5.735	7.877	32.729	48.232	68.535
Outstanding others	12.297	11.650	10.930	10.184	9.633
Total Outstanding	226.694	250.133	286.410	300.366	344.572
Maturity of bonds					
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector	0	0	0	0	0
New Issues of Covered Bonds backed by Mortgage	99.727	95.009	149.708	114.014	138.066
New Issues of Covered Bonds backed by Ships	318	139	1.837	960	3.283
New Issues of Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Issuance	99.727	95.009	149.708	114.014	141.349
Issuance Jumbo	0	0	0	0	1.341
Issuance non-Jumbo	99.727	95.009	149.708	114.014	136.725
Total Issuance	99.727	95.009	149.708	114.014	138.066
Total Issuance Public Placement	99.727	95.009	149.708	114.014	139.586
Total Issuance Private Placement	0	0	0	0	1.762
Total Issuance	99.727	95.009	149.708	114.014	141.348
Issuance denominated in EURO	8.455	8.530	8.850	8.844	10.549
Issuance denominated in domestic currency (in m EUR)	91.273	86.478	140.858	105.171	130.378
Issuance denominated in other currencies (in m EUR)	0	0	0	0	421
Total Issuance	99.727	95.008	149.708	114.015	141.348
Issuance fixed bullet	97.598	91.127	121.753	92.811	110.730
Issuance floating bullet	2.128	3.881	27.955	21.203	30.619
Issuance others	1	0	0	0	0
Total Issuance	99.727	95.008	149.708	114.014	141.349
Maturity of bonds					

Note: For Denmark, 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 the refinancing and the bonds they are replacing are in ultimo figures. If one takes the figures as of 31.01.2008, the total outstanding for the Danish market would be EUR 47 bn less.

5.2.6 FINLAND

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector		0	0	0	0
Outstanding Covered Bonds backed by Mortgage		250	1 500	3 000	4 500
Outstanding Covered Bonds backed by Ships		0	0	0	0
Outstanding Covered Bonds backed by Mixed Assets		0	0	0	0
Total Outstanding		250	1 500	3 000	4 500
Outstanding Jumbo		0	1 000	2 000	3 000
Outstanding non-Jumbo		250	500	1 000	1 500
Total Outstanding		250	1 500	3 000	4 500
Total Outstanding Public Placement		0	1 000	2 000	3 000
Total Outstanding Private Placement		250	500	1 000	1 500
Total Outstanding		250	1 500	3 000	4 500
Outstanding denominated in EURO		250	1 500	3 000	4 500
Outstanding denominated in domestic currency (in m EUR)		0	0	0	0
Outstanding denominated in other currencies (in m EUR)		0	0	0	0
Total Outstanding		250	1 500	3 000	4 500
Outstanding fixed bullet		0	1 000	2 250	3 750
Outstanding floating bullet		250	500	750	750
Outstanding others		0	0	0	0
Total Outstanding		250	1 500	3 000	4 500
Maturity of bonds					
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector		0	0	0	0
New Issues of Covered Bonds backed by Mortgage		250	1 250	1 500	1 500
New Issues of Covered Bonds backed by Ships		0	0	0	0
New Issues of Covered Bonds backed by Mixed Assets		0	0	0	0
Total Issuance		250	1 250	1 500	1 500
Issuance Jumbo		0	1 000	1 000	1 000
Issuance non-Jumbo		250	250	500	500
Total Issuance		250	1 250	1 500	1 500
Total Issuance Public Placement		0	1 000	1 000	1 000
Total Issuance Private Placement		250	250	500	500
Total Issuance		250	1 250	1 500	1 500
Issuance denominated in EURO		250	1 250	1 500	1 500
Issuance denominated in domestic currency (in m EUR)		0	0	0	0
Issuance denominated in other currencies (in m EUR)		0	0	0	0
Total Issuance		250	1 250	1 500	1 500
Issuance fixed bullet		0	1 000	1 250	1 500
Issuance floating bullet		250	250	250	0
Issuance others		0	0	0	0
Total Issuance		250	1 250	1 500	1 500
Maturity of bonds					

5.2.7 FRANCE

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector	31.340	37.600	42.600	49.660	56.403
Outstanding Covered Bonds backed by Mortgage	21.079	26.816	32.133	43.012	63.555
Outstanding Covered Bonds backed by Ships	0	0	0	0	0
Outstanding Covered Bonds backed by Mixed Assets	34.530	41.350	50.040	61.930	80.097
Total Outstanding	86.949	105.766	124.773	154.602	200.055
Outstanding Jumbo	64.757	75.307	80.132	102.577	102.550
Outstanding non-Jumbo	22.192	30.459	44.641	52.025	97.505
Total Outstanding	86.949	105.766	124.773	154.602	200.055
Total Outstanding Public Placement	21.079	26.083	61.465		194.593
Total Outstanding Private Placement	0	733	20.668		5.461
Total Outstanding	86.949	105.766	124.773	154.602	200.054
Outstanding denominated in EURO	77.109	94.104	109.236		165.779
Outstanding denominated in domestic currency (in m EUR)	0	0	0		
Outstanding denominated in other currencies (in m EUR)	9.840	11.662	15.537		34.276
Total Outstanding	86.949	105.766	124.773	154.602	200.055
Outstanding fixed bullet	21.079	26.333	30.465		174.388
Outstanding floating bullet	0	0	0		10.502
Outstanding others	0	483	1.668		15.165
Total Outstanding	86.949	105.776	124.773	154.602	200.055
Maturity of bonds	5,6	6,0	6,4	6,4	
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector	6.500	8.600	9.070	12.134	15.271
New Issues of Covered Bonds backed by Mortgage	6.181	5.737	6.397	12.637	21.670
New Issues of Covered Bonds backed by Ships	0	0	0	0	
New Issues of Covered Bonds backed by Mixed Assets	9.600	11.150	13.150	17.263	23.682
Total Issuance	22.281	25.487	28.617	42.034	60.623
Issuance Jumbo	10.562	8.640	7.210	29.471	33.200
Issuance non-Jumbo	2.119	5.697	8.257	12.563	27.423
Total Issuance	22.281	14.337	15.467	42.034	60.623
Total Issuance Public Placement	17.492	16.611	16.963	32.437	52.393
Total Issuance Private Placement	4.660	8.877	11.654	9.597	8.230
Total Issuance	22.152	25.487	28.617	42.034	60.623
Issuance denominated in EURO	19.774	21.369	20.637	34.172	50.700
Issuance denominated in domestic currency (in m EUR)	0	0	0	0	
Issuance denominated in other currencies (in m EUR)	2.507	4.119	7.980	7.862	9.923
Total Issuance	22.281	25.488	28.617	42.034	60.623
Issuance fixed bullet	6.052	12.279	14.904		57.009
Issuance floating bullet	0	1.004	526		2.614
Issuance others	0	3.605	4.117		1.000
Total Issuance	22.281	25.487	28.617	42.034	60.623
Maturity of bonds	7,7	8,9	9,2	8,8	

Note: 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.

5.2.8 GERMANY

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector	797 492	760 264	734 713	720 835	677 656
Outstanding Covered Bonds backed by Mortgage	256 027	246 636	237 547	223 306	206 489
Outstanding Covered Bonds backed by Ships	3 172	3 212	3 670	4 669	4 413
Outstanding Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Outstanding	1 056 691	1 010 112	975 930	948 810	888 558
Outstanding Jumbo	413 700	391 400	372 600	345 640	312 358
Outstanding non-Jumbo	642 991	618 712	603 330	603 170	576 200
Total Outstanding	1 056 691	1 010 112	975 930	948 810	888 558
Total Outstanding Public Placement	672 091	576 463	567 910	512 621	427 073
Total Outstanding Private Placement	384 600	433 649	408 020	436 189	461 485
Total Outstanding	1 056 691	1 010 112	975 930	948 810	888 558
Outstanding denominated in EURO	1 030 959	985 370	952 485	922 878	863 594
Outstanding denominated in domestic currency (in m EUR)					
Outstanding denominated in other currencies (in m EUR)	25 732	24 742	23 445	25 932	24 964
Total Outstanding	1 056 691	1 010 112	975 930	948 810	888 558
Outstanding fixed bullet	901 004	838 345	845 386	823 130	789 338
Outstanding floating bullet	144 270	160 693	120 681	121 754	90 552
Outstanding others	11 417	11 075	9 863	3 926	8 668
Total Outstanding	1 056 691	1 010 112	975 930	948 810	888 558
Maturity of bonds	4,6	4,8	5,0	5,4	5,6
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector	151 690	131 506	137 235	129 452	107 913
New Issues of Covered Bonds backed by Mortgage	57 621	40 773	33 722	35 336	26 834
New Issues of Covered Bonds backed by Ships	2 103	1 646	1 742	2 374	628
New Issues of Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Issuance	211 414	173 925	172 699	167 162	135 375
Issuance Jumbo	49 725	44 075	47 950	42 660	33 105
Issuance non-Jumbo	161 689	129 850	124 749	124 502	102 270
Total Issuance	211 414	173 925	172 699	167 162	135 375
Total Issuance Public Placement	138 958	109 423	106 895	76 935	57 973
Total Issuance Private Placement	72 456	64 502	65 804	90 227	77 402
Total Issuance	211 414	173 925	172 699	167 162	135 375
Issuance denominated in EURO	203 206	172 085	163 931	159 340	131 807
Issuance denominated in domestic currency (in m EUR)	0	0	0	0	0
Issuance denominated in other currencies (in m EUR)	8 208	1 840	8 768	7 822	3 568
Total Issuance	211 414	173 925	172 699	167 162	135 375
Issuance fixed bullet	155 531	130 723	138 259	143 869	113 085
Issuance floating bullet	45 685	36 559	27 077	18 859	20 099
Issuance others	10 198	6 643	7 363	4 434	2 191
Total Issuance	211 414	173 925	172 699	167 162	135 375
Maturity of bonds	6,4	6,3	7,1	7,4	7,2

5.2.9 HUNGARY

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector	0	0	0	0	0
Outstanding Covered Bonds backed by Mortgage	3 568	4 962	5 072	5 924	5 987
Outstanding Covered Bonds backed by Ships	0	0	0	0	0
Outstanding Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Outstanding	3 622	4 962	5 072	5 924	5 987
Outstanding Jumbo	0	0	0	0	0
Outstanding non-Jumbo	3 622	4 962	5 072	5 924	5 987
Total Outstanding	3 622	4 962	5 072	5 924	5 987
Total Outstanding Public Placement	2 178	2 993	3 182	4 188	4 131
Total Outstanding Private Placement	1 444	1 970	1 890	1 736	1 856
Total Outstanding	3 622	4 962	5 072	5 924	5 987
Outstanding denominated in EURO	0	350	540	1 547	1 784
Outstanding denominated in domestic currency (in m EUR)	3 622	4 612	4 532	4 377	4 203
Outstanding denominated in other currencies (in m EUR)	0	0	0	0	0
Total Outstanding	3 622	4 962	5 072	5 924	5 987
Outstanding fixed bullet	3 236	4 556	4 587	5 214	5 080
Outstanding floating bullet	297	316	398	635	907
Outstanding others	89	90	87	75	0
Total Outstanding	3 622	4 962	5 072	5 924	5 987
Maturity of bonds	5,0	5,0	4,0	4,0	9,0
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector	0	0	0	0	0
New Issues of Covered Bonds backed by Mortgage	2 961	2 381	808	1 418	331
New Issues of Covered Bonds backed by Ships	0	0	0	0	0
New Issues of Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Issuance	2 961	2 381	808	1 418	331
Issuance Jumbo	0	0	0	0	0
Issuance non-Jumbo	2 961	2 381	808	1 418	331
Total Issuance	2 961	2 381	808	1 418	331
Total Issuance Public Placement	2 135	1 815	618	1 412	158
Total Issuance Private Placement	826	566	190	6	173
Total Issuance	2 961	2 381	808	1 418	331
Issuance denominated in EURO	0	350	190	1 007	291
Issuance denominated in domestic currency (in m EUR)	2 961	2 031	618	411	40
Issuance denominated in other currencies (in m EUR)	0	0	0	0	0
Total Issuance	2 961	2 381	808	1 418	331
Issuance fixed bullet	2 779	2 377	718	1 168	116
Issuance floating bullet	177	0	90	250	215
Issuance others	4	4	0	0	0
Total Issuance	2 961	2 381	808	1 418	331
Maturity of bonds	5,0	5,0	2,8	3,0	9,0

5.2.10 ICELAND

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector				0	0
Outstanding Covered Bonds backed by Mortgage				467	794
Outstanding Covered Bonds backed by Ships				0	0
Outstanding Covered Bonds backed by Mixed Assets				0	0
Total Outstanding				467	794
Outstanding Jumbo				0	0
Outstanding non-Jumbo				467	794
Total Outstanding				467	794
Total Outstanding Public Placement				0	0
Total Outstanding Private Placement				467	794
Total Outstanding				467	794
Outstanding denominated in EURO				0	0
Outstanding denominated in domestic currency (in m EUR)				467	794
Outstanding denominated in other currencies (in m EUR)				0	0
Total Outstanding				467	794
Outstanding fixed bullet				0	0
Outstanding floating bullet				0	0
Outstanding others				467	794
Total Outstanding				467	794
Maturity of bonds				26,0	
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector				0	0
New Issues of Covered Bonds backed by Mortgage				467	321
New Issues of Covered Bonds backed by Ships				0	0
New Issues of Covered Bonds backed by Mixed Assets				0	0
Total Issuance				467	321
Issuance Jumbo				0	0
Issuance non-Jumbo				467	321
Total Issuance				467	321
Total Issuance Public Placement					
Total Issuance Private Placement				467	321
Total Issuance				467	321
Issuance denominated in EURO				0	0
Issuance denominated in domestic currency (in m EUR)				467	321
Issuance denominated in other currencies (in m EUR)				0	0
Total Issuance				467	321
Issuance fixed bullet				0	0
Issuance floating bullet				0	0
Issuance others				467	321
Total Issuance				467	321
Maturity of bonds				26,0	

Notes: 2007 data - estimate

5.2.11 IRELAND

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector	12 362	27 204	40 965	49 914	51 204
Outstanding Covered Bonds backed by Mortgage	0	2 000	4 000	11 900	13 575
Outstanding Covered Bonds backed by Ships	0	0	0	0	0
Outstanding Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Outstanding	12 362	29 204	44 965	61 814	64 779
Outstanding Jumbo	11 490	25 418	32 467	39 417	41 440
Outstanding non-Jumbo	872	3 787	12 499	22 397	23 339
Total Outstanding	12 362	29 204	44 965	61 814	64 779
Total Outstanding Public Placement	11 999	27 278	35 050	43 557	43 833
Total Outstanding Private Placement	363	1 926	9 916	18 257	20 947
Total Outstanding	12 362	29 204	44 965	61 814	64 779
Outstanding denominated in EURO	10 881	26 696	37 312	52 800	52 328
Outstanding denominated in domestic currency (in m EUR)	0	0	0	0	0
Outstanding denominated in other currencies (in m EUR)	1 481	2 508	7 654	9 014	12 451
Total Outstanding	12 362	29 204	44 965	61 814	64 779
Outstanding fixed bullet	12 027	28 460	40 717	56 225	56 487
Outstanding floating bullet	335	631	1 955	2 635	4 906
Outstanding others	0	114	2 294	2 954	3 386
Total Outstanding	12 362	29 204	44 965	61 814	64 779
Maturity of bonds	6,6	6,9	7,9	7,9	6,2
Issuance (in million EUR)					
Total Covered Bonds Issuance	2 000	3 384	99	5 608	1 707
New Issues of Covered Bonds backed by Public Sector	12 362	15 047	13 576	9 722	9 533
New Issues of Covered Bonds backed by Mortgage	0	2 000	2 000	7 900	1 675
New Issues of Covered Bonds backed by Ships	0	0	0	0	0
New Issues of Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Issuance	12 362	17 047	15 576	17 622	11 208
Issuance Jumbo	11 490	14 000	6 907	12 259	3 883
Issuance non-Jumbo	872	3 047	8 669	5 363	7 325
Total Issuance	12 362	17 047	15 576	17 622	11 208
Total Issuance Public Placement	11 999	15 285	8 667	12 508	5 314
Total Issuance Private Placement	363	1 761	6 910	5 114	5 894
Total Issuance	12 362	17 047	15 576	17 622	11 208
Issuance denominated in EURO	10 881	15 816	10 593	15 182	6 612
Issuance denominated in domestic currency (in m EUR)	0	0	0	0	0
Issuance denominated in other currencies (in m EUR)	1 481	1 231	4 984	2 440	4 596
Total Issuance	12 362	17 047	15 576	17 622	11 208
Issuance fixed bullet	12 027	16 467	12 103	15 937	8 183
Issuance floating bullet	335	466	1 305	848	2 351
Issuance others	0	114	2 167	837	674
Total Issuance	12 362	17 047	15 576	17 622	11 208
Maturity of bonds	6,6	7,4	10,3	8,3	9,6

5.2.12 ITALY

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector			4.000	8.063	8.063
Outstanding Covered Bonds backed by Mortgage					
Outstanding Covered Bonds backed by Ships					
Outstanding Covered Bonds backed by Mixed Assets					
Total Outstanding	0	0	4.000	8.063	8.063
Outstanding Jumbo			4.000	8.000	8.000
Outstanding non-Jumbo			0	63	63
Total Outstanding	0	0	4.000	8.063	8.063
Total Outstanding Public Placement			4.000	8.000	8.000
Total Outstanding Private Placement			0	63	63
Total Outstanding	0	0	4.000	8.063	8.063
Outstanding denominated in EURO			4.000	8.000	8.000
Outstanding denominated in domestic currency (in m EUR)			0	0	0
Outstanding denominated in other currencies (in m EUR)				63	63
Total Outstanding	0	0	4.000	8.063	8.063
Outstanding fixed bullet			4.000	8.063	8.063
Outstanding floating bullet			0	0	0
Outstanding others			0	0	0
Total Outstanding	0	0	4.000	8.063	8.063
Maturity of bonds			6	5	
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector			4.000	2.063	
New Issues of Covered Bonds backed by Mortgage					
New Issues of Covered Bonds backed by Ships					
New Issues of Covered Bonds backed by Mixed Assets					
Total Issuance	0	0	4.000	2.063	0
Issuance Jumbo			4.000	2.000	
Issuance non-Jumbo			0	63	
Total Issuance	0	0	4.000	2.063	0
Total Issuance Public Placement			4.000	2.000	
Total Issuance Private Placement			0	63	
Total Issuance	0	0	4.000	2.063	0
Issuance denominated in EURO			4.000	2.000	
Issuance denominated in domestic currency (in m EUR)					
Issuance denominated in other currencies (in m EUR)				63	
Total Issuance	0	0	4.000	2.063	0
Issuance fixed bullet			4.000	2.000	
Issuance floating bullet			0	0	
Issuance others			0	63	
Total Issuance	0	0	4.000	2.063	0
Maturity of bonds			6	4	

5.2.13 LATVIA

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector	0	0	0	0	0
Outstanding Covered Bonds backed by Mortgage	35	54	60	63	36
Outstanding Covered Bonds backed by Ships	0	0	0	0	0
Outstanding Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Outstanding	35	54	60	63	36
Outstanding Jumbo	0	0	0	0	0
Outstanding non-Jumbo	35	54	60	63	36
Total Outstanding	35	54	60	63	36
Total Outstanding Public Placement	35	54	60	63	36
Total Outstanding Private Placement	0	0	0	0	0
Total Outstanding	35	54	60	63	36
Outstanding denominated in EURO	0	0	0	20	12
Outstanding denominated in domestic currency (in m EUR)	35	36	38	34	18
Outstanding denominated in other currencies (in m EUR)	0	18	21	8	6
Total Outstanding	35	54	60	63	36
Outstanding fixed bullet	26	27	26	21	12
Outstanding floating bullet	9	27	34	41	24
Outstanding others	0	0	0	0	0
Total Outstanding	35	54	60	63	36
Maturity of bonds	5,4	5,0	4,5	3,3	
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector	0	0	0	0	
New Issues of Covered Bonds backed by Mortgage	11	22	4	20	
New Issues of Covered Bonds backed by Ships	0	0	0	0	
New Issues of Covered Bonds backed by Mixed Assets	0	0	0	0	
Total Issuance	11	22	4	20	
Issuance Jumbo	0	0	0	0	
Issuance non-Jumbo	11	22	4	20	
Total Issuance	11	22	4	20	
Total Issuance Public Placement	11	22	4	20	
Total Issuance Private Placement	0	0	0	0	
Total Issuance	11	22	4	20	
Issuance denominated in EURO	0	0	0	20	
Issuance denominated in domestic currency (in m EUR)	11	3	4	0	
Issuance denominated in other currencies (in m EUR)	0	18	0	0	
Total Issuance	11	22	4	20	
Issuance fixed bullet	9	3	0	0	
Issuance floating bullet	2	18	4	20	
Issuance others	0	0	0	0	
Total Issuance	11	22	4	20	
Maturity of bonds	5,9	8,1	4,6	5,1	

Notes: 2007 data - estimate

5.2.14 LUXEMBOURG

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector	16 870	19 627	24 968	28 360	33 741
Outstanding Covered Bonds backed by Mortgage	0	0	0	150	150
Outstanding Covered Bonds backed by Ships	0	0	0	0	0
Outstanding Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Outstanding	16 870	19 627	24 968	28 510	33 891
Outstanding Jumbo	5 000	4 000	2 000	2 000	2 250
Outstanding non-Jumbo	11 870	15 627	22 968	26 510	31 641
Total Outstanding	16 870	19 627	24 968	28 510	33 891
Total Outstanding Public Placement	12 384	12 358	16 577	18 833	21 993
Total Outstanding Private Placement	4 486	7 270	8 391	9 677	11 898
Total Outstanding	16 870	19 627	24 968	28 510	33 891
Outstanding denominated in EURO	9 473	11 032	10 909	12 319	16 172
Outstanding denominated in domestic currency (in m EUR)	0	0	0	0	
Outstanding denominated in other currencies (in m EUR)	7 397	8 595	14 059	16 191	17 719
Total Outstanding	16 870	19 627	24 968	28 510	33 891
Outstanding fixed bullet	11 631	12 236	15 427	19 077	22 573
Outstanding floating bullet	4 465	5 489	7 376	7 217	9 210
Outstanding others	774	1 902	2 165	2 216	2 108
Total Outstanding	16 870	19 627	24 968	28 510	33 891
Maturity of bonds	4,0				
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector	4 528	5 516	9 611	9 730	10 052
New Issues of Covered Bonds backed by Mortgage	0	0	0	150	0
New Issues of Covered Bonds backed by Ships	0	0	0	0	0
New Issues of Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Issuance	4 528	5 516	9 611	9 880	10 052
Issuance Jumbo	750	0	0	0	250
Issuance non-Jumbo	3 778	5 516	9 611	9 880	9 802
Total Issuance	4 528	5 516	9 611	9 880	10 052
Total Issuance Public Placement	3 197	2 870	6 749	6 798	4 819
Total Issuance Private Placement	1 331	2 646	2 862	3 082	5 233
Total Issuance	4 528	5 516	9 611	9 880	10 052
Issuance denominated in EURO	2 131	3 589	2 468	3 628	5 773
Issuance denominated in domestic currency (in m EUR)	0	0	0	0	
Issuance denominated in other currencies (in m EUR)	2 397	1 927	7 143	6 252	4 279
Total Issuance	4 528	5 516	9 611	9 880	10 052
Issuance fixed bullet	2 828	3 516	7 511	8 092	5 425
Issuance floating bullet	1 500	1 600	1 700	1 601	4 448
Issuance others	200	400	400	187	178
Total Issuance	4 528	5 516	9 611	9 880	10 051
Maturity of bonds	4,0				

5.2.15 NETHERLANDS

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector			0	0	0
Outstanding Covered Bonds backed by Mortgage			2 000	7 500	15 727
Outstanding Covered Bonds backed by Ships			0	0	0
Outstanding Covered Bonds backed by Mixed Assets			0	0	0
Total Outstanding			2 000	7 500	15 727
Outstanding Jumbo			2 000	5 500	11 000
Outstanding non-Jumbo			0	2 000	4 727
Total Outstanding			2 000	7 500	15 727
Total Outstanding Public Placement			2 000	5 500	11 000
Total Outstanding Private Placement			0	2 000	4 727
Total Outstanding			2 000	7 500	15 727
Outstanding denominated in EURO			2 000	6 400	14 319
Outstanding denominated in domestic currency (in m EUR)			0	0	0
Outstanding denominated in other currencies (in m EUR)			0	1 100	1 408
Total Outstanding			2 000	7 500	15 727
Outstanding fixed bullet			2 000	7 200	13 725
Outstanding floating bullet			0	0	1 647
Outstanding others			0	300	355
Total Outstanding			2 000	7 500	15 727
Maturity of bonds					
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector			0	0	0
New Issues of Covered Bonds backed by Mortgage			2 000	5 500	8 227
New Issues of Covered Bonds backed by Ships			0	0	0
New Issues of Covered Bonds backed by Mixed Assets			0	0	0
Total Issuance			2 000	5 500	8 227
Issuance Jumbo			2 000	3 500	5 500
Issuance non-Jumbo			0	2 000	2 727
Total Issuance			2 000	5 500	8 227
Total Issuance Public Placement			2 000	3 500	5 500
Total Issuance Private Placement			0	2 000	2 727
Total Issuance			2 000	5 500	8 227
Issuance denominated in EURO			2 000	4 400	7 919
Issuance denominated in domestic currency (in m EUR)			0	0	0
Issuance denominated in other currencies (in m EUR)			0	1 100	308
Total Issuance			2 000	5 500	8 227
Issuance fixed bullet			2 000	5 200	6 525
Issuance floating bullet			0	0	1 647
Issuance others			0	300	55
Total Issuance			2 000	5 500	8 227
Maturity of bonds					

5.2.16 NORWAY

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector					0
Outstanding Covered Bonds backed by Mortgage					6 009
Outstanding Covered Bonds backed by Ships					0
Outstanding Covered Bonds backed by Mixed Assets					0
Total Outstanding					6 009
Outstanding Jumbo					4 500
Outstanding non-Jumbo					1 509
Total Outstanding					6 009
Total Outstanding Public Placement					6 009
Total Outstanding Private Placement					
Total Outstanding					6 009
Outstanding denominated in EURO					4 500
Outstanding denominated in domestic currency (in m EUR)					1 071
Outstanding denominated in other currencies (in m EUR)					438
Total Outstanding					6 009
Outstanding fixed bullet					5 569
Outstanding floating bullet					440
Outstanding others					0
Total Outstanding					6 009
Maturity of bonds					
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector					0
New Issues of Covered Bonds backed by Mortgage					6 009
New Issues of Covered Bonds backed by Ships					0
New Issues of Covered Bonds backed by Mixed Assets					0
Total Issuance					6 009
Issuance Jumbo					4 500
Issuance non-Jumbo					1 509
Total Issuance					6 009
Total Issuance Public Placement					6 009
Total Issuance Private Placement					
Total Issuance					4 122
Issuance denominated in EURO					4 500
Issuance denominated in domestic currency (in m EUR)					1 071
Issuance denominated in other currencies (in m EUR)					438
Total Issuance					6 009
Issuance fixed bullet					5 569
Issuance floating bullet					440
Issuance others					0
Total Issuance					6 009
Maturity of bonds					

5.2.17 POLAND

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector					131
Outstanding Covered Bonds backed by Mortgage	160	220	558	453	676
Outstanding Covered Bonds backed by Ships					
Outstanding Covered Bonds backed by Mixed Assets					
Total Outstanding	160	220	558	453	807
Outstanding Jumbo					
Outstanding non-Jumbo	160	220	558	453	807
Total Outstanding	160	220	558	453	807
Total Outstanding Public Placement	91	91	265	339	
Total Outstanding Private Placement	69	129	293	114	
Total Outstanding	160	220	558	453	807
Outstanding denominated in EURO	37	62	62	62	
Outstanding denominated in domestic currency (in m EUR)	111	115	440	357	
Outstanding denominated in other currencies (in m EUR)	11	43	56	34	
Total Outstanding	159	220	558	453	807
Outstanding fixed bullet	4	4	4	4	
Outstanding floating bullet	156	216	554	450	
Outstanding others	0	0	0	0	
Total Outstanding	160	220	558	453	807
Maturity of bonds	6,0	5,0	5,0	5,0	
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector	0	0	0	0	131
New Issues of Covered Bonds backed by Mortgage	123	63	224	52	206
New Issues of Covered Bonds backed by Ships	0	0	0	0	
New Issues of Covered Bonds backed by Mixed Assets	0	0	0	0	
Total Issuance	123	63	224	52	337
Issuance Jumbo					
Issuance non-Jumbo	123	63	224	52	337
Total Issuance	123	63	224	52	337
Total Issuance Public Placement	91	0	174	52	206
Total Issuance Private Placement	32	63	50	0	
Total Issuance	123	63	224	52	337
Issuance denominated in EURO	23	25	0	0	
Issuance denominated in domestic currency (in m EUR)	100	7	211	52	206
Issuance denominated in other currencies (in m EUR)	0	31	12	0	
Total Issuance	123	63	223	52	337
Issuance fixed bullet	0	0	0	0	
Issuance floating bullet	123	63	224	52	206
Issuance others	0	0	0	0	
Total Issuance	123	63	224	52	337
Maturity of bonds	5,0	5,0	5,0	5,0	

5.2.18 PORTUGAL

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector					
Outstanding Covered Bonds backed by Mortgage				2 900	7 850
Outstanding Covered Bonds backed by Ships					
Outstanding Covered Bonds backed by Mixed Assets					
Total Outstanding				2 900	7 850
Outstanding Jumbo				2 000	6 500
Outstanding non-Jumbo				900	1 350
Total Outstanding				2 900	7 850
Total Outstanding Public Placement				2 000	6 500
Total Outstanding Private Placement				900	1 350
Total Outstanding				2 900	7 850
Outstanding denominated in EURO				2 900	7 850
Outstanding denominated in domestic currency (in m EUR)					
Outstanding denominated in other currencies (in m EUR)					
Total Outstanding				2 900	7 850
Outstanding fixed bullet				2 000	6 500
Outstanding floating bullet				900	1 350
Outstanding others					
Total Outstanding				2 900	7 850
Maturity of bonds				9,9	8,4
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector					
New Issues of Covered Bonds backed by Mortgage				2 900	4 950
New Issues of Covered Bonds backed by Ships					
New Issues of Covered Bonds backed by Mixed Assets					
Total Issuance				2 900	4 950
Issuance Jumbo				2 000	4 500
Issuance non-Jumbo				900	450
Total Issuance				2 900	4 500
Total Issuance Public Placement				2 000	4 500
Total Issuance Private Placement				900	450
Total Issuance				2 900	4 950
Issuance denominated in EURO				2 900	4 950
Issuance denominated in domestic currency (in m EUR)					
Issuance denominated in other currencies (in m EUR)					
Total Issuance				2 900	4 950
Issuance fixed bullet				2 000	4 500
Issuance floating bullet				900	450
Issuance others					
Total Issuance				2 900	4 950
Maturity of bonds				10,0	7,6

5.2.19 SPAIN

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector	4 900	7 200	9 640	11 590	16 375
Outstanding Covered Bonds backed by Mortgage	57 111	94 707	150 213	214 768	266 959
Outstanding Covered Bonds backed by Ships	0	0	0	0	0
Outstanding Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Outstanding	62 011	101 907	159 853	226 358	283 334
Outstanding Jumbo	60 598	98 683	155 463	220 058	268 723
Outstanding non-Jumbo	1 413	3 224	4 390	6 300	14 611
Total Outstanding	62 011	101 907	159 853	226 358	283 334
Total Outstanding Public Placement	62 011	101 907	159 853	226 358	282 631
Total Outstanding Private Placement	0	0	0	0	703
Total Outstanding	62 011	101 907	159 853	226 358	283 334
Outstanding denominated in EURO	62 011	101 907	159 853	226 358	283 334
Outstanding denominated in domestic currency (in m EUR)	0	0	0	0	0
Outstanding denominated in other currencies (in m EUR)	0	0	0	0	0
Total Outstanding	62 011	101 907	159 853	226 358	283 334
Outstanding fixed bullet	61 921	100 417	153 588	212 878	238 273
Outstanding floating bullet	90	1 490	6 265	13 480	45 061
Outstanding others	0	0	0	0	0
Total Outstanding	62 011	101 907	159 853	226 358	283 334
Maturity of bonds	7,5	7,6	8,0	8,3	7,5
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector	5 600	1 600	2 440	5 150	5 060
New Issues of Covered Bonds backed by Mortgage	28 502	37 835	57 780	69 890	51 801
New Issues of Covered Bonds backed by Ships	0	0	0	0	0
New Issues of Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Issuance	34 102	39 435	60 220	75 040	56 861
Issuance Jumbo	31 800	36 335	58 780	69 230	50 955
Issuance non-Jumbo	2 302	3 100	1 440	5 810	5 906
Total Issuance	34 102	39 435	60 220	75 040	56 861
Total Issuance Public Placement	34 102	39 435	60 220	75 040	56 158
Total Issuance Private Placement	0	0	0	0	703
Total Issuance	34 102	39 435	60 220	75 040	56 861
Issuance denominated in EURO	34 102	39 435	60 220	75 040	56 861
Issuance denominated in domestic currency (in m EUR)	0	0	0	0	0
Issuance denominated in other currencies (in m EUR)	0	0	0	0	0
Total Issuance	34 102	39 435	60 220	75 040	56 861
Issuance fixed bullet	33 312	38 635	55 545	66 125	35 870
Issuance floating bullet	790	800	4 675	8 915	20 991
Issuance others	0	0	0	0	0
Total Issuance	34 102	39 435	60 220	75 040	56 861
Maturity of bonds	5,4	6,6	10,4	10,5	9,3

5.2.20 SWEDEN

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector				0	0
Outstanding Covered Bonds backed by Mortgage				55 267	92 254
Outstanding Covered Bonds backed by Ships				0	0
Outstanding Covered Bonds backed by Mixed Assets				0	0
Total Outstanding				55 267	92 254
Outstanding Jumbo				5 283	11 114
Outstanding non-Jumbo				49 984	81 140
Total Outstanding				55 267	92 254
Total Outstanding Public Placement				54 781	90 780
Total Outstanding Private Placement				486	1 474
Total Outstanding				55 267	92 254
Outstanding denominated in EURO				5 283	13 171
Outstanding denominated in domestic currency (in m EUR)				49 474	77 436
Outstanding denominated in other currencies (in m EUR)				510	1 648
Total Outstanding				55 267	92 254
Outstanding fixed bullet				55 029	88 944
Outstanding floating bullet				21	3 046
Outstanding others				217	265
Total Outstanding				55 267	92 254
Maturity of bonds				2,8	2,6
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector				0	0
New Issues of Covered Bonds backed by Mortgage				17 569	36 638
New Issues of Covered Bonds backed by Ships				0	0
New Issues of Covered Bonds backed by Mixed Assets				0	0
Total Issuance				17 569	36 638
Issuance Jumbo				5 283	5 875
Issuance non-Jumbo				12 286	30 762
Total Issuance				17 569	36 638
Total Issuance Public Placement				17 482	36 084
Total Issuance Private Placement				87	554
Total Issuance				17 569	36 638
Issuance denominated in EURO				5 283	7 085
Issuance denominated in domestic currency (in m EUR)				11 794	28 417
Issuance denominated in other currencies (in m EUR)				492	1 135
Total Issuance				17 569	36 638
Issuance fixed bullet				17 560	35 779
Issuance floating bullet				2	752
Issuance others				7	107
Total Issuance				17 569	36 638
Maturity of bonds				4,1	3,1

5.2.21 SWITZERLAND

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector	0	0	0	0	0
Outstanding Covered Bonds backed by Mortgage	30 326	29 941	29 010	29 395	29 013
Outstanding Covered Bonds backed by Ships	0	0	0	0	0
Outstanding Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Outstanding	30 326	29 941	29 010	29 395	29 013
Outstanding Jumbo	0	0	0	0	0
Outstanding non-Jumbo	30 326	29 941	29 010	29 395	29 013
Total Outstanding	30 326	29 941	29 010	29 395	29 013
Total Outstanding Public Placement					
Total Outstanding Private Placement					
Total Outstanding	30 326	29 941	29 010	29 395	29 013
Outstanding denominated in EURO	0	0	0	0	0
Outstanding denominated in domestic currency (in m EUR)	30 326	29 941	29 010	29 395	29 013
Outstanding denominated in other currencies (in m EUR)	0	0	0	0	0
Total Outstanding	30 326	29 941	29 010	29 395	29 013
Outstanding fixed bullet	30 326	29 941	29 010	29 395	29 013
Outstanding floating bullet	0	0	0	0	0
Outstanding others	0	0	0	0	0
Total Outstanding	30 326	29 941	29 010	29 395	29 013
Maturity of bonds					
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector	0	0	0	0	0
New Issues of Covered Bonds backed by Mortgage	3 027	2 755	4 171	4 967	4 559
New Issues of Covered Bonds backed by Ships	0	0	0	0	0
New Issues of Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Issuance	3 027	2 755	4 171	4 967	4 559
Issuance Jumbo					
Issuance non-Jumbo	3 027	2 755	4 171	4 967	4 559
Total Issuance	3 027	2 755	4 171	4 967	4 559
Total Issuance Public Placement	2 500	2 342	3 940	4 047	4 076
Total Issuance Private Placement	527	413	231	920	483
Total Issuance	3 027	2 755	4 171	4 967	4 559
Issuance denominated in EURO	0	0	0	0	0
Issuance denominated in domestic currency (in m EUR)	3 027	2 755	4 171	4 967	4 559
Issuance denominated in other currencies (in m EUR)	0	0	0	0	0
Total Issuance	3 027	2 755	4 171	4 967	4 559
Issuance fixed bullet	3 027	2 755	4 171	4 967	4 559
Issuance floating bullet	0	0	0	0	0
Issuance others	0	0	0	0	0
Total Issuance	3 027	2 755	4 171	4 967	4 559
Maturity of bonds					

Note: Breakdown between outstanding public and private placement not available

5.2.22 UNITED KINGDOM

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector	0	0	0	0	0
Outstanding Covered Bonds backed by Mortgage	5 000	14 959	26 778	50 548	81 964
Outstanding Covered Bonds backed by Ships	0	0	0	0	0
Outstanding Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Outstanding	5 000	14 959	26 778	50 548	81 964
Outstanding Jumbo	5 000	14 250	23 250	45 269	66 774
Outstanding non-Jumbo	0	709	3 528	5 279	15 190
Total Outstanding	5 000	14 959	26 778	50 548	81 964
Total Outstanding Public Placement	5 000	14 250	23 250	45 269	66 774
Total Outstanding Private Placement	0	709	3 528	5 279	15 190
Total Outstanding	5 000	14 959	26 778	50 548	81 964
Outstanding denominated in EURO	5 000	14 250	24 384	44 884	69 672
Outstanding denominated in domestic currency (in m EUR)	0	709	2 335	3 127	4 704
Outstanding denominated in other currencies (in m EUR)	0	0	60	2 536	7 588
Total Outstanding	5 000	14 959	26 778	50 548	81 964
Outstanding fixed bullet	5 000	14 959	24 689	48 467	76 515
Outstanding floating bullet	0	0	2 089	2 081	4 563
Outstanding others	0	0	0	0	886
Total Outstanding	5 000	14 959	26 778	50 548	81 964
Maturity of bonds					
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector	0	0	0	0	0
New Issues of Covered Bonds backed by Mortgage	5 000	9 959	11 819	23 770	31 874
New Issues of Covered Bonds backed by Ships	0	0	0	0	0
New Issues of Covered Bonds backed by Mixed Assets	0	0	0	0	0
Total Issuance	5 000	9 959	11 819	23 770	31 874
Issuance Jumbo	5 000	9 250	9 000	22 019	21 665
Issuance non-Jumbo	0	709	2 819	1 751	10 208
Total Issuance	5 000	9 959	11 819	23 770	31 874
Total Issuance Public Placement	5 000	9 250	9 000	22 019	21 665
Total Issuance Private Placement	0	709	2 819	1 751	10 208
Total Issuance	5 000	9 959	11 819	23 770	31 874
Issuance denominated in EURO	5 000	9 250	10 134	20 500	24 788
Issuance denominated in domestic currency (in m EUR)	0	709	1 626	745	1 841
Issuance denominated in other currencies (in m EUR)	0	0	60	2 525	5 245
Total Issuance	5 000	9 959	11 819	23 770	31 874
Issuance fixed bullet	5 000	9 959	9 730	23 770	28 424
Issuance floating bullet	0	0	2 089	0	2 564
Issuance others	0	0	0	0	886
Total Issuance	5 000	9 959	11 819	23 770	31 874
Maturity of bonds					

5.2.23 UNITED STATES

Outstanding (in million EUR)	2003	2004	2005	2006	2007
Total Covered Bonds Outstanding					
Outstanding Covered Bonds backed by Public sector				4.000	12.859
Outstanding Covered Bonds backed by Mortgage				0	0
Outstanding Covered Bonds backed by Ships				0	0
Outstanding Covered Bonds backed by Mixed Assets				0	0
Total Outstanding				4.000	12.859
Outstanding Jumbo				4.000	12.859
Outstanding non-Jumbo				0	0
Total Outstanding				4.000	12.859
Total Outstanding Public Placement				4.000	12.859
Total Outstanding Private Placement				0	
Total Outstanding				4.000	12.859
Outstanding denominated in EURO				4.000	11.500
Outstanding denominated in domestic currency (in m EUR)				0	1.359
Outstanding denominated in other currencies (in m EUR)				0	0
Total Outstanding				4.000	12.859
Outstanding fixed bullet					
Outstanding floating bullet					
Outstanding others					
Total Outstanding					
Maturity of bonds					
Issuance (in million EUR)					
Total Covered Bonds Issuance					
New Issues of Covered Bonds backed by Public Sector				0	
New Issues of Covered Bonds backed by Mortgage				4.000	8.859
New Issues of Covered Bonds backed by Ships					0
New Issues of Covered Bonds backed by Mixed Assets				0	0
Total Issuance				4.000	8.859
Issuance Jumbo				4.000	8.859
Issuance non-Jumbo				0	0
Total Issuance				4.000	8.859
Total Issuance Public Placement				4.000	8.859
Total Issuance Private Placement				0	0
Total Issuance				4.000	8.859
Issuance denominated in EURO				4.000	7.500
Issuance denominated in domestic currency (in m EUR)				0	1.359
Issuance denominated in other currencies (in m EUR)				0	0
Total Issuance				4.000	8.859
Issuance fixed bullet					
Issuance floating bullet					
Issuance others					
Total Issuance					
Maturity of bonds					

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The Covered Bond Voice of the European Mortgage Federation

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