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The Covered Bond Voice of the European Mortgage Federation

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Contact Details

Luca Bertalot
Head of European Covered Bond Council
lbertalot@hypo.org

Sophie Blave
Administrative Assistant
sblave@hypo.org

EUROPEAN MORTGAGE FEDERATION
Av de la Joyeuse Entrée 14/2
B - 1040 Brussels
Tel: + 32 2 285 40 30

LIST OF EDITORS

We would like to extend a special thanks to the Editorial Committee, whose work has made this ECBC Factbook possible.

Michelle Bradley
Associate - Covered Bonds Research
MORGAN STANLEY BANK
michelle.bradley@morganstanley.com

Ralf Burmeister
Senior Credit Analyst
LANDESBANK BADEN-WÜRTTEMBERG
ralf.burmeister@lbbw.de

Niamh Haughey
Associate
DEPFA BANK PLC
niamh.haughey@depfa.com

Wolfgang Kälberer
Head of Brussels Office
VERBAND DEUTSCHER PFANDBRIEFBANKEN
kaelberer@pfandbrief.de

Peter Munch-Madsen
Head of Brussels Office
ASSOCIATION OF DANISH MORTGAGE BANKS
pmm@realkreditraadet.dk

Jennifer Johnson
Head of Valuation
EUROPEAN MORTGAGE FEDERATION
jjohnson@hypo.org

Amy Bouckley
Personal Assistant to the Secretary General
EUROPEAN MORTGAGE FEDERATION
Abouckley@hypo.org

LIST OF CONTRIBUTORS

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

CHAPTER 1
KEY THEMES OF THE YEAR

Ted Packmohr
Covered Bond Analyst
DRESDNER KLEINWORT
ted.packmohr@drkw.com

Fritz Engelhard
Covered Bond Strategist
BARCLAYS CAPITAL
fritz.engelhard@barclayscapital.com

Regina Koelsch
Senior Covered Bond Strategist
UBS
regina.koelsch@ubs.com

Michelle Bradley
Associate - Covered Bonds research
MORGAN STANLEY BANK
michelle.bradley@morganstanley.com

Frank Will
Senior Strategic
RBS – ROYAL BANK OF SCOTLAND
frank.will@rbos.com

Alain Marcel
Chairman's Adviser
CAISSE CENTRALE DU CRÉDIT IMMOBILIER DE FRANCE – 3CIF
alain.marcel@3cif.fr

Bernd Volk
Vice President; Director; Senior Covered Bonds Analyst
DEUTSCHE BANK
Bernd.volk@db.com

CHAPTER 2
GENERIC SECTION

Ralf Grossmann
Senior Analyst - Covered Bond markets
NATIXIS
rgrossmann@ixis-cib.com

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

CHAPTER 3
THE ISSUER'S PERSPECTIVE

CZECH REPUBLIC

Pavel Kühn
Deputy Division Director
ČESKÁ BANKOVNÍ ASOCIACE - CZECH BANKING ASSOCIATION
pkuhn@csas.cz

DENMARK

Lars Blume-Jensen
Head of Funding & Statistics Department
ASSOCIATION OF DANISH MORTGAGE BANKS
lbj@realkreditraadet.dk

Svend Bondorf
Vice President - Research and Development
NYKREDIT GROUP TREASURY
SBO@nykredit.dk

GERMANY

Wolfgang Kälberer
Head of Brussels Office
VERBAND DEUTSCHER PFANDBRIEFBANKEN - VDP
kaelberer@pfandbrief.de

Otmar Stöcker
Managing Director
VERBAND DEUTSCHER PFANDBRIEFBANKEN - VDP
stoecker@pfandbrief.de

SPAIN

Juan Garcia Muñoz
Secretary General
SPANISH MORTGAGE ASSOCIATION
jgarcia@ahe.es

FRANCE

Francis Gleyze
Director General of CIF Euromortgage
CAISSE CENTRALE DU CREDIT IMMOBILIER DE FRANCE
francis.gleyze@3cif.fr

Henry Raymond
Chief Executive Officer
CAISSE DE REFINANCEMENT DE L'HABITAT
crh@wanadoo.fr

Simon Martin
Head of Covered Bond Structuring, France and Italy
BNP PARIBAS
simon.martin@uk.bnpparibas.com

IRELAND

Nicholas Pheifer
Head of Legal
DEPFA BANK
nicholas.pheifer@depfa.com

ITALY (CDP)

Monica Tamisari
Senior Covered Bond Analyst
CASSA DEPOSITI E PRESTITI
monica.tamisari@cassaddpp.it

ITALY (GENERAL FRAMEWORK)

Alfredo Varrati
Adviser - Credit and Internationalisation Department
ITALIAN BANKERS ASSOCIATION
a.varrati@abi.it

LATVIA

Kaspars Gibeiko
Head of the Mortgage Deals Administration
MORTGAGE AND LAND BANK OF LATVIA
kasparsg@hipo.lv

LUXEMBOURG

Frank Will
Senior Strategist – Frequent Borrower Group
ROYAL BANK OF SCOTLAND
frank.will@rbos.com

HUNGARY

András Gábor Botos
Secretary General
ASSOCIATION OF HUNGARIAN MORTGAGE BANKS
jelzbank@axelero.hu

Rita Mayer
Director
FHB LAND & MORTGAGE BANK
mayerner@fhb.hu

THE NETHERLANDS

Christian Moor
Associate Director
HSBC BANK
christian.moor@hsbcgroup.com

AUSTRIA

Michelle Bradley
Associate - Covered Bonds Research
MORGAN STANLEY BANK
michelle.bradley@morganstanley.com

Roland Berger
BANK AUSTRIA CREDITANSTALT
Roland.berger@ba-ca.com

POLAND

Agnieszka Drewicz-Tułodziecka
President
MORTGAGE CREDIT FOUNDATION
a.drew-tulo@fukrehip.pl

Piotr Cyburt
CEO
BRE BANK HIPOTECZNY
piotr.cyburt@rhb.com.pl

PORTUGAL

Alda Pereira
Capital Markets Funding & Origination
CAIXA GÉRAL DE DEPÓSITOS
alda.pereira@cgd.pt

ROMANIA

Carmen Retegan
Chief Executive Officer
DOMENIA CREDIT
carmen.retegan@domenia.ro

FINLAND

Ralf Burmeister
Senior Credit Analyst
LANDESBANK BADEN-WÜRTTEMBERG
ralf.burmeister@lbbw.de

Martti Porkka
Managing Director
AKTIA REAL ESTATE MORTGAGE BANK
Martti.porkka@aktia.fi

SWEDEN

Regina Koelsch
Senior Covered Bond Strategist
UBS
regina.koelsch@ubs.com

Tomas Tetzell
Chief Lawyer
SWEDISH BANKERS' ASSOCIATION
tomas.tetzell@bankforeningen.se

UK

Fritz Engelhard
Covered Bond Strategist
BARCLAYS CAPITAL
fritz.engelhard@barclayscapital.com

Neil Sankoff
Director, Covered Bond and ABS Issuance
HSBC BANK
neil.sankoff@hsbcib.com

NORWAY

Stein Sjølie
Director, Financial and Legal Department
NORWEGIAN FINANCIAL SERVICES ASSOCIATION
stein.sjolie@fnh.no

Bernd Volk
Vice President; Director; Senior Covered Bonds Analyst
DEUTSCHE BANK
Bernd.volk@db.com

SWITZERLAND

Regina Koelsch
Senior Covered Bond Strategist
UBS
regina.koelsch@ubs.com

Andreas Flatt
Corporate Executive Director
PFANDBRIEFZENTRALE DER SCHWEIZERISCHEN KANTONALBANKEN
andreas.flatt@zkb.ch

Joerg Schmid
Corporate Executive Director
PFANDBRIEFBANK SCHWEIZERISCHER HYPOTHEKARINSTITUTE
joerg.schmid@pfandbriefbank.ch

UKRAINE

Anton Sergeev
Executive Director
UKRAINIAN NATIONAL MORTGAGE ASSOCIATION
sergeev@unia.com.ua

Arsen Nizelsky
Senior Legal Advisor
UKRAINIAN NATIONAL MORTGAGE ASSOCIATION
nizelsky@mortgage.in.ua

Konstantin Kuczerenko
Legal Advisor
UKRAINIAN NATIONAL MORTGAGE ASSOCIATION
kucherenko@unia.com.ua

UNITED STATES

Chris Ginieczki
First Vice President
WASHINGTON MUTUAL
christopher.ginieczki@wamu.net

CHAPTER 4
THE INVESTOR'S PERSPECTIVE

Felix Blomenkamp
Asset- Backed Securities Specialist
PIMCO

Ulrich Frølich
Senior Portfolio Manager
DANSKE CAPITAL
ufr@danskecapital.com

Lisbeth Alber
Senior Portfolio Manager
DANSKE CAPITAL
lal@danskecapital.com

Rasmus Majborn
Analyst
DANSKE CAPITAL
rmaj@danskecapital.com

Torsten Strohrmann
Vice President, Senior Portfolio Manager
DWS INVESTMENT
torsten.strohrmann@dws.com

CHAPTER 5
RATING AGENCIES & METHODOLOGY

Helene Heberlein
Managing Director and Head of European Covered Bonds
FITCH RATINGS
Helene.Heberlein@fitchratings.com

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

Nicholas Lindstrom
Team Leader for European Covered Bonds - Senior Vice President
MOODY'S
nicholas.lindstrom@moodys.com

Jörg Homey
Assistant Vice-President
MOODY'S
Joerg.homey@moodys.com

Karen Naylor
Managing Director
STANDARD & POOR'S
karen_naylor@standardandpoors.com

Karlo Fuchs
Associate Director
STANDARD & POOR'S
karlo_fuchs@standardandpoors.com

Sabrina Miehs
Associate Director
STANDARD & POOR'S
sabrina_miehs@standardandpoors.com

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FOREWORD

The European Covered Bond market is one of the most dynamic segments of the European capital market. As such, it is one of the main driving forces behind the integration of European financial and mortgage markets. This was highlighted respectively by the Financial Services Action Plan and the Mortgage Funding Expert Group report published in December 2006. With the volume outstanding in more than 20 countries amounting to 1.9 trillion EUR in 2006, Covered Bonds play a significant role in the financial system and contribute not only to the efficient allocation of capital, but also ultimately to economic growth.

The internationalisation of formerly domestic Covered Bond markets began 10 years ago with the introduction of a new benchmark product attracting international institutional investors and providing the necessary market liquidity. As a consequence, a majority of European countries have either introduced new Covered Bond legislation or overhauled existing rules in order to be a part of this development and to respond to the considerable growth of mortgage lending activities in the European Union.

The overwhelming developments in Covered Bonds led the European Mortgage Federation to launch the European Covered Bond Council (ECBC) in late 2004. Almost three years later, the ECBC has succeeded in attracting more than 84 members including Covered Bond issuers, investment banks, research analysts, rating agencies and trading platforms. The ECBC represents almost 85% of all Covered Bond issuers in the EU. The ECBC's 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. Recently, significant regulatory developments have been observed in certain number of countries. Existing Covered Bond frameworks have been amended or new Covered Bond legislation has been introduced.

Following on from the outstanding success of the first edition of the European Covered Bond Fact Book in 2006, the ECBC is pleased to present herewith the 2007 edition of the Fact Book, which is designed to be a comprehensive source of information on the different national Covered Bond markets and their legal basis. The first chapter of the book consists of expert articles on the key themes of the year. In Chapter 2 the book provides a generic section on the European Covered Bond market by outlining the history of this asset class and its main features. It provides information on the different legal frameworks that exist (both at national and EU level), detailing the common characteristics of Covered Bond models throughout Europe in terms of framework, cover assets, asset-liability guidelines and valuation, among others, and highlighting who the main investors are. Chapter 3 is comprised of summaries covering 22 different countries and includes relevant statistics. Chapter 4 provides an insight into different investor perspectives and Chapter 5 covers rating agencies' Covered Bond methodologies. The Annex to the book contains the Covered Bond statistics for each country and the comparative table of the different Covered Bond frameworks elaborated by the ECBC Technical Issues Working Group.

Special thanks must be extended to the members of the 'Technical', 'Statistic' and 'Fact Book' working groups of the ECBC, the dedication of whom has resulted in the publication of this 2007 edition of the ECBC European Covered Bond Fact Book.

Annik Lambert
Secretary General
European Mortgage Federation

Louis Hagen
Chairman
European Covered Bond Council

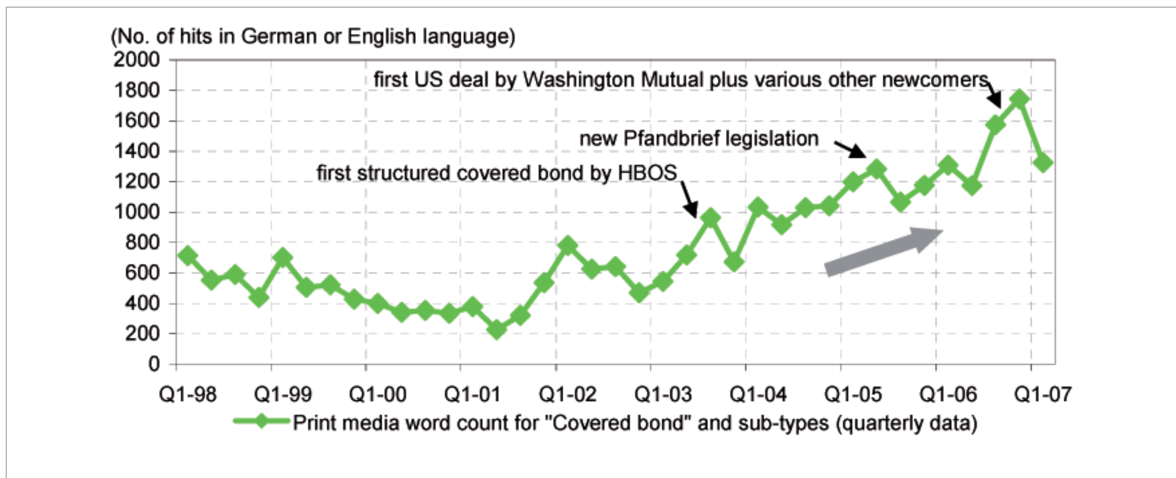
CHAPTER I - KEY THEMES OF THE YEAR

1.1 COVERED BONDS GOING GLOBAL

By Ted Packmohr, Dresdner Kleinwort

Covered Bonds have become a buzzword. This is not only reflected in the growing number of conferences held almost monthly somewhere in the world; but also in the increased enthusiasm amongst the media. A closer look at the frequency of use of the term "Covered Bond" (including its product subtypes) in print media, as summarised in the graph below, demonstrates the growing public interest. This increase in attention has of course partly to do with the rise in issuing activities (quarterly correlation based on Jumbo issuance data: +57%). At the same time, various key events have prompted additional interest in Covered Bonds across a broad front. These two factors are inseparable from the regional expansion of both the issuer and the investor base of the Covered Bond market, which has gained a truly global reach.

Chart 1: Growing popularity of Covered Bonds is reflected in media coverage



Source: Factiva, Dresdner Kleinwort Debt research

Taking the €-Jumbo market as an example, the internationalisation of the issuer space is clearly noticeable in Covered Bond issuance statistics: While in 2001, 80% of the new Jumbo issuance volume was still in the form of German Pfandbriefe, their share had fallen to only 23% five years later. This was partly due to the strong issuance momentum displayed by the Spanish banks for example. Moreover this trend was fostered by the large number of newcomers: 2006 saw a record of 14 new issuers joining the Jumbo club, including three from countries totally new to this market segment. And with already another four newcomers in Q1/07 there is no end to this trend is yet in sight.

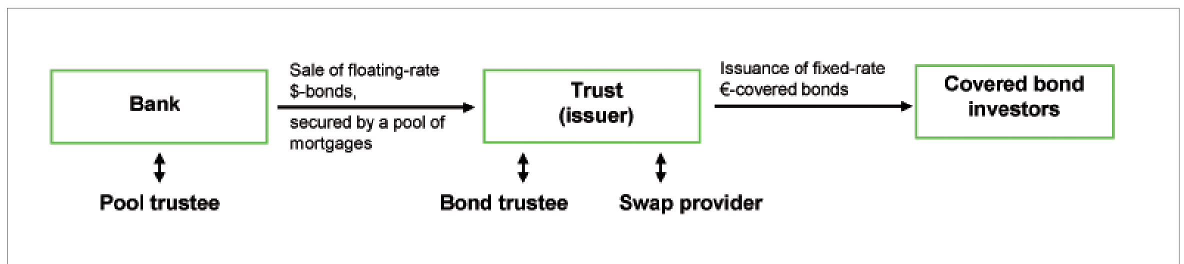
As it is widely known, Western Europe continues to be at the heart of the Covered Bond market: Only few blank spaces are left on the European Covered Bond country map. Nevertheless, the Covered Bond market has in the meantime been stretching far beyond European borders. This development dates back to 2003 when HBOS established the market segment of structured Covered Bonds, which allows the issuance outside of any specific legislative framework. As a result, no general legislative barriers seem to exist for the Covered Bond product anymore when including such purely structural set-ups, and it has thus become a subject of discussion among potential issuers across the world. To illustrate how Covered Bonds are slowly but surely gaining a global foothold, let us go on a journey across continents by briefly examining a selection of individual country case studies.

NORTH AMERICA: USA

Rarely has a new market participant attracted as much degree of attention as *Washington Mutual* did when it prepared and launched the inaugural US Covered Bond deal in Q3/2006. Hopes were very high for the entry of the $350bn institution to finally clear the way for Covered Bonds' conquering of the huge US market. Given the well-established local agency and MBS segments, US investors had formerly never really engaged with Covered Bonds on a large scale, despite continuous marketing efforts. Even dollar-denominated Covered Bonds were traditionally barely sold to a US client base but mainly to Asian central banks investing their currency reserves. As such, it was hoped that the creation of a US Covered Bond model would represent a breakthrough for the asset class in various ways.

Since there is no dedicated Covered Bond legislation in the US, issuers have to resort to structuring techniques to create respective characteristics. In contrast to the structuring scheme established by the UK and Dutch banks, however, the two US institutions active so far employ a model whereby a trust acts as issuer to the markets instead of the bank itself (for further details see country report in this fact book). It remains to be seen whether this model will also serve as a blueprint for future issuers.

CHART 2: SIMPLIFIED STRUCTURAL OVERVIEW OF COVERED BONDS ISSUED BY WAMU AND BOA



Source: Dresdner Kleinwort Debt research

Have US Covered Bonds managed to live up to the high expectations so far?

> **Market acceptance:** Admittedly, initial feedback from investors on the structural set-up was not all positive. In addition, uncertainty over some basic features such as ECB eligibility persisted for some time. Nevertheless, *Washington Mutual's* inaugural double-tranche deal was able to boast one of the largest order books ever collected in the Covered Bond market and turned in a relatively stable performance in the secondary market directly after launch. While the US papers trade towards the upper end of the Jumbo spread universe, they have thus turned out to be a successful addition to the market.

> **Growth:** While *Washington Mutual's* success prompted hopes of a quick rise of US issuance, the segment was probably somewhat held back by the slowing of the US housing market and the associated sub-prime turmoil. Nonetheless, not only did *Washington Mutual* succeed in a second issuance round in May 2007, but *Bank of America* also entered the Covered Bond market in March and further banks are expected to join the club later this year. US Covered Bonds are therefore well on the way to establishing themselves firmly in the market.

- **Domestic demand:** US investor interest in Covered Bonds has certainly moved up a gear as a result of the market entry of local firms and should be further enhanced once the US banks choose to also tap the dollar Covered Bond market more frequently. This works to the benefit of all Covered Bond issuers and the development of the dollar segment in particular.

Hence, no wonder that market participants are now also turning their attention to **Canada** with regard to potential future issuance. Watch this space

SOUTH AMERICA: ARGENTINA

Argentina created the basis for structured Covered Bond issuance back in 1995[1]. In an effort to strengthen the real estate sector and reap the associated economic benefits, a set of legal instruments was introduced which, among other things, allow the easier transfer of mortgages through so-called 'Letras Hipotecarias' (mortgage bonds). By applying this instrument, a mortgage loan is transformed into a payment claim incorporated into a transferable document, in combination with a pledge/charge on land. While a regular sale of mortgages is typically quite complex and costly, the introduction of 'Letras Hipotecarias' thus has created a much more effective way of transfer under civil law, paving the way for the use of respective claims as cover for public bond issues. To this end, the mortgage bonds are transferred to a trust typically held by another bank, which issues bonds upon them often referred to as 'Cédulas Hipotecarias'.

A comparison of this model with, for example, the US version of Covered Bonds reveals several similarities. And while investors are only secured on the trust portfolio without full recourse against the issuing institution, this is likewise the case for other products (such as Italian CDP issues) generally accepted as Covered Bonds by market participants. Against this background, the Argentinean papers can equally be referred to as structured Covered Bonds, even though they have not yet gained the same degree of international recognition.

AUSTRALIA

Once UK issuers had established the structured Covered Bond model, the market quickly diverted its attention to Australia to see whether a similar set-up could be transferred to banks down-under. The Australian regulator *APRA*, however, threw a spanner in the banks' efforts by stating that a segregation of assets for the privileged access of Covered Bond holders would contradict its principle of depositor protection. Hence, Australian Covered Bonds never saw the light of day.

In 2006, however, the Australian federal treasurer argued for the introduction of a depository insurance scheme. While in November of the same year, *APRA* once again explicitly stated that the issuance of Covered Bonds is not permitted for deposit-taking institutions, the regulator had mentioned earlier that the implementation of such a financial guarantee scheme could give reason to review its approach to this product class. At the same time, various international Covered Bond issuers have increasingly made use of kangaroo issuance, proving investors' appetite for this product. 2007 has therefore seen Covered Bonds moving back up the agenda again in Australia, underscoring the product's international appeal.

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1 For further details see "Structured Covered Bonds in Argentina" by Maria José Cristiá and Otmar M. Stöcker, published in Immobilien & Finanzierung 09/2007, p. 318-319

CENTRAL AMERICA: MEXICO

Q: What do Mexico and Denmark have in common? A: The Covered Bond system.

For several years the Mexican government has been working on improving the domestic mortgage funding system in order to support the real estate market's development. With the support of the US Soros Foundation – a non-profit organisation established by hedge-fund pioneer George Soros – the Danish Covered Bond model was identified as a role model in this respect, as it provides a long-established and successful framework for the refinancing of prepayable mortgage loans. Hence, the *Soros Foundation* and Mexican mortgage bank *Hipotecaria Crédito y Casa* set up a company called *Hipotecaria Total (HiTo),* which aims to offer mortgage credit loans modelled on the Danish system through local banks in future. The company received further capital contributions by the *Netherlands Development Finance Company (FMO)* and Mexico's public-sector *Sociedad Hipotecaria Federal* in November 2006. Furthermore, the Danish mortgage bank *Totalkredit* and *VP Securities Services* (Denmark's Central Security Depository) teamed up to provide software systems and other infrastructural support. Hence, the Mexican Covered Bond project is the result of far-reaching international cooperation. HiTo is expected to be fully operational from 2008, with some initial services already available from H2/2007.

ASIA: TURKEY

True, Turkey could be equally regarded as a European stop, as well as an Asian one, on our journey across continents (after all Turkey is not only a candidate for EU membership negotiations but also participates in the UEFA Champions League and the Eurovision Song Contest). However, based on its relatively low credit rating and the status of its mortgage market, Turkey offers another interesting blueprint for various Asian countries to which the Covered Bond idea has also been introduced of late.

Turkey's economy is characterised by a high volume of unauthorised housing and a relatively ineffective finance system for residential real estate (bank loans represent only a small fraction of the housing financing market). The introduction of capital market instruments allowing banks to refinance mortgages on attractive terms has been a pivotal part of a legislative initiative designed to spur the housing market and thus contribute to economic welfare.

The respective legislation was passed in March 2007 and introduced both Covered Bonds and ABS as new funding instruments. Within the Covered Bond category, the act foresees two kinds of product: mortgage Covered Bonds, which are mainly backed by residential housing loans (15% limit for commercial mortgages), and so-called 'asset Covered Bonds', the pool of which is also open to other kind of receivables. Hence, the Turkish legislation goes beyond the asset eligibility standards enshrined in the CRD and many established Western European Covered Bond acts, which were used as a role model during its creation. Other criteria, such as asset liability matching rules, LTV restrictions, administration in case of issuer bankruptcy etc are modelled more closely on Western European Covered Bond standards (see country report within this fact book for further details).

With associated regulations still outstanding, it is too early to return a verdict on the legislation's success, but the market is watching Turkey's progress on the Covered Bond front with considerable interest. The fact that foreign currency debt of potential issuers is largely rated in the B to BB segment could render top ratings for Turkish Covered Bonds doubtful. While this might be countered by additional structural enhancements, investors might as well welcome higher rating diversification within the Covered Bond market, which has been steadily declining towards a uniform AAA segment in recent years.

CONCLUSIONS

What are the drivers behind this geographical expansion? For the developed countries, it is typically a mix of booming housing markets, attractive funding spreads and issuers' wish to diversify their investor base. Less developed countries frequently hope to reap economic benefits by creating an efficient funding system for mortgages through Covered Bonds. Mexico and Turkey serve as excellent examples for the international recognition the European Covered Bond concept has gained in this respect, which is likely to inspire further countries going forward. Hence, the globalisation of Covered Bonds looks set to continue. A few trends are noteworthy in this regard:

First, the relative importance of Covered Bonds backed by **public-sector loans** continues to be in decline. The product's internationalisation fosters this trend, as new countries typically look at Covered Bonds especially for the purpose of refinancing mortgages.

Second, internationalisation is also inspiring increasing issuance of Covered Bonds denominated in **foreign currencies.** While CHF, GBP and JPY have already been actively used by various issuers for some time, USD issuance in particular has seen a significant rise, and CAD as well as AUD Covered Bonds have also become much more common recently.

Third, new countries are less likely to be bound by established Western European standards when setting up their Covered Bond versions, in particular if not primarily targeting the liquid Jumbo segment and its investor base. The internationalisation can therefore be expected to further increase the product's **diversity** (including rating and spread diversity) and hamper **transparency**. As a result, a unanimous Covered Bond definition and distinction from ABS seems more difficult than ever.

As shown by the Turkish example, this is particularly true with regard to the **definition of cover assets.** As described by Regina Kölsch and Michelle Bradley (see their article on recent trends in the Covered Bond market within this fact book), there already is a general tendency to allow for senior ABS tranches as cover assets. Further potential new asset classes currently discussed include student loans, airplane financing or junior mortgages. Once more taking a global standpoint, **Panama** provides another interesting case study in this respect: In July 2006, Fitch classified the structured FRN issue by Panama's *Global Bank Corporation* as a Covered Bond and consequently applied its Covered Bond methodology for assigning its BBB- rating. Unlike conventional Covered Bond types, however, this transaction was not based on mortgages or public-sector loans; instead the collateral assets comprised consumer loans to pensioners. While the latter's cash flows are directly serviced by the government social security agency (which creates a direct link to the public sector and circumvents the risk associated with individual payment morale), the loans continue to carry the risk of an early death of the borrower and thus introduce a new risk component. This is particularly true because loan insurance does not take effect until one year after the loan was granted.

Ultimately, it will be left to the judgement of the individual investor to decide how extensive a product mutation he is willing to accept within the Covered Bond landscape and at what price. With the globalisation of Covered Bonds continuing, issuers and product types are becoming too numerous and diverse for investors to focus on all of them equally. Hence, carrying the Covered Bond label – in whatever way you define it – will no longer be sufficient per se to secure access to the market's advantageous funding conditions. Offering the right marketing story and risk/return mix therefore continues to be pivotal for issuers, despite the bond market's current low risk aversion, tight spreads and high investing needs.

1.2 COVERED BONDS AND THE EU CAPITAL REQUIREMENTS DIRECTIVE

By Fritz Engelhard,
Barclays Capital

The Directive 2006/48/EC, the capital requirements directive (CRD), implies that the new framework will have a significant impact on the covered bond market, given that banks represent the largest single group of covered bond investors (taking about 45% of new Jumbo issues). The market could see an overall reduction in capital requirements, but also an increased differentiation in risk weightings with respect to issuer credit quality and maturity. Importantly, the net effect may rather strongly depend on the implementation of CRD across the EU. Finally it is also worth noting, that many Covered Bonds will become a less interesting investment compared to triple-A rated senior ABS/MBS notes from a bank investors point of view, once Basel 2 / CRD will become fully effective in 2010.

EXPIRING REGIME FOR ASSIGNING RISK WEIGHTS TO COVERED BONDS

Within the EU, the treatment of Covered Bonds used to be regulated by the EU directive 2000/12

The expiring regime for the treatment of Covered Bonds with respect to capital adequacy is generally stipulated by individual countries. The bottom line for the risk weighting of Covered Bonds within OECD countries is 20%, the same as for debt issued by credit institutions. However, within the EU, the treatment of Covered Bonds used to be regulated by the EU Directive 2000/12. This directive stipulated that Covered Bonds may benefit from a 10% risk weighting if they fulfil 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.

EU notification is another prerequisite for a lower risk weighting

In order to benefit from a preferential treatment, the governments of the issuer's home countries must notify the European Commission whether they have issuers of Covered Bonds, and whether they have stipulated higher investment limits (in general, this would mean 25% instead of 5%) for the covered bond holdings of investment funds. The respective notifications are published on the following EU website: http://europa.eu.int/comm/internal_market/securities/ucits/instruments_en.htm. The following table gives an overview of Covered Bonds from countries which fulfil UCITS 22(4), which is the notification about specific investment limits and the application of risk weights to domestic and foreign Covered Bonds across major European countries. It is important to note that in the past, countries that applied a 20% risk weighting switched to a 10% approach once they introduced their own covered bond legislation. In addition, some new EU member countries, namely Latvia and Poland, have not submitted a notification to the European Commission, although they have covered bond legislation in place, which fulfils the criteria of UCITS 22(4).

> FIGURE 1: OVERVIEW ON THE CURRENT TREATMENT OF COVERED BONDS ACROSS EUROPEAN COUNTRIES

Country	Fulfils UCITS 22(4)?	Special investment limits according to EU notification	Risk weighting of domestic CBs	Risk weighting of foreign CBs
Austria	Yes	Yes	10%	in general, 10%*
Belgium	No	Yes	-	in general, 10%*
Czech Republic	Yes	Yes	10%	in general, 10%*
Denmark	Yes	Yes	10%	in general, 10%*
Finland	Yes	Yes	10%	in general, 10%*
France**	Yes	Yes	10%	in general, 10%*
Germany	Yes	Yes	10%	in general, 10%*
Greece	Yes	Yes	-	in general, 10%*
Hungary	Yes	Yes	10%	in general, 10%*
Ireland	Yes	Yes	10%	in general, 10%*
Italy***	No	No	20%	20%
Latvia	Yes	No notification	10%	in general, 10%*
Lithuania	Yes	Yes	10%	in general, 10%*
Luxembourg	Yes	Yes	10%	in general, 10%*
Netherlands	No	No	20%	in general, 10%*
Norway	No, but only because there is no EU membership	No	10% expected	in general, 10%*
Poland	Yes	No notification	10%	in general, 10%*
Portugal	Yes	Yes	10%	in general, 10%*
Slovakia	Yes	Yes	10%	in general, 10%*
Spain	Yes	Yes	10%	in general, 10%*
Sweden	Yes	Yes	10%	in general, 10%*
Switzerland	No, but only because there is no EU membership	-	10%	in general, 10%*
United Kingdom	No	No	20%	20%

Note: *Except Dutch, Italian CDP and UK CBs. **to be decided with regards to French structured Covered Bonds. ***refers to CDP Covered Bonds; Obligazione Bancarie Garantite will meet the criteria of UCITS 22(4) and thus will qualify for a 10% risk weight under the Revised Standardised Approach (RSA) Source: Barclays Capital.

NEW EC CAPITAL REQUIREMENTS DIRECTIVE

EC legislation to implement Basel capital adequacy framework published in mid-July 2004

In mid-July 2004, the European Commission published its proposals for implementing the Basel Committee proposals for a new capital framework within the EU context. Specifically, the EC has adopted a proposal for the amendment of the Consolidated Banking Directive (2000) and the Capital Adequacy Directive (1993). This followed the final publication in June of the Basel Committee's "International Convergence of Capital Measurement and Capital Standards" and is intended broadly to mirror that document in order to maximise consistency between EU legislation and the international framework. The special treatment of Covered Bonds is an important feature of these proposals, as it goes beyond the Basel II framework.

Final agreement reached in October 2005

The draft EC directives were subject to debate in the European Council of Ministers in November 2004, amendments to the draft directive were stipulated at this stage. The initial proposal for the CRD of the European Commission was amended by the European Council on 7 December 2004. The amended draft was reviewed by the European Parliament and finally, in October 2005, the European Council and the European Parliament agreed on the wording of the new CRD. In June 2006, the final directive was published in the official journal.

Eligibility criteria for assets securing Covered Bonds

With regards to Covered Bonds, the CRD text (Annex VI, PART 1, paragraph 68-70) continues to refer to UCITS 22(4). In addition, a series of eligibility criteria for cover assets were stipulated. According to these criteria, the asset pool of a covered bond may include:

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

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

c) substitute assets from institutions with a minimum rating of AA-; the total exposure of this kind shall not exceed 15% of the nominal amount of outstanding Covered Bonds; exposures caused by transmission and management of payments of the obligors of, or liquidation proceeds in respect of, loans secured by real estate to the holders of Covered Bonds shall not be comprised by the 15% limit; exposures to institutions in the EU with a maturity not exceeding 100 days shall not be comprised by the AA- rating requirement but those institutions must as a minimum qualify for an A- rating.

d) loans secured by residential real estate or shares in Finnish residential housing companies up to an LTV of 80% or by senior RMBS notes issued by securitisation entities governed by the laws of a Member State provided that at least 90% of the assets of such securitisation entities are composed of mortgages up to an LTV of 80% and the notes are at least rated AA- and do not exceed 20% of the nominal amount of the outstanding issue.

e) loans secured by commercial real estate or shares in Finnish housing companies up to an LTV of 60% or by senior CMBS notes issued by securitisation entities governed by the laws of a Member

State provided that, 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% overcollateralisation is established and such overcollateralisation 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 (d) and (e) 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 to 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.

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 is in some contrast to most central bank regulations for repo business with Covered Bonds. For example in the Eurozone, in Denmark and in 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 REVISED STANDARDISED APPROACH

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

Under the Revised Standardised Approach (RSA), Covered Bonds are assigned a risk weight on the basis of the risk weight 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 2: 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, are shown in the following two tables:

> FIGURE 3: 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 4: RISK WEIGHTS UNDER OPTION 2 (%)

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

Source: Basel Committee, European Commission, Barclays Capital.

So, for example, under Option 1, if a bank is based in a country with a sovereign rating of AA- or better, its senior debt will be assigned a risk weighting of 20% and its Covered Bonds a weighting of 10%. For investing banks whose regulator applies Option 1, all banks within the Euro zone, except for Greece, would attract a 20% risk weighting on senior unsecured debt because their sovereign ratings are all at least AA-/Aa3 (except for Greece, which is single-A). Hence, under this option, all covered bond issues within the Euro zone would be assigned a risk weighting of 10%. (As yet, there are no Greek 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 5 below gives an overview on those EU countries which already decided on the respective options.

THE INTERNAL RATINGS BASED APPROACH (IRBA)

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 5: National discretions regarding option 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	No	Yes
Czech Republic	-	-
Denmark	No	No
Estonia	No	No
Finland	Yes	No
France	Yes	No
Germany	Yes	No
Greece	No	Yes
Hungary	Yes	No
Ireland	No	Yes
Italy	Yes	No
Latvia	Yes	No
Lithuania	No	-
Luxembourg	No	Yes
Malta	No	Yes
Netherlands	No	Yes
Poland	-	-
Portugal	Yes	No
Romania	No	No
Slovakia	-	-
Slovenia	No	No
Spain	Yes	No
Sweden	Yes	No
United Kingdom	No	Yes

* 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 a 11.25% LGD. Also, we illustrate figures for the range of possible effective maturities, as well as the central 2.5-year case.

The room for discretion on the part of individual banks is clearly rather limited, given these 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 6: RATING AGENCY CUMULATIVE ONE-YEAR DEFAULT RATES (%)

	S&P (1981-2006)	Moody's (1985 - 2006)	Fitch (1990 – 2006)
AAA/Aaa	0.00	0.00	0.00
AA/Aa	0.01	0.00	0.00
A/A	0.03	0.02	0.03
BBB/Baa	0.22	0.24	0.26

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

Room for debate on default probabilities

These figures reflect default history for corporates globally and so there may be reservations about their applicability to European banks. The different time periods used in the agencies' surveys complicate comparisons, but the divergences in the agencies' figures highlight that this is not exactly 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 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 rather than lower default probabilities than the rating agencies' historical studies suggest and also that banks apply more differentiation than is provided by the rating agencies' broad alphabetic bands.

Figure 7 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 7: 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.

Fall in 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 both the current regulatory regime and to the risk weightings under the RSA. It also highlights that in the IRBA, the risk weighting is significantly affected by the remaining life of the bond, which is not the case in the RSA. Banks applying the IRBA will have a significant incentive in terms of capital utilisation to invest in shorter maturities.

The third column shows that at a default probability of 0.10%, the risk weighting for longer-dated bonds is approximately in line with the current standard 10% risk weighting. This looks likely to be the appropriate risk weighting for single-A flat to A-issuers, depending on investing banks' individual risk models.

Steep rise in risk weightings for bonds issued by BBB banks

For Covered Bonds issued by banks in the BBB range, the risk weighting rises steeply. Just how steeply again depends on the values used for the one-year default probability. Rating agency data suggest a value of 0.25%. As before, it may well be that bank risk models apply a higher figure. The 0.35% column gives a reasonable guide.

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

For M >2.5, the threshold increases to AA-

The general point here is that different banks may use differing assumptions about default probabilities, and Figure 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 case where 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 issuers for longer-dated Covered Bonds.

TIMING

To allow reasonable transition arrangements, institutions are able to continue to use the expiring rules as an alternative until the end of 2007. Banks qualifying for the advanced version of the IRBA are expected to implement this by end-2007.

Transitional arrangements when the IRBA produces lower capital requirements

For situations in which the IRBA of the new regime produces lower risk weightings than in the expiring regime, there is a further three-year transitional period during which the amount of capital allocated to positions is subject to minimum levels related to the levels that would be required by the current capital directives as indicated in Figure 8.

> FIGURE 8: TRANSITIONAL PROVISIONS FOR PHASING IN LOWER CAPITAL REQUIREMENTS

Period from implementation of new directive	Minimum capital requirement as % of current
First 12 months (2007)	95
Second 12 months (2008)	90
Third 12 months (2009)	80

Source: European Commission.

Increased risk weightings have to be implemented immediately

Hence, the lower risk weighting for many Covered Bonds will not materialise until 2010. Note, however, that there is an asymmetry in the transitional treatment of changes in capital requirements. Where the new regime results in higher capital requirements, there are no transitional provisions. Bank investors in Covered Bonds issued by BBB banks have had to apply the increased risk weightings to their positions since the start of 2007, or in case they opted for maintaining the expiring rules in 2007, they will have to apply higher risk weightings from 2008 onwards.

No transitional delay for RSA implementation

For banks applying the RSA, the new regime had to be implemented at the beginning of 2007. There are no corresponding transitional arrangements. Therefore, for banks that find the regulatory requirement of their Covered Bonds changing, this has to be already applied.

REGULATORY IMPLICATIONS

Implementation of CRD

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. Obviously, now the focus is on a consistent implementation of CRD 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. However, this is not facilitated by the fact that the legal system in many EU countries differs. Whilst the large part of the transposition of CRD in continental European countries is done through primary and secondary legislation, in the UK, rules were issued by the FSA, following a public consultation process.

Signs of inconsistent implementation across countries

With regards to Covered Bonds, at this stage it is difficult to get a full overview on how CRD rules are implemented across EU countries. In many cases, the process is either not yet complete or not transparent. At first glance, assessing CRD implementation in those countries where the respective rules are visible is disillusioning. For example, the definition of Covered Bonds according to §20a of the amended German Banking Act (Kreditwesengesetz – KWG) is in contrast to the way that Covered Bonds are described in Annex VI, PART 1, paragraph 68-70 of the CRD text. Unlike the CRD text, the German Banking Act explicitly mentions Pfandbriefe as Covered Bonds, irrespective of whether they fulfil a catalogue of rules, which any other covered bond has to comply with to benefit from preferential treatment under German capital adequacy regulation. Whilst similar to CRD, reference is made to the criteria of UCITS 22(4), in particular the catalogue of eligible assets is more restrictive than CRD. For example, it does not contain securitisation notes backed by real estate exposures. In addition, non-

Pfandbrief issuers have to demonstrate that mortgage assets which are used as collateral do satisfy the specific rules of article 16 of the German Pfandbrief Act.

Rather narrow implementation in France, Ireland, Spain and the UK

The German example is in some contrast to the French, Irish, Spanish and UK regulations, which either refer to Annex VI, PART 1, paragraph 68-70 of the CRD text or contain a definition with similar wording. In the French case, article 24 of Arrêté 2007/220a stipulates that the domestic product, Obligations Foncières, should fulfil the requirements of the respective rules in the French Banking Code (L.515-13 Code Monétaire et Financier). The relevant eligibility criteria, which are defined in L.515-14 to L.515-17, basically reflect the rules of CRD Annex VI, PART 1 paragraph 68-70. Otherwise, we assume that with "similar bonds issued by an institution with head office in the EU," the French regulatory bodies would accept Covered Bonds fulfilling CRD Annex VI, PART 1 paragraph 68-70.

Individual definition also in Austria

According to our observations, other than Germany, only Austria also implemented an individual definition of Covered Bonds. It is stipulated in §18 and §19 of the Solvabilitätsverordnung (SolvaV). However, unlike in the German §20a KWG, there is no explicit legal privilege for the domestic product. In addition, the Austrian law leaves open whether the list of eligible assets is exclusive. Thus, there could be some more tolerance for interpretation compared with §20a in Germany, although we would regard this as rather limited. Figure 9 gives an overview of the implementation of the covered bond definitions in selected countries.

> FIGURE 9: IMPLEMENTATION OF COVERED BOND DEFINITION ACCORDING TO CRD IN SELECTED COUNTRIES

	Name of Regulation	Reference to CRD text	Narrow imple-mentation of CRD text	Individual definition of «covered bond»	Inclusion of ABS/MBS	Explicit legal privilege of domest. product
Austria*	SolvaV §18			o	No	
France**	Arrêté 2007/220a Art.24 / CMF L.515-13 & L515-14 - 515-17	o			Yes	
Germany***	KWG §20a			o	No	o
Ireland	S.I. No. 661 of 2006 Part 6 Art.59 (1) I	o			Yes	
Spain	CBE 404 12/2006 Norma SA4 (12) 41,42		o		Yes	
UK	FSA Prudential Sourcebook 3.4.107 – 110		o		Yes	

*The text leaves open whether the list of eligible assets is exclusive, there might be some discretion of the financial regulator; **we assume that with "similar bonds issued by an institution with head office in the EU" refers to covered bond fulfilling Annex VI, PART 1, paragraph 68-70 of the CRD text; ***in the explanatory statement of the draft CRD implementation law it is said that "it is assumed that Pfandbriefe fulfill the minimum requirements of the CRD" Source: Laws and financial regulations in the respective countries, Barclays Capital.

Mutual recognition unlikely before year end

There are efforts to use the instrument of mutual recognition of Covered Bonds via a similar EU notification process which is currently in place for clarifying whether the respective bonds fulfill UCITS 22(4). However, we understand that no formal plan has been adopted to establish such a notification procedure. Thus, it is regarded as rather unlikely that an appropriate mechanism will be put in place before year end. We also believe that the Austrian and German laws leave rather limited room for interpretation

when it comes to the application of the covered bond definition by the respective regulators. As a result, German and Austrian banks investing in Covered Bonds issued after 31 December 2007, which do not comply with the narrower definition of Covered Bonds in both countries (ie, Covered Bonds containing ABS/MBS in the cover pool) will have to apply an LGD of 45% and, thus, under IRB from 2010 onwards may incur a four times higher risk weighting than comparable products which were either issued before this date or which do comply with CRD.

Level playing field may change again if German lawmakers allow the inclusion of MBS in the cover of a mortgage Pfandbrief

Interestingly, it is currently discussed to enhance the range of eligible assets for a German mortgage Pfandbrief to MBS.[2] If such a change is implemented, without a respective change of §20a KWG, Pfandbrief issuers would have a material advantage versus their European peers, as the mortgage Pfandbrief would be automatically regarded as covered bond, while non-German products containing MBS would be non-compliant with §20a KWG. Still, in case MBS is made eligible for the cover pool of a mortgage Pfandbrief there is some likelihood that either lawmakers will amend §20a KWG or at least there would be an enhanced tolerance by regulators to allow for a rather broad interpretation of the current rules. However, an outcome of these discussions will very likely not be clear before year-end.

Adjustment of existing regulations

The final agreement on CRD was also the starting signal for many regulators in countries with existing covered bond legislation to review their frameworks to ensure that the respective products will be compliant with the definition of Covered Bonds as set out in the CRD. This was the case, for example, in Ireland. On 9 April 2007, an amendment of the Asset Covered Securities (ACS) Act was passed. Among other things, the limit for the inclusion of substitution assets was lowered from 20% to 15% and the definition of substitute assets was redesigned to fulfill CRD Annex VI, Part 1 point 68(c). At the same time, this was used as an opportunity to enhance the existing framework and adjust it to market trends. In particular, the instrument of commercial mortgage ACS was introduced and in compliance with CRD rules also, MBS were made eligible for ACS cover pools. In France, too, the limit for the inclusion of substitution assets was lowered from 20% to 15% and the definition of substitute assets was redesigned to fulfill CRD Annex VI, Part 1 point 68(c). Again, other modifications to the regulations for Obligations Foncières were made. However, given what is said above, the respective amendments in Ireland and France do not seem to ensure that Covered Bonds issued out of these countries will benefit from a preferential treatment in all EU countries.

UK Treasury presents proposal for UK Recognised Covered Bond regime

The discussions surrounding CRD have also resulted in a shift in opinion in the UK. Historically, the FSA has been resistant to the argument for allowing 10% risk weightings for Covered Bonds, mainly due to concerns relating to the potential adverse implications for the rest of an issuing bank's balance sheet and, hence, its unsecured debt holders. However, on 23 July 2007, the UK Treasury and the FSA published a joint consultation document entiteld «Proposals for a UK Recognised Covered Bonds legislative framework». The consultation paper contains the proposals for both the legislative framework and FSA guidance on its implementation of the regime. The new regime is scheduled to come into force on 1 January 2008. Under the legislation, the FSA will act as a special public supervisor of covered bond programmes which meet the requirements of the legislation. It is expected that all existing UK covered

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bond programmes will be capable of meeting these requirements. Whilst it also can be assumed that the existing programmes will fulfill the requirements of CRD Annex VI Part1 paragraph 68-70 once the regime will come into force, the proposed framework as well allows for the issuance of covered bonds which are not CRD compliant.

SPREAD IMPLICATIONS

We estimate that a 5 percentage point lower risk weighting would reflect in a 3.1 bp spread gain

Ultimately, the new regime will reduce the total capital required to support bank holdings of Covered Bonds. In order to estimate the potential spread gain in bp of a respective bond in a Basel II/CRD environment, the following model calculation might be helpful. In a first step, we calculate the give-up in yield a typical EU bank investing in Covered Bonds would be willing to accept in return for a lower risk weighting under Basel II/CRD. In the model, the bank would be rated A+ and would have a target total capital ratio of 11.2%. Thus, on a 5 percentage point change in the risk weighting of a bond, the bank would benefit from a capital release of 0.6% on the nominal amount. Assuming that the respective bank would have a weighted average cost of capital of 5.9%, the yield give-up that the generic bank would be ready to accept in a Basel II/CRD environment would be 3.3 bp. Finally, one has to take into account the fact that banks (excluding central banks) make up about 47% of the investor base in AAA debt instruments. Thus, the reduced yield requirement may only reflect up to this share in the yield, which will be observed in the market. Consequently, we estimate that a 5 percentage point lower risk weighting would reflect in a 1.6 bp spread gain of the respective instrument.

> FIGURE 10: SUMMARY OF ASSUMPTIONS

Model parameters	Model values
Difference in risk weighting	5%
Target total capital ratio (assuming an A+ rated bank)	11.3%
Capital release	0.6% of nominal
Weighted average cost of capital*	6.5%
Spread give up	3.7 bp
Assumed take up of banks	45%
Estimated spread give up	1.7 bp

Note: assuming a target tier1 ratio of 7%, a hybrid tier 1 share of 10% and a target return on equity of 8%. Source: Barclays Capital.

Model results are in line with anecdotal evidence

Clearly, this model can only serve as a reference. The final spread movements will also depend on other factors, such as supply and demand patterns, bond-specific features, credit fundamentals and other regulatory issues such as eligibility for central bank repo transactions. However, the estimated spread difference is in line with anecdotal evidence. For example, it reflects rather well the difference that could be observed until the UK's FSA announcement in February 2006 between 20% risk weighted UK Covered Bonds and 10% risk weighted Covered Bonds from most continental European countries. However, it is important to note that there are limits to the relationship between risk weighting and spreads in

particular when comparing 0% risk weighted debt with the area of low risk weighted (0-20%) and high risk weighted products (100%), as other factors, such as the structure of the typical investor base, might differ significantly.

Covered Bonds of highly rated institutions become more attractive

The implementation of Basel II/CRD will encourage banks to extend their holdings in Covered Bonds issued by higher quality issuers versus their holdings in existing 0% risk weighted debt, and 20% weighted public sector debt. In addition, banks operating in jurisdictions that under expiring regime apply 20% risk weightings have an incentive to increase their investment in Covered Bonds.

More differentiation among Covered Bonds

CRD will also introduce greater differentiation in risk weightings related to the maturities of individual Covered Bonds and the credit ratings of issuing banks. This differentiation arises both under the IRBA and the RSA (Option 2). The key thresholds for higher risk weightings are at different levels for the two approaches – ie, below AA- for RSA (Option 2) and below A- for the IRBA – although there is also variation within rating categories. Furthermore, this is also subject to some variation depending on the risk models employed by individual banks. Given the greater volume of assets represented by banks that will be applying the IRBA, this implies that BBB issuers of Covered Bonds will be particularly disadvantaged by the new regime.

COVERED BONDS, ABS/MBS AND THE CRD

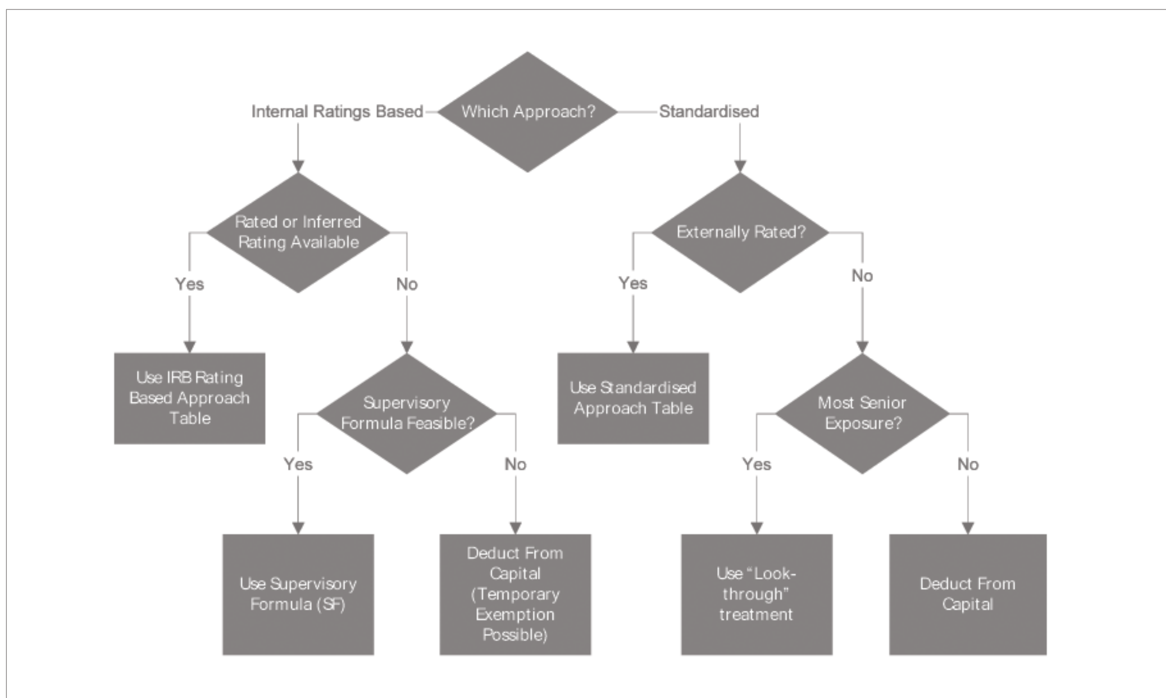
MBS versus Covered Bonds

Whilst the application of Basel 2 and CRD will lead on average to a lower risk weighting of Covered Bonds it is worth noting, that when it comes to the comparison with ABS/MBS, in many areas, the significant decrease of risk weightings in particular for highly-rated securitisation notes will outpace the general drop in covered bond risk weightings. Thus, in this section the treatment of securitised notes under the Basel II regime will first be discussed and then the trade-off between ABS/MBS and Covered Bonds under CRD from a bank's investor perspective will be analysed.

The risk weighting of securitised notes

When considering the treatment of asset backed securities, that is, the different tranches of notes backed by securitised assets, a brief look at Figure 11 should be helpful. It shows the process for arriving at the risk weight of securitised notes held by a bank.

> FIGURE 11: THE RISK WEIGHTING OF SECURITISED NOTES



Source: Basel Committee on Banking Supervision – June 2004 Framework, Barclays Capital.

As most securitised bonds do have a rating and investments in such notes are the most common by far, the calculation of risk weights basically boils down to a single table, shown in Figure 12. The table highlights that the most senior tranche of a transaction, whether granular or not, will fall under the IRB Senior column. Most retail assets (RMBS, Consumer ABS) and more granular CMBS would fall under the IRB Base column. However, single borrower CMBS or a transaction with a very small number of loans would fall under IRB Non-Granular. So for RMBS and granular CMBS transactions, a 7% risk weighting would be applied to the senior tranche compared to 50% for RMBS previously and 100% for CMBS previously.

> FIGURE 12: RISK WEIGHTS OF RATED SECURITISED NOTES

	Basel I	Basel II Internal Ratings Based (IRB) Approach			Standardised
Securitised Bond Rating	RMBS/Other ABS	IRB Senior (1)	IRB Base (2)	IRB Non-granular (3)	Approach
AAA	50%/100%	7%	12%	20%	20%
AA+	50%/100%	8%	15%	25%	20%
AA	50%/100%	8%	15%	25%	20%
AA-	50%/100%	8%	15%	25%	20%
A+	50%/100%	10%	18%	35%	50%

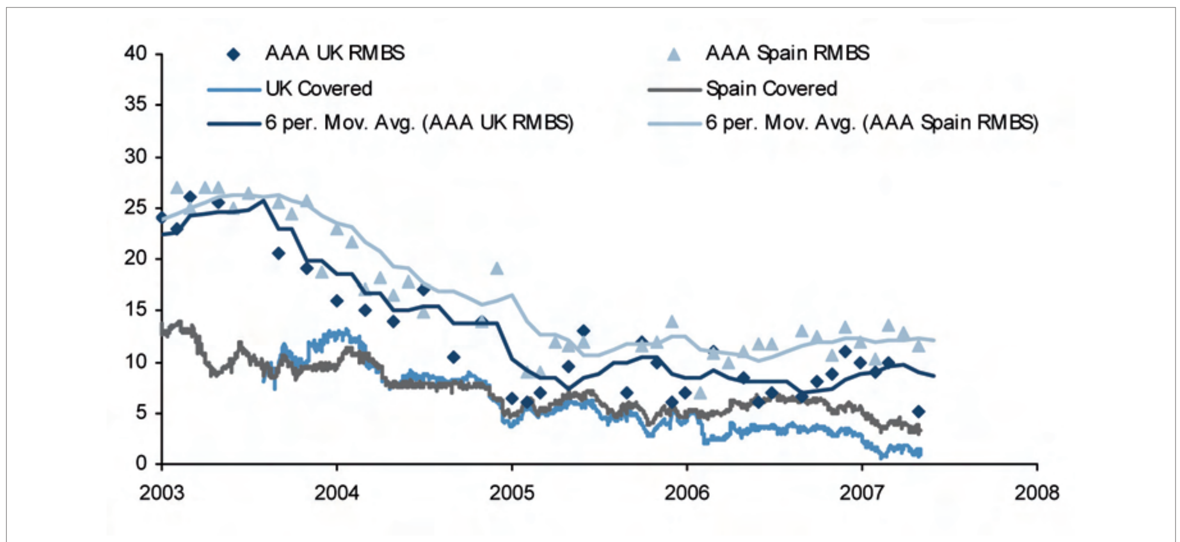
	Basel I	Basel II Internal Ratings Based (IRB) Approach			Standardised
Securitised Bond Rating	RMBS/Other ABS	IRB Senior (1)	IRB Base (2)	IRB Non-granular (3)	Approach
A	50%/100%	12%	20%	35%	50%
A-	50%/100%	20%	35%	35%	50%
BBB+	50%/100%	35%	50%	50%	100%
BBB	50%/100%	60%	75%	75%	100%
BBB-	50%/100%	100%	100%	100%	100%
BB+	50%/100%	250%	250%	250%	350%
BB	50%/100%	425%	425%	425%	350%
BB-	50%/100%	650%	650%	650%	350%
A-1/P-1	50%/100%	7%	12%	20%	20%
A-2/P-2	50%/100%	12%	20%	35%	50%
A-3/P-3	50%/100%	60%	75%	75%	100%
Unrated or Below BB-	50%/100%	SF or DEDUCT	SF or DEDUCT	SF or DEDUCT	DEDUCT

Note: 1) Backed or secured by a first claim on all the underlying assets, ie, the most senior tranche in a standard securitisation structure. 2) Neither senior nor non-granular 3) Where N, the number of effective exposures (as defined), is less than 6. In practise, any securitisation of retail assets should qualify as granular. So in the above table, the most senior tranche of a transaction, whether granular or not, will fall under the IRB Senior column. Single borrower CMBS or a transaction with a very small number of loans would fall under IRB Non-Granular. More granular CMBS and most other retail assets (RMBS, Consumer ABS) would fall under the IRB Base column.
Source: Basel Committee on Banking Supervision, Barclays Capital.

Currently, AAA rated RMBS notes offer a 8.5bp premium over Covered Bonds backed by assets with a comparable risk profile

AAA rated RMBS notes offer a significant premium over Covered Bonds which are backed by similar types of assets. In Figure 13 we show the development of average primary market margins of UK and Spanish AAA RMBS notes and compare this with the asset swap margin, which on average could be achieved over Euribor when swapping fixed coupon payments of outstanding UK and Spanish Covered Bonds into floating rate payments. Interestingly, the margin differential of AAA notes versus Covered Bonds is currently 8.5bp for both, the UK and Spain. Clearly, there is a rather complex mix of factors, such as different supply and demand structures, liquidity requirements and regulatory treatment, which explains this difference. However, in our view, it should not be forgotten, that both products are secured debt instruments, which are backed by a stream of cash flows with a quite similar risk profile. Thus, investors may increasingly regard the two products as substitutes. Bank capital requirements, which still discriminate against senior MBS notes versus Covered Bonds, may play an important role in this process. As explained above, in 2010, when the transition period for the implementation of Basel II/ CRD will end, the risk weighting of senior AAA notes will decrease significantly.

> FIGURE 13: THE RISK WEIGHTING OF SECURITISED NOTES



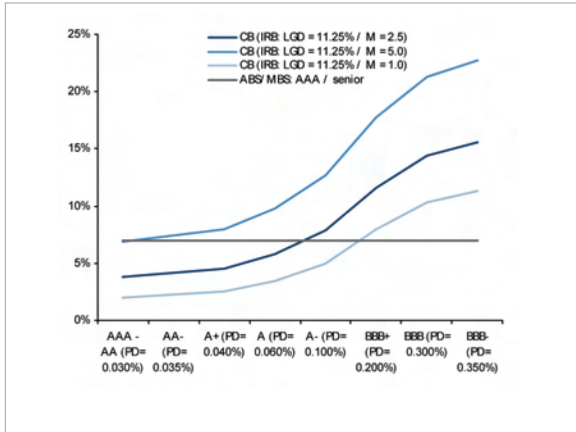
Source: Basel Committee on Banking Supervision – June 2004 Framework, Barclays Capital.

The critical barrier for the senior unsecured rating of covered bond issuers stands at A+

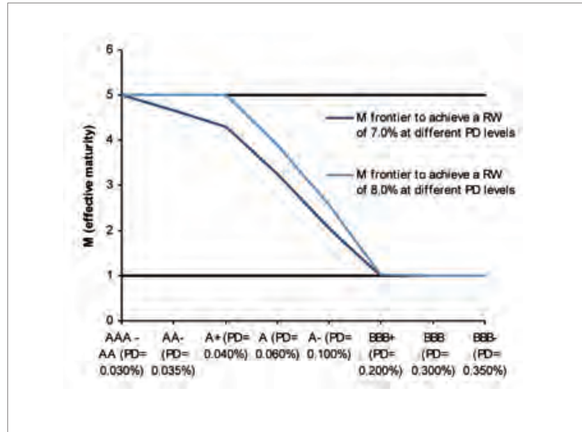
Given, that a 7% risk weighting is applied for triple-A rated senior ABS/MBS notes irrespective of the weighted average life of the respective transaction, makes ABS/MBS rather attractive compared to Covered Bonds from a bank investors point of view. In Figure 13 we compare the risk weighting of Covered Bonds across different M-values and PD levels, with the stable 7% risk weighting, which can be applied for triple-A rated senior MBS notes under the IRB approach. The chart signals, that the incentive for banks to invest in Covered Bonds vs. AAA-rated senior ABS/MBS notes lowers substantially if the covered bond issuer's senior unsecured rating level is below A+. Figure 14 shows the M-value frontier at given risk weighting levels of 7% and 8%[3]. The chart shows, what M-values are allowed across different PD levels in order to achieve a 7% or 8% risk weighting for the respective covered bond. Given that the average life of Covered Bonds included in the iBoxx Euro Covered index currently stands at 5.9 years and in most cases no cap at 2.5 years for the effective maturity is applicable, Figure 14 underlines that again Covered Bonds issued by banks with a rating below A+ will struggle to remain competitive versus ABS/MBS notes.

3 Although the benchmark level vs. highly granular MBS is 7%, we would regards a 1percentage point difference in risk weight as negligible and thus also include the calculation for a given risk weighting of 8%.

> Figure 14:
Risk weighting across M-values and comparison with ABS/MBS



> Figure 15:
M-value frontier at given risk weighting



Source: Barclays Capital.

Further convergence of both asset classes likely

The above calculations indicate that many Covered Bonds will become a less interesting investment compared with triple-A rated senior ABS/MBS notes from a bank investors point of view, once Basel 2 / CRD will become fully effective in 2010. Consequently, ceteris paribus this should reflect in a spread tightening of products in both asset classes which are backed by comparable asset portfolios. In addition, covered issuers may react to this situation, by broadening their distribution towards non-bank investors. Finally, it may also be feasible to structure a product which may be regarded as a triple-A rated senior ABS/MBS from a regulatory perspective, but from a marketing perspective has the look & feel (i.e. fixed coupon, bullet maturity) of a covered bond. Under such circumstances, it seems rather likely that there will be a further convergence of both asset classes.

1.3 RECENT TRENDS IN THE COVERED BONDS MARKET

By Regina Koelsch, UBS & Michelle Bradley, Morgan Stanley Bank

The Covered Bonds market is changing faster than ever, as more countries, issuers and investors are joining the universe. In this article, we aim to provide an overview of the recent trends in the Covered Bonds market and venture an outlook about potential trends that may emerge in the near future.

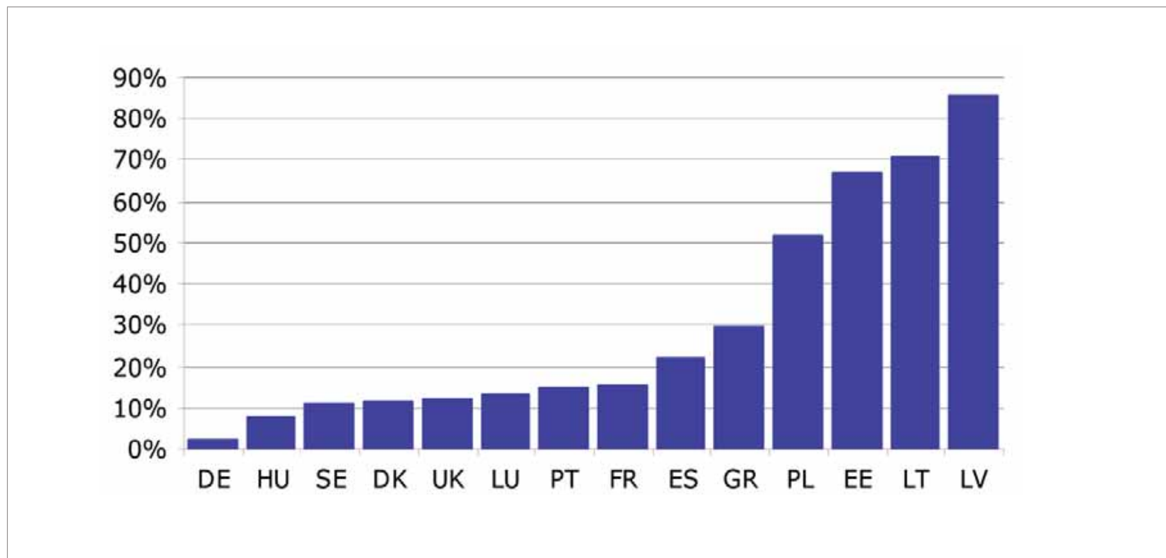
Rapid geographical expansion

Ten years ago the Covered Bonds, or Pfandbrief market, was a purely German domestic product, issued by German institutions and bought by German investors. However, the Covered Bonds market has since 'exploded' onto the European scene and now looks set to break into the international market. Today, 26 countries have implemented special Covered Bonds legislation. Moreover, in the UK, the Netherlands and most recently the US, so-called structured Covered Bonds are issued without specific Covered Bonds legislation.[4] So, what are the reasons for the increased interest in this product – both from issuers and investors?

Residential housing boom in Europe

It is no coincidence that the growth of the Covered Bonds market – in particular the mortgage-backed segment – has gone hand in hand with the boom in European housing markets. Growing mortgage volumes on the banks' balance sheets have equally provided growing collateral volumes for Covered Bonds. While the stories of momentous growth in property prices in Ireland and Spain are well known, they are not only confined to these regions of Europe. The mortgage market is clearly still growing, despite the widely diverse levels of growth throughout Europe, and the fact that the ECB has been raising rates since December 2005.

Exhibit 1 Annual % in Change of Total Outstanding Residential Mortgage Lending Q3 2005-Q3 2006



Source: European Mortgage Federation

4 The UK and the Netherlands are currently in the process of establishing a legal framework for covered bonds. The UK aims to implement its framework by end 2007. It will be an umbrella framework, accommodating all the existing issuance structures in the market.

Funding diversification

As mortgage growth began to outpace growth in deposits, banks have resorted to alternative funding sources; ie, Covered Bonds and residential mortgage-backed securities (RMBS). Apart from offering very attractive funding levels, Covered Bonds allow banks to: (1) lengthen their funding profile; (2) optimise their asset and liability matching; and (3) access a different investor base compared to RMBS. Retail banks in the UK and Spain have historically been large users of RMBS, but have recently incorporated Covered Bonds into their funding portfolios. While RMBS attract credit investors, the Covered Bond investor typically includes Covered Bonds as part of a fixed income government portfolio. Therefore, issuing Covered Bonds gives these banks access to a whole new range of investors.

Basel II supports growth in Covered Bond supply

Covered Bonds have also become more attractive as a funding tool because of the introduction of Basel II. From an investor perspective, asset-backed-securities (including RMBS) is one of the asset classes that has benefited most from the reduction of the risk weightings under Basel II. However, from an issuer perspective, the cost of issuing Covered Bonds relative to RMBS also goes down, because the cost of holding mortgages on the balance sheet falls under Basel II. Table 1 shows how the cost of issuing Covered Bonds decreases because of the fall in the cost of capital of holding mortgages on the balance sheet.

TABLE 1: ISSUING COVERED BONDS IS CHEAPER UNDER BASEL II

Basel I	Covered Bonds	Spreads		Costs
AAA	91%	-0.02%	3.83%	3.48%
on B/S debt	5%	0.12%	3.97%	0.20%
on B/S capital	4%		7.01%	0.28%
				3.96%
Basel II	Covered Bonds	Spreads	---	Costs
AAA	91%	-0.02%	3.83%	3.48%
on B/S debt	7%	0.12%	3.97%	0.30%
on B/S capital	2%		7.01%	0.11%
				3.89%
			Cost Saving	**7 bp**

Source: Morgan Stanley. Assumptions: Libor of 3.85%, Bank Funding Spread (B/S) 12 bp, Mortgage Risk Rating under Basel 1 50%, Mortgage Risk Rating under Basel II: 20%

Growing investor demand

As nominal yields have fallen to low levels, the demand for yield has grown, and this has been instrumental in supporting the growth of the Covered Bond market. Although moving out the credit spectrum is one option to increase yield, this is not an option open to many investors who must remain in the triple-A asset class.

Covered Bonds have filled a gap in the triple-A sector as the net supply of the top sovereign issuers in Europe (i.e. France, Germany, Italy, and Spain) and other triple-A paper, such as supras and agency

paper, has fallen in Europe, while the issuance of state-guaranteed Landesbanken debt stopped entirely after July 2005.

Covered Bonds are getting more complex

The Covered Bond market is getting more complex, driven not only by the rapid geographical expansion, but also by product innovation and the new capital regulations. Understanding the differences between jurisdictions and issuance templates has become increasingly important for market participants, because they have the potential to drive – at least partially – Covered Bond valuations, particularly in a less benign credit environment.

The rapid geographical expansion is one factor that adds to increasing complexity as new laws are set up in each country. There is some legal convergence occurring among the various Covered Bond legislations, as new laws ensure that they (1) fulfil the criteria required by the ratings agencies for a Covered Bond rating up to triple-A, and (2) comply with the minimum standards of the new European Capital Requirement Directive (EU CRD). However, each law maintains its idiosyncrasies because of national differences in each domestic mortgage market and insolvency regulations. Moreover, some issuers commit to contractual features in order to enhance the legal framework.

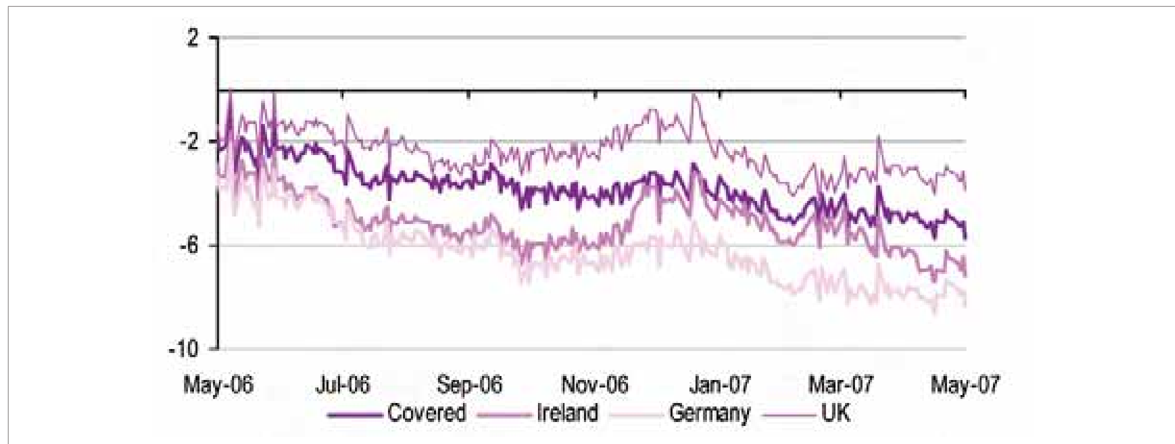
Product innovation reached a new cycle in 2006 and 2007, particularly with regards to new issuance structures. As investors have become familiar with the UK issuance template, HSBC developed the UK model one step further and introduced a new structure that allows the bank to issue Covered Bonds and RMBS backed by the same cover pool. US-based Washington Mutual created a new structure, aiming to replicate Covered Bonds under existing US corporate law. Under the structure, Covered Bonds are issued out of a special purpose vehicle (SPV) and collateralised by floating rate mortgage bonds, which are backed by residential mortgages. Bank of America – the second US bank issuing Covered Bonds – adopted this model for its debut issue in March 2007. However, the verdict is still out on whether this model will become the Covered Bond master template for all subsequent US-based issuers.

So-called structured Covered Bonds, based on corporate law, used to be issued only in countries without a special Covered Bond law, but, since the end of 2006, this is no longer the case. Structured Covered Bonds outside a legal framework and statutory Covered Bonds, based on a special Covered Bond law, now co-exist in the same country. BNP Paribas, the French bank, opted to set up an individual structured Covered Bond programme, rather than establish a specialised mortgage bank under the existing French Obligations Foncières framework. Equally, Landesbank Berlin has set up a Covered Bond programme outside the German Pfandbrief framework. The main driver behind this development is issuers' aim to be more flexible with regards to the use of the underlying collateral, which can be refinanced with Covered Bonds while simultaneously preserving the attractive funding advantages of the Covered Bond product.

Finally, EU CRD has the tendency to harmonise the Covered Bond universe and to increase its complexity over time. To a certain extent, the EU CRD harmonises the Covered Bond universe, as issuers generally have the incentive to comply with EU CRD standards in order to receive preferential risk weights and hence, better funding levels (eg, the UK and Dutch regulators are in the process of implementing a regulatory framework to ensure compliance with EU CRD). However, EU CRD is also likely to increase complexity because the old rule of thumb, with regards to risk weightings, will no longer apply. Prior to EU CRD, it held true that structural Covered Bonds were not compliant with UCITS Art 22 (4) and

carried a 20% risk weight, while statutory Covered Bonds were UCITS-compliant and carried a 10% risk weight. Under EU CRD, Covered Bonds not only have to comply with UCITS Art 22 (4) but also with the criteria regarding eligible cover assets and mortgage valuation methods. The definition of the universe of eligible assets could be wider under national Covered Bond laws compliant with UCITS Art. 22 (4) than the EU CRD definition. Hence, under EU CRD, structured Covered Bonds or statutory Covered Bonds - even if they meet the UCITS criteria - can either be EU CRD-compliant or not, depending on the respective composition of the cover pool.

Chart 1: Structured Covered Bonds versus statutory Covered Bonds (mid ASW in bps)



Source: UBS CreditDelta iBoxx Covered Bonds sub-indices 5yr tenor point.

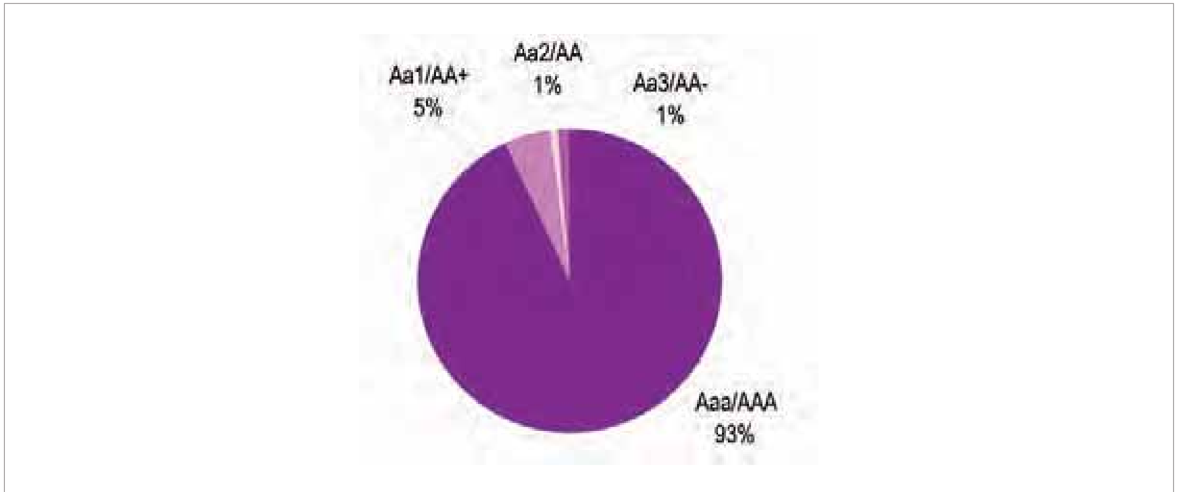
There are those in the market who question whether the increasing complexity in the Covered Bond market could turn out to be detrimental to its growth. The fundamental analysis of new issuance structures is time consuming, while the various models – now even co-existent in the same country – may increase the entry barriers for new investors. Contrary to these concerns, it is often mentioned that competing legislation and issuance models ensure that the market strives for product innovation and efficiency, and offers flexibility to issuers while simultaneously ensuring investors the highest level of legal protection.

In the end, the market – in particular the investor base – will have to decide to either accept continued product innovation and diversification, or require greater harmonisation. As Ted Packmohr discusses in his article (See §1.1 "Covered Bonds going global"), the Covered Bond market is set for further expansion. Hence, if anything, the market will become even more diverse and complex. However, this also presents a chance for issuers to positively distinguish themselves by further enhancing the level of transparency, making their Covered Bond product as accessible as possible to the investor base.

Covered Bonds have developed to a truly AAA credit universe

The Jumbo Covered Bond market has developed into a virtually triple-A rated credit universe, with more than 90% of rated bonds assigned a prime rating by one or more of the three major rating agencies (Moody's, S&P and Fitch). Indeed, over the past two years the ratings trend in Covered Bond ratings has been clearly positive. The upgrades related to ratings actions by Moody's and Fitch on individual Pfandbriefe and Cédulas, and have been driven by upgrades of the issuer rating, revised ratings methodologies, legal reforms or a combination of these factors.

Chart 2: Jumbo Covered Bonds – virtual AAA credit universe*



Source: Moody's, S&P, Fitch.*as of 02 May 2007

The positive ratings momentum in recent years can be mainly attributed to two factors:

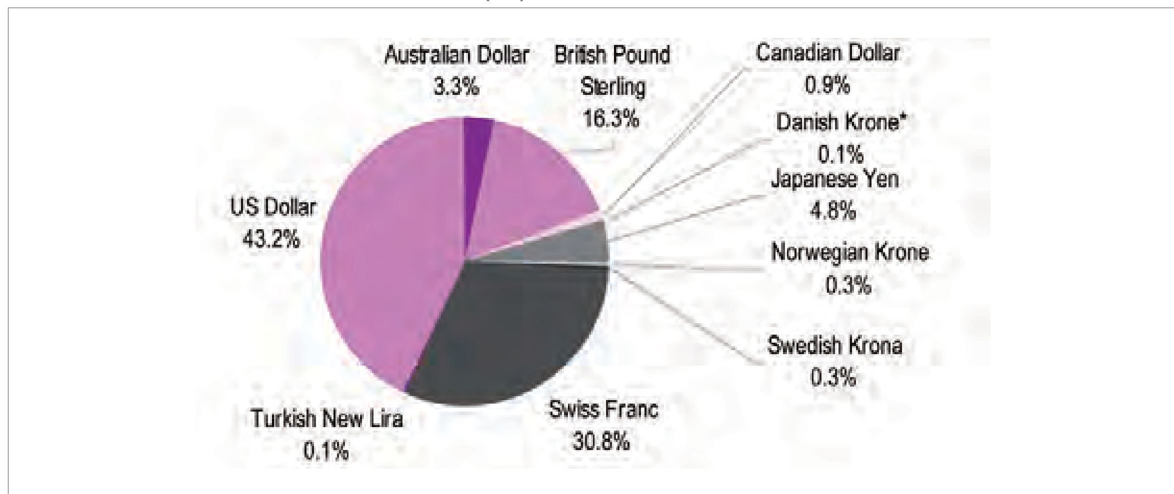
First, competition among legal frameworks and issuance structures is increasing. New Covered Bond frameworks or issuance structures ensure from the outset that they meet the minimum criteria on credit and market risk as well as insolvency protection, which are considered as pre-conditions for ratings agencies to assign a Covered Bond rating up to triple-A. Indeed, triple-A rated debut issues have become market standard. To remain competitive, established legal frameworks have been reformed in recent years, with particular focus on strengthening (a) the bankruptcy remoteness of Covered Bonds and (b) the liquidity in the cover pool in the event of issuer insolvency.

Second, structured finance analysis has gained in importance in Covered Bond ratings' methodologies. As a response to tighter insolvency regulations and the increasing use of structured finance techniques to ensure bankruptcy remoteness of Covered Bonds, ratings agencies have shifted their analytical focus to the cash flow analysis of the cover pool and the outstanding Covered Bonds. In 2005, Moody's introduced its 'Expected Loss Covered Bond Ratings Model' (ES Model). Under this model, a potential negative impact on the Covered Bond rating, triggered by a downgrade of the issuer, can be mitigated, or even compensated for, by a higher collateral value of the pool (eg, overcollateralisation). Fitch refined its Covered Bond methodology in 2006, introducing a so-called 'discontinuity factor'. This measure aims to capture all factors acting as potential obstacles to a smooth transition of cash flows from the issuer to the cover pool as a source of payments on the Covered Bonds. S&P has always de-linked the Covered Bond rating from the issuer rating when the insolvency protection of Covered Bonds was ensured (See §5.1 "Rating Agencies & Methodology").

Multi-currency and multi-market strategies

A big development in the Covered Bond market at the end of 2006 and into 2007 has been the diversification of European Covered Bond issues into dollar issuance. This topic is discussed in the article of Frank Will and Regina Koelsch on multi-currency funding strategies (See § 1.5 "Multi Currency Strategy"). However, aside from US dollars, there have also been moves into other currencies such as GBP and CHF. Chart 3 shows the range of currencies, apart from euro, in which Covered Bonds are now issued. When we consider the growth in mortgage markets in Eastern European countries, we would also expect to see increased issuance from these regions in the coming years.

Chart 3: Issuance in Covered Bond market (€m)



Source: Bondware. *Excl. the Danish Realkreditobligationer market

Most of the currency issuance outside of euro is in the non-Jumbo segment of the market. Although most of the development and growth in the market has been in the Jumbo sector, non-Jumbo and private placement issuance form an integral part of most issuers' funding strategies. The demand in the Jumbo market is very strong, and in 2007 we have seen exceptional performance from new deals; however, this demand may not be infinite and, in the interest of diversification, issuers also look to diversify in terms of format and currencies. In addition, banks that operate in a global environment may accumulate assets in different currencies, and issuing in this respective foreign currency avoids the necessity for, and cost of, cross-currency hedging.

Another important element in the growth of the Covered Bond market is that when a new issuer in a new country issues Covered Bonds, the issue tends to bring not only a new product to the Covered Bond market but introduces also the respective domestic investors base to Covered Bonds. An example of this is the growing participation of UK and Irish investors in the Covered Bond market since UK and Irish issuers launched their inaugural Covered Bond deals. Therefore, a new country joining the Covered Bond market positively affects investors demand for Covered Bonds as well. A further example of this is in the US where the emergence of Washington Mutual as a Covered Bond issuer brought increased awareness of the Covered Bond product to the US investor base, which led to highly successful US$ deals by European-based issuers.

Outlook – what next?

We believe several potential trends may emerge in the near future:

There seems to be a tendency to enlarge the universe of eligible assets backing Covered Bonds. Under more and more existing and new legislation, senior ABS tranches – in turn backed by eligible public-sector or mortgage assets – can be included in the cover pool (eg, France, Ireland and Italy). Student loans and agricultural loans – besides public-sector assets and prime mortgages – are often cited as potential new asset classes because they display comparable cash flow patterns and risk profiles than mortgage or public-sector assets. Moreover, issuers think about techniques to refinance junior mortgages or the part of the mortgage above the maximum loan-to-value limit (LTV) of existing Covered Bond legislations. 'Junior' Covered Bonds could represent an investment alternative with a higher risk/return profile.

Covered Bonds may be issued not only by financial institutions, but also soon by corporates. Earlier this year, Veolia, the French environmental services firm, announced its intention to issue Covered Bonds backed by high-quality receivables, such as concession contracts to municipalities in 2H07.

Initially, these trends are likely to create niche markets for Covered Bonds besides the big benchmark transactions. Depending on available collateral volumes and investors' acceptance, these developments may also, at some stage, overlap to the liquid benchmark market. However, investors and issuers may both have an interest in maintaining the benchmark Jumbo Covered Bonds as a straightforward asset class, to preserve their status as liquid surrogates to government bonds.

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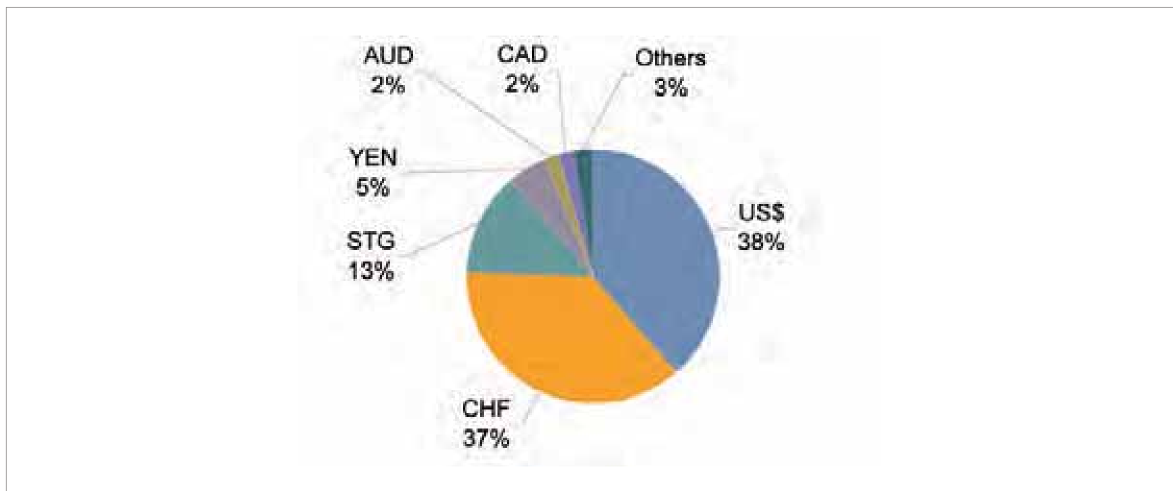
1.4 MULTI-CURRENCY STRATEGY

By Frank Will, RBS & Regina Koelsch, UBS

Multi currency Covered Bond supply on the rise

The core market for Covered Bonds is the so-called Jumbo market, which comprises plain-vanilla fixed rate bullet bonds issued in euros with a minimum size of €1 billion. However, as the Covered Bond market is turning global on both the issuer and investor side, Covered Bond issuance in non-euro currencies has been on the rise. The greatest interest is currently in the development of the US$ Covered Bond market, due to the huge growth potential this market offers in terms of issuance volumes and investor demand. However, Covered Bond issuers are not only active in the US$ segment; other important currencies include GBP and CHF, while issuers have also been active in JPY and have recently made their inroads in the AUD. Chart 1 provides an overview of the currencies in which Covered Bonds have been issued so far.

CHART 1: OUTSTANDING COVERED BONDS IN NON-EURO CURRENCIES



Source: RBS, Bondware Dealogic (as of 1 June 2007)

Drivers behind multi-currency supply

Multi-currency supply and growth in new issuance volumes is driven by numerous factors.

First, supply in another currency is in general most compelling for an issuer, if the respective basis swap works in his favour, opening arbitrage opportunities. As a result many issuers used to have or still maintain a more opportunistic approach to multi-currency funding.

Second, issuers are keen to diversify their investor base in order to create new placement opportunities. By issuing in local currency, issuers attract higher demand from the domestic investor base, such as a fund manager who manages portfolios in the respective local currency. This holds particular true for Covered Bond issuance in GBP, CHF, JPY and AUD. Covered Bond supply in US$ not only targets the US domestic investors base, but also attracts demand from central banks world-wide as the US$ is still the dominant reserve currency. Moreover, multi-currency funding allows Covered Bond issuers to avoid oversupply in the euro Jumbo market, and hence to support valuations of their outstanding benchmarks.

Third, as issuers have been increasing their lending activities outside the European Economic Area (EEA), Covered Bond legislation has expanded the geographical universe of eligible assets. A significant proportion of national Covered Bond legislation – in compliance with the Capital Requirement Directive (CRD) – allow as eligible cover assets, public-sector assets and mortgages, originated in the US, Canada, Japan and European OECD countries. For issuers with a growing portfolio of foreign currency cover assets, it is therefore a natural currency hedge to issue Covered Bonds denominated in the same currency.

Finally, in entering the Covered Bond market, US issuers aim to diversify their funding tools, and to lower their dependence on the Federal Home Loan System. US issuers debuted with their inaugural Covered Bond issues in the euro market, to benefit from the maturity and depth of the market and the European investor base. In June this year, Bank of America issued its first US$ benchmark.

Drivers behind multi-currency demand

The Covered Bond market is a huge and fast growing market and demand for Covered Bonds remains very strong. The major incentives for investors to buy Covered Bonds are manifold: (1) Covered Bonds are highly secure, they often carry the highest ratings and no Covered Bond has ever defaulted. Investors benefit from two layers of protection in that they have a direct claim against the issuer and - in case of issuer insolvency - a preferential claim over the asset cover pool backing all the issuers' bonds. (2) Moreover, Covered Bonds offer an attractive yield pick-up over similar rated government debt, as well as over supranational & agency paper. (3) Covered Bonds are very liquid instruments often benefiting from strict market-making agreements which ensures that investors are always offered two-way prices with pre-defined bid-ask spreads by at least three market makers.

The attractiveness of non-euro Covered Bonds from an investor perspective is based on a number of factors: In the case of CHF, GBP, AUD or NZD, the local currency investors regard non-euro Covered Bonds as an interesting diversification opportunity to local issuers such as sub-sovereigns or agencies. Central banks around the globe are looking for ways to diversify their fast growing currency reserves in terms of assets and currencies. Non-euro Covered Bonds are therefore very attractive for those investors.

The US$ denominated Covered Bonds focus on different investor bases depending if the bonds are eurodollar deals or regulated by the US Securities and Exchange Commission (SEC).

Non-US issuers have principally two options to issue US-dollar denominated Covered Bonds. The first option is to issue Covered Bonds under Regulation S and Rule A of the US Securities Act of 1933 governing an offer or sale of securities by a non-US issuer. Those bonds are exempt from the registration requirement of the Securities Act. Under Rule 144A, bonds can only be sold to qualified institutional buyers (QIBs) within the US ('restricted offering'). QIBs are primarily institutions that manage at least $100 million in securities as well as registered broker-dealers owning and investing at least $10 million in securities. Those investors are believed to be financially sophisticated and therefore not in need of the protection of state registration. Regulation S – often used in combination with Rule 144A - allows an unrestricted placement of securities offshore (i.e. outside of the US).

The second option is to issue eurodollar Covered Bonds. These instruments are denominated in US$ but are not regulated by the US Securities and Exchange Commission (SEC). They can only be sold to non-US investors and US offshore accounts. Eurodollar issuance significantly reduces the regulatory costs involved in dollar denominated issuance making these instruments an attractive way for issuers.

The pie charts below show the different investor distribution of Covered Bond issued under Rule 144A and eurodollar Covered Bonds. The former attracts a strong US investor base which accounts usually for about 30 to 70%, but can even be higher. Eurodollar deals on the other hand, are mainly targeted at central banks buying between 70% and 90% of the issue. The geographical distribution is skewed to Asia and Europe. US investors are only offshore investors.

Chart 2: Typical Allocation (144A)

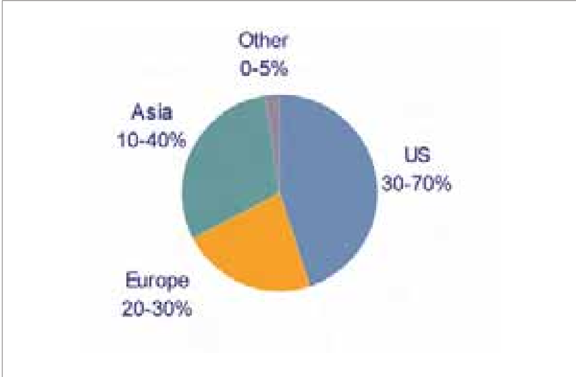


Chart 3: Typical Allocation (144A)

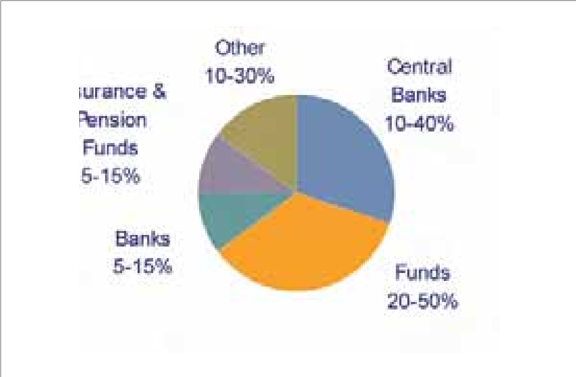


Chart 4: Typical Allocation (euro-dollar)

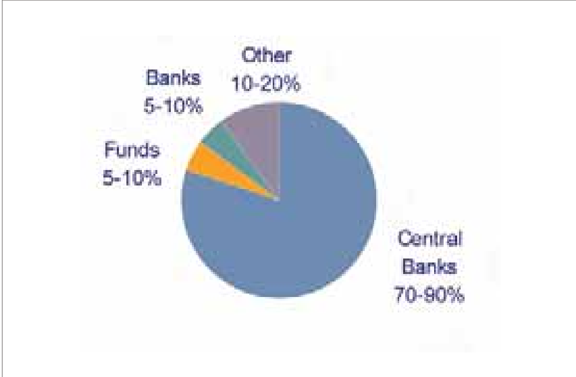
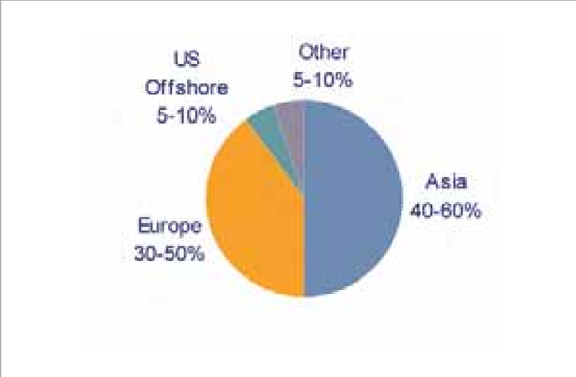


Chart 5: Typical Allocation (euro-dollar)



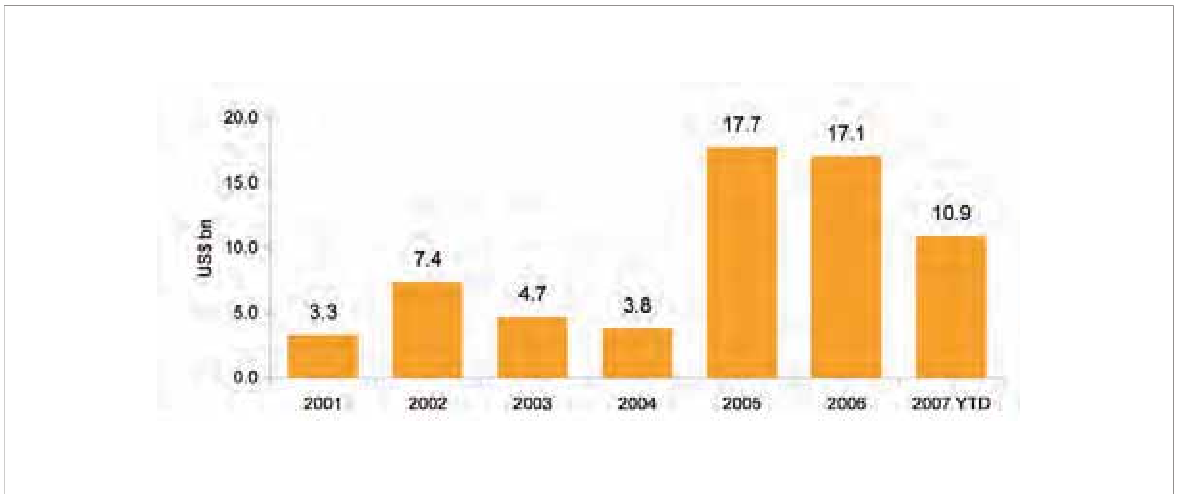
Source: RBS

SPECIFIC NON-EURO COVERED BOND MARKET IN FOCUS

The USD Covered Bond Market

Over the last couple of years, an increasing number of issuers have started to issue Covered Bonds denominated in US$ and the outstanding volume of US$ Covered Bonds is already approaching $60 billion. Between 2000 to 2004, annual Covered Bond issuance in USD was less than $5bn – with the exemption of 2002 where it reached $7.4 billions. However, in 2005 and 2006, the new issue volume in USD jumped to more than $17 billion (see the chart below). The year-to-date volume already exceeds $10 billion and we believe that it could exceed the $20 billion threshold this year. So far, only DexMa, HBOS, Depfa ACS Bank and CFF have issued US$ Covered Bonds in benchmark size of $1bn or more but the pipeline for the rest of the year includes a number of new issuers out of Spain and the UK. Moreover, more US banks are expected to follow Bank of America and issue Covered Bonds not only in € but also in US$.

Chart 6: History of issuance volumes

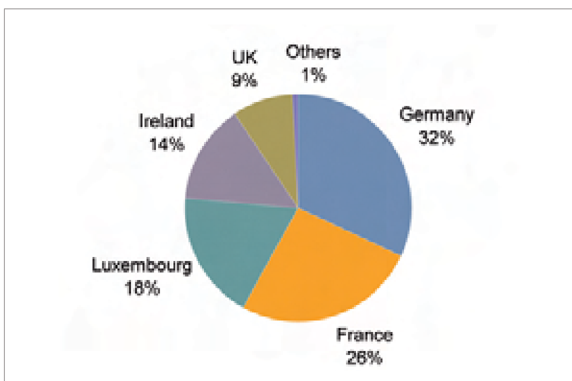


Source: RBS, Bondware Dealogic

The US$ Covered Bond market is dominated by five Covered Bond types (Pfandbriefe, Obligations Foncières, Lettres de Gage, ACS and UK Covered Bonds). The major issuers are Depfa ACS Bank, Eurohypo Luxembourg, DexMA, CFF, HBOS and Essen Hyp. These six issuers make up almost three-quarters of the outstanding Covered Bond volume (see the two charts below).

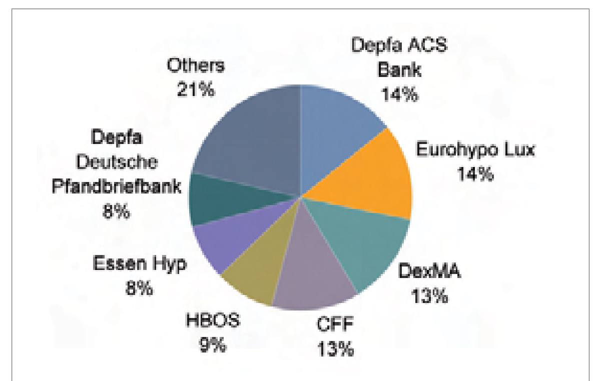
Interestingly, Cédulas issuance in US$ has been almost negligible despite the fact that Spanish Covered Bonds hold the fastest growing market segment in euros. However, we believe that the expected new Spanish Covered Bond legislation will boost the issuance of non-euro Cédulas and there are already a number of Spanish issuers in US$.

Chart 7: US$ Covered Bonds by country



Source: RBS, Bondware Dealogic (as of 1 June 2007)

Chart 8: US$ Covered Bonds by country



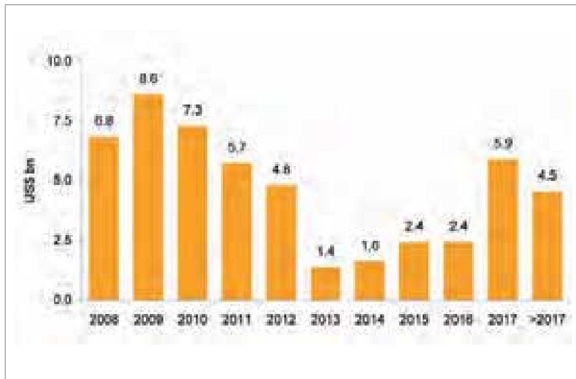
Source: RBS, Bondware Dealogic (as of 1 June 2007)

The average original maturity of the outstanding US$ Covered Bonds is about 5 years. Only four benchmark deals with a volume of at least $1 billion had original maturity of 10 years and longer. Most other benchmark deals have a maturity of 3 to 5 years ensuring high central bank participation which

is usually crucial for the success of a Euro US$-deal. The chart below shows the breakdown of the outstanding US$ Covered Bonds by maturity.

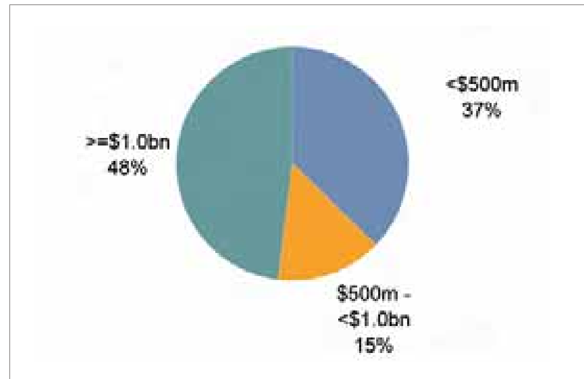
Almost half of the outstanding US$ Covered Bonds have a benchmark size of $1 billion or more. However, 37% of the bonds are less than $500 million.

CHART 9: US$ COVERED BONDS BY MATURITY



Source: RBS, Bondware Dealogic (as of 1 June 2007)

CHART 10: US$ COVERED BONDS BY SIZE



Source: RBS, Bondware Dealogic (as of 1 June 2007)

THE CHF COVERED BOND MARKET

The Swiss Covered Bond market comprises two different types of Covered Bonds, *Swiss Pfandbriefe* and CHF *Covered Bonds*. Swiss *Pfandbriefe* are governed by the Swiss Pfandbriefgesetz, which only grants two institutions the right to issue Pfandbriefe. One institution is the central Covered Bond issuing vehicle of the Swiss cantonal banks[5][6]called '*Pfandbriefzentrale der schweizerischen Kantonalbanken.*' The other institution is called *'Pfandbriefbank schweizerischer Hypothekarinstitute'*and operates as the Pfandbrief-issuing vehicle for Swiss banks other than cantonal banks.

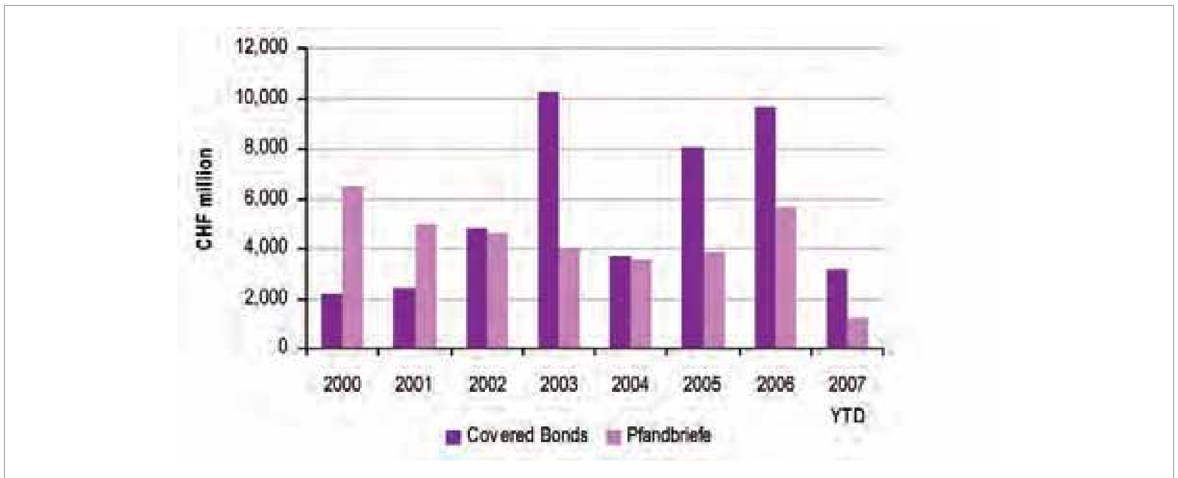
In this paragraph, focus is given to the second type, namely CHF *Covered Bonds* which are issued in CHF by non-Swiss based institutions.

In parallel to the geographical expansion of the Jumbo Covered Bond market, new issuers also entered the CHF Covered Bond market. Since the beginning of 2006, eight institutions have debuted in the CHF Covered Bond market. At present, the CHF Covered Bond market comprises of about 26 issuers from eight different countries or jurisdictions.

5 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.

6 Two of PBZ's member banks do not benefit from a cantonal guarantee, namely Banque Cantonale de Genève (BCG) and Banque Cantonale Vaudoise.

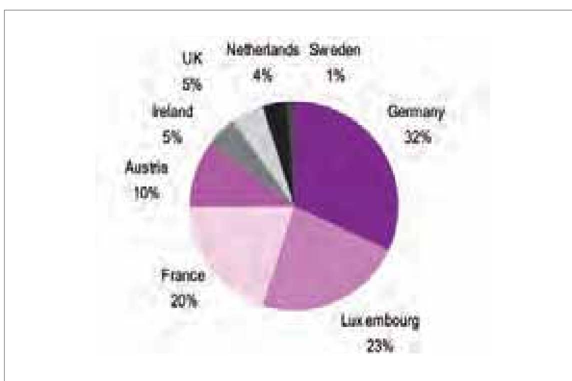
Chart 11: History of issuance volumes



Source: UBS, Dealogic

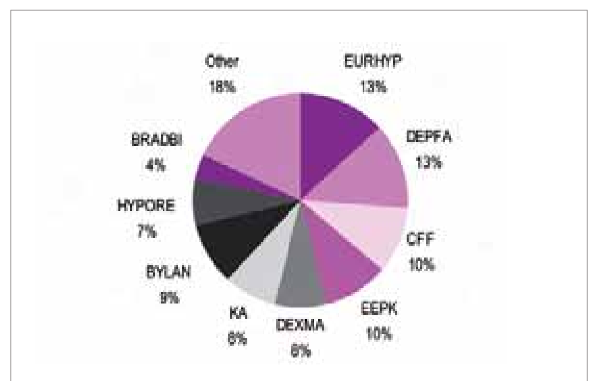
Most of the drivers behind foreign currency supply discussed earlier apply to the Swiss market. One of the most important factors determining supply volumes is the development of the basis swap between CHF/ EUR, as well as issuers aiming to diversify their investor base by specifically targeting the Swiss domestic investor base. The Swiss market is also attractive for issuers who would like to access the Covered Bond market frequently but whose volume of cover assets may not be sufficient to make a regular appearance in the euro Jumbo market. Moreover, many issuers are active mortgage or public-sector lenders in Switzerland, and as such have CHF cover assets on their balance sheet. This holds particularly true for the Austrian Covered Bond issuers (e.g. Kommunalkredit, Erste Bank der Oesterreichischen Sparkassen) and to a large extent – at least in the past – for the Luxembourg issuers.

Chart 12: CHF Covered Bonds by country*



Source: UBS, Dealogic. * as of end April 07. (Public and private transactions)

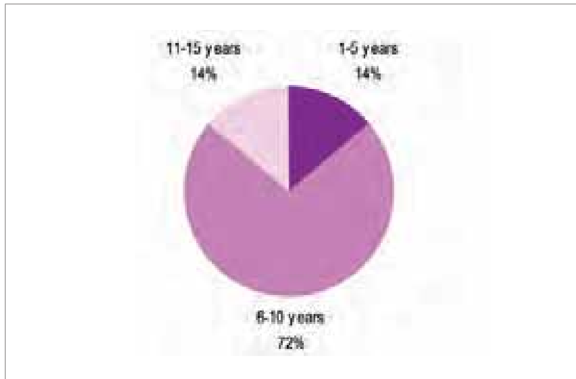
Chart 13: CHF Covered Bonds by issuer



Source: RBS, Bondware Dealogic (as of 1 June 2007)

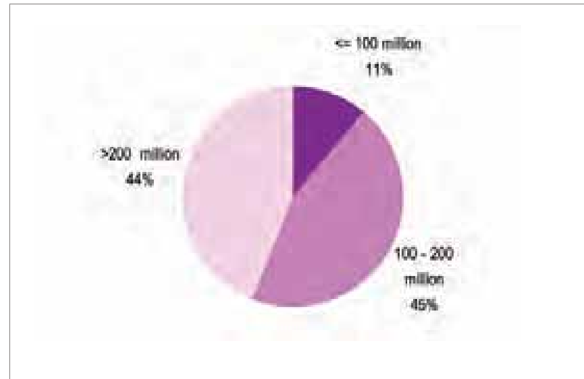
Primary issuance volumes typically exceed CHF 200 million up to CHF 400 million. The relatively big share of issuance of CHF 100 million to CHF 200 million represents re-openings and taps, which is a common feature for the Swiss market.

Chart 14: YTD issues* by maturity



Source: UBS. *incl. re-openings. As of end April 2007

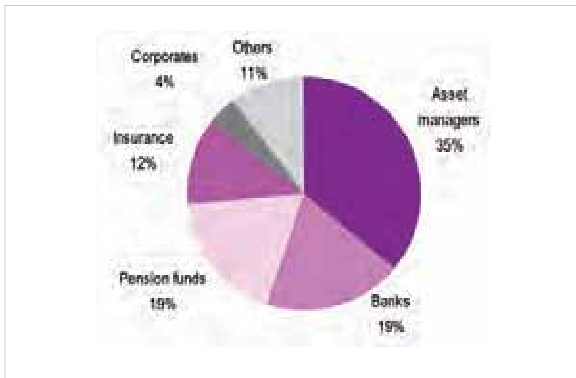
Chart 15: YTD issues* by size



Source: UBS. *incl. re-openings As of end April 2007

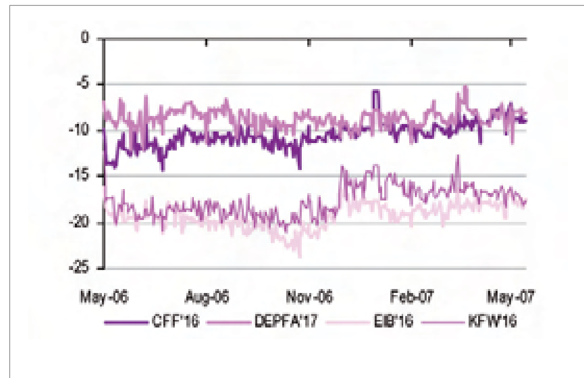
The biggest Swiss investor base in Covered Bonds are asset manager, banks, pension funds and insurance companies. Central bank demand is not as important, as most Central banks hold their currency reserves in US$, EUR and GBP. This is also reflected in the maturity profile, as most issues fall in the medium term bracket to attract demand from banks and asset managers, as well as in long-term maturities targeted at pension funds and insurance companies. Similar to other markets, Covered Bonds offer Swiss investors a higher yielding investment alternative to European agencies and supranationals, with the latter particularly in scarce supply.

Chart 16: CHF Covered Bonds- investor allocation*



Source: UBS. *Average distribution of four deals of 7yr maturity

Chart 17: CHF Covered Bonds - triple A with yield pick up



Source: UBS

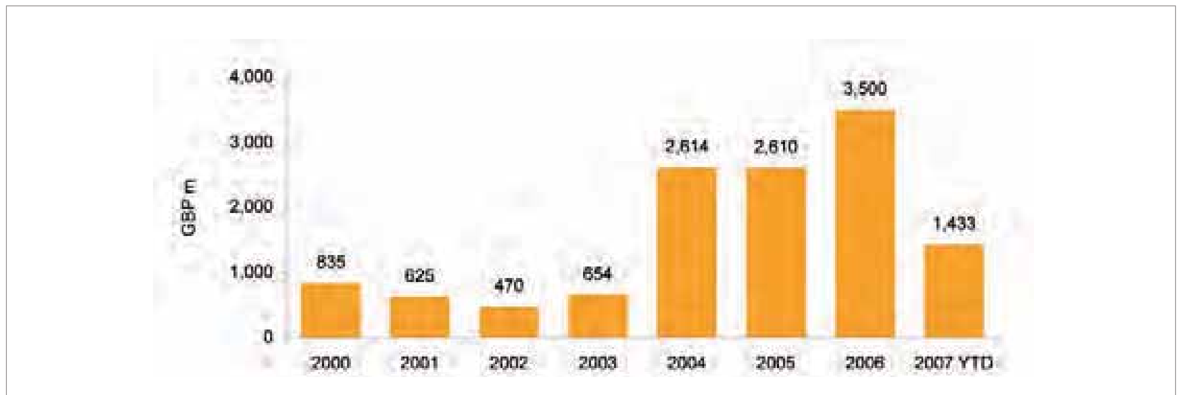
So far this year, Covered Bond supply has been moderate for two reasons. First, a third of issuance this year has been for well-known triple-A names in the deep sub-libor segment (especially Austrian Landesbanks prior to their loss of state guarantees in April). Second, a narrow swap spread (20-25 bps in 5-10years) left Covered Bond investors with a relatively small pick-up vs. Swiss government bonds. Third, many issuers have been deterred by the expensive basis swap into EURIBOR. However, these factors are only temporary market conditions, while overall the CHF Covered Bond market has experienced good growth momentum over recent years, which looks set to continue for the future.

THE STERLING COVERED BOND MARKET

The Sterling Covered Bond market is still relatively small compared to the huge euro Covered Bond market and even to the US$market. Nonetheless, the outstanding volume of Covered Bonds in Sterling already exceeds £10 billion. Between 2000 and 2003, the annual Covered Bond issuance in Sterling was well below £1 billion. However, since 2004, the annual new issue volume in Sterling has exceeded £2.5 billion and the year-to-date volume already amounts to almost £1.5 billion (see the chart below). We believe that this trend will continue and that an increasing number of Covered Bond issuers will use Pound Sterling as one of their three or four favourite funding currencies.

Supply in the Sterling Covered Bond market is based on two pillars. The first pillar comprises domestic issuers like HBOS, Nationwide Building Society and Abbey. However, over the last few years, a number of non-domestic Covered Bond issuers including Dexia MA, CFF, Eurohypo, Depfa ACS Bank have entered the Sterling market as well. These issuers form the second pillar of the Sterling market.

CHART 18: HISTORY OF ISSUANCE VOLUMES



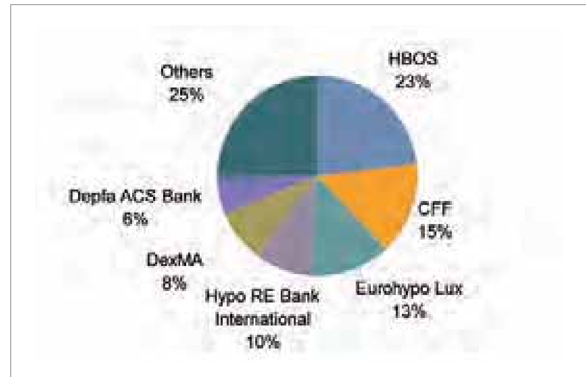
Source: RBS, Bondware Dealogic

The Sterling Covered Bond market is dominated by four Covered Bond types (UK Covered Bonds, Obligations Foncières, Pfandbriefe and Lettres de Gage) accounting for more than 90% of the outstanding volume. The major issuers are HBOS, CFF, Eurohypo Luxembourg, Hypo Real Estate Bank International, DexMA and Depfa ACS Bank. These six issuers make up about three-quarters of the outstanding Covered Bond volume (see the two charts below).

Chart 19: Sterling Covered Bonds by country

Source: RBS, Bondware Dealogic (as of 1 June 2007)

Chart 20: Sterling Covered Bonds by country

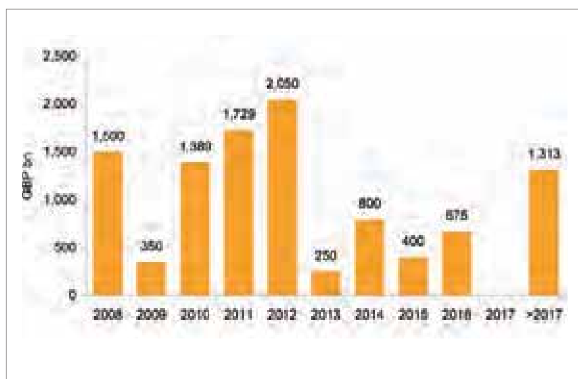


Source: RBS, Bondware Dealogic (as of 1 June 2007)

Most Sterling Covered Bonds have a maturity of 10 years or less and the average original maturity lies between 5 to 6 years. However, HBOS, Hypo Real Estate Bank International as well as CFF have issued longer-dated deals with maturities beyond 15 years. The chart below shows the breakdown of the outstanding Sterling Covered Bonds by maturity.

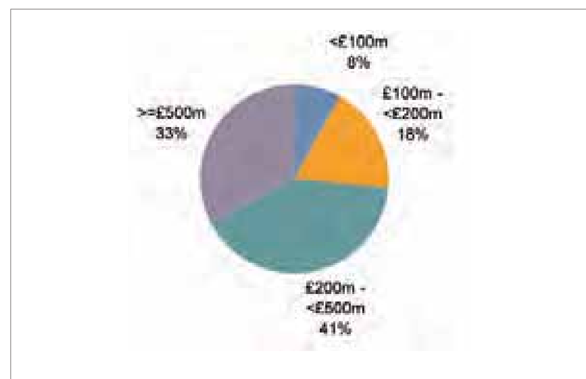
Only a third of the outstanding Sterling Covered Bonds have a volume of £500 million and more. Almost 60% have a volume of £100 up to £500 million, which is characteristic for the Sterling market. The Sterling investor base is relatively small compared to the euro or US dollar investor base and the market's capacity to absorb large benchmark deals with a volume of £1.0 billion and more is very limited. Issuers tend therefore to issue smaller bonds with a typical volume of £200 to 300 million which are however often tapped at later stages by £100 – 200 million to increase liquidity.

Chart 21: Sterling Covered Bonds by maturity



Source: RBS, Bondware Dealogic (as of 1 June 2007)

Chart 22: Sterling Covered Bonds by size

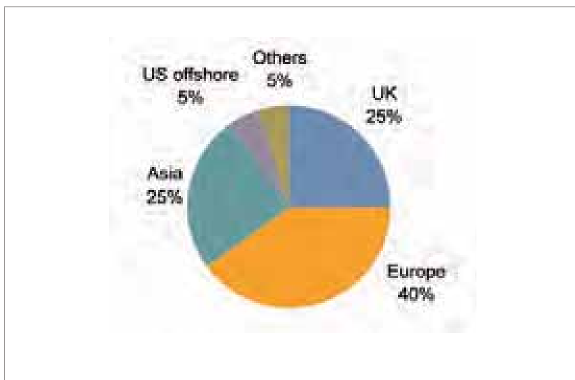


Source: RBS, Bondware Dealogic (as of 1 June 2007)

Demand for Sterling Covered Bonds is mainly driven by central banks accounting typically for more than half of the book. Funds usually buy about a third of the deal and banks make up roughly 10%. Insurance companies and pension funds tend to be negligible. In terms of geographical distribution,

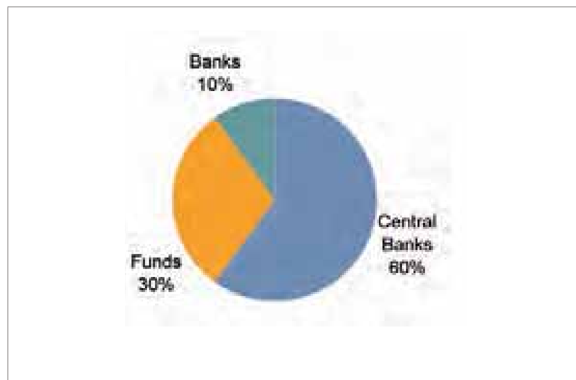
UK investors and Asian counterparts account usually for a quarter each. Continental Europe makes up about 40% followed by US offshore accounts with 5% and others with 5 %.

Chart 23: Typical Allocation by Country



Source: RBS

Chart 24: Typical Allocation by Type



Source: RBS

Outlook

We believe that the euro will remain the preferred funding currency for Covered Bond issuers. However, non-euro currencies like the US-dollar, Swiss franc or Pound Sterling will continue to gain in importance, in our view, driven by the issuers' desire to diversify their investor base and to exploit arbitrage opportunities. The issue volumes in niche-currencies will probably also grow significantly over the coming years – a trend also seen in the European supras & agency sector.

The outstanding Covered Bond volume in US-dollars is still relatively small compared to the huge euro Covered Bond market and some of the US$ Covered Bonds are not very liquid. However, these are typical teething problems of a young market and we expect that the liquidity will improve over the coming years as the market grows in size. The recent success of HBOS, Essen Hyp and Depfa in placing their US$ denominated Covered Bonds into US accounts has already attracted other issuers. A number of Spanish issuers plan to issue US$ denominated Cédulas, and other US banks are expected to follow Bank of America and issue Covered Bonds in US$ which is likely to boost demand for Covered Bonds from US investors. We have seen similar trends in France, Spain, Italy and the UK where investors first bought domestic products and then at a later stage non-domestic Covered Bonds.

The CHF Covered Bond market is one of the largest non-euro Covered Bond market and is used by a wide variety of different issuers. The CHF market has experienced good growth momentum over recent years, which is set to continue for the future.

The Sterling Covered Bond volume is small compared to the huge euro Covered Bond market and even to the US dollar market. However, we believe that the Sterling market will remain an important Covered Bond market. Covered Bond issuers will continue to use the Sterling market to diversify their investor base and to benefit from arbitrage opportunities.

The Covered Bond market is one of the fastest growing financial market segments. More and more issuers fund their business activities through Covered Bonds increasing the overall issue volumes. It seems therefore a very sensible move by the issuers to issue in various currencies since it broadens their investor base and reduces the oversupply risks in euro Covered Bond market.

This article partially draws on material from UBS Investment Bank and Regina Koelsch and from RBS plc and Frank Will. The views and opinions expressed in this article are those of the authors and are not necessarily those of UBS and/or RBS plc. UBS or RBS plc accept no liability over the content of this article. This article is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments.

1.5 COVERED BONDS : INFLUENCE OF SECURITISATION TECHNIQUES

By Alain Marcel,
Caisse Centrale du Crédit Immobilier de France - 3CIF & Bernd Volk, Deutsche Bank

In recent years, the boundaries between Covered Bonds and RMBS have become blurred. In some jurisdictions, RMBS are eligible as collateral for Covered Bonds (e.g. France, Italy, Ireland); Covered Bonds are 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); and finally, Covered Bonds are structured with the help of securitisation techniques to replicate the legislated Covered Bond method of funding (e.g. Dutch and UK Covered Bonds). The new Covered Bond law in Italy even structures Covered Bonds as in the UK by separating eligible assets in a SPV guaranteeing the Covered Bonds. Moreover, securitisation techniques enable future claims to be securitised. This is similar to Veolia's plan to issue French Covered Bonds (Obligations Foncières) based on their public contracts with *'prestations successives'*. This type of future claims can also be found in securitisations when there are solid public contracts.

Covered Bonds are on balance sheet funding

In the case of Covered Bonds, the assets are usually on the balance sheet of the issuer. New structures like BNPP Covered Bonds, despite being issued by a credit institution, BNPP Covered Bonds, 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 BNPP, the originator of the mortgage loans. BNPP keeps the mortgage loans on its balance sheet and pledges them to guarantee the loans received from BNPP Covered Bonds. The loans from BNPP Covered Bonds to BNPP are comparable to Washington Mutual Covered Bond Issuer (specialised Covered Bond issuing Delaware trust) buying mortgage bonds from Washington Mutual Bank with the proceeds from issuing Covered Bonds. The mortgage bonds in turn are pledged for the benefit of the Covered Bond holders.

Generally, securitisation is based on the segregation of assets: the originator sells assets backing the securitisation issue to a SPV. The structure of UK Covered Bonds is based on a transfer of assets to a Limited Liability Partnership (LLP). The transfer is done via an 'equitable assignment' which is a form of true sale and can in case of issuer insolvency easily be transformed into a true sale (legal assignment). The sale via equitable assignment is only fully perfected in case of issuer insolvency and enables the originator to keep the assets on its balance sheet.

The covered bond structure used by Anglo Irish Bank Corporation in the UK is less similar to the RMBS technique: it is based on a fiduciary system (assets are segregated according to a 'declaration of trust'). The trust is not the owner of the assets, but is established to monitor the assets and guarantee the Covered Bonds.

Covered Bond holders have recourse against a bank

The crucial difference between Covered Bonds and RMBS is that Covered Bond holders have recourse against a bank, not only the underlying assets transferred to a SPV like RMBS. Hence, investors have a dual claim. Some RMBS 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'.

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 pool accelerates (depending on the relevant legal framework).

RMBS 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 RMBS.

In RMBS, 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. RMBS 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 RMBS 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. RMBS 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 RMBS 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 RMBS

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 RMBS 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 Securitisation Forum has published guidelines which provide helpful criteria to measure the seriousness of the execution of the securitisation. With the increasing convergence of the two asset classes, transparency standards should also converge. So far, RMBS cover pool reports usually provide more details than Covered Bond cover pool reports.

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. There are tendencies to include other assets in structured Covered Bonds in the future, e.g. car loans. However so far, there have been no such issues. The increasing diversity of Covered Bond structures has led to concerns regarding the 'risk of fragmentation of the market'. The notion 'Covered Bond' 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, RMBS are permitted in Covered Bond pools. Ireland has just recently modified its legal framework to include RMBS. The CRD had limited their share to a maximum of 20% of the pool. However, CRD allows 100% when the RMBS 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 RMBS in cover pools without limit, to encourage the RMBS market at the European level and to increase the liquidity of these two complementary funding tools.

Conclusion

RMBS investors are exposed to the risk of underperformance of the cover pool. Covered Bond holders benefit from the support of the issuing bank, but they have to bear the operational risk regarding the management of the dynamic cover pool. The increasing diversification of the Covered Bond structures is inspired by the use of securitisation techniques, even sometimes using the two instruments directly together.

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. The new structured Covered Bonds offer the issuers more flexibility regarding the eligibility of assets (like the loans guaranteed by a specialised institution in case of BNPP and not by a mortgage based on a property) and 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.

Basel 2/CRD supports Covered Bonds and RMBS

Even though it is difficult to statistically quantify the spread impact, it seems reasonable to assume that the risk weighting is a key determinated of Covered Bond spreads.

The individual European Member States have to implement Basel 2/CRD by 1 January 2008. In 2007, banks can choose to use either Basel 1 or Basel 2. Most European banks have straightaway applied the foundation internal rating based approach and as quickly as possible thereafter the advanced internal rating based approach. As most European Covered Bonds will end up with a risk weighting below 10%, this is positive for the Covered Bond market as a whole.

Generally, the different national legislation and supervisory authorities have some room for manoeuvre in implementing Basel 2/CRD. National legislation can still be stricter than European law, but cannot be more lenient. Hence, the different European Member States may allow different treatment under Basel 2/CRD e.g. neither the Austrian nor the German law implementing Basel 2/CRD mentions the special role of the Finnish Housing Association as cover pool assets.

There are no reliable historical PDs for banks. It seems reasonable to assume that banks have a lower PD than corporates, given the important role they play for the economy as a whole, the high cost involved in bank runs and the fact that they are often considered 'too big to fail'. The PD statistics of rating agencies are based on corporate default rates. Hence, banks may try to use the lowest possible PD of 0.03% for most Covered Bond issuers. Combined with a LGD of 7%, something underpinned by studies of the German Association of Pfandbrief Banks (vdp) and the European Mortgage Federation (EMF), and Maturity (M) of 5, this leads to a risk weighting below 4%. However, if banks apply higher LGDs or PDs for Covered Bonds, the risk weighting will end up markedly above 7%, particularly for long dated Covered Bonds.

Even without taking into account potential lower spreads of Covered Bonds, funding costs decrease under Basel 2/CRD. The main reason is the reduced risk weighting of underlying mortgage loans under Basel 2/CRD. Whereas the risk weighting for residential mortgage loans (according to the German regulation up to the minimum of 60% of the mortgage lending value and 50% of the market value) was 50% under Basel 1, it is 35% under the Basel 2/CRD standard approach and 13% under Basel 2/CRD internal rating based approach. The risk weighting for commercial mortgage loans (according to the German regulation up to the minimum of 60% of the mortgage lending value and 50% of the market value) under Basel 2/CRD standard approach is 50% in contrast to 100% under Basel 1.

As the risk weighting of Covered Bonds, RMBS and underlying mortgage loans changes under Basel 2/CRD, it seems reasonable to compare funding costs of Covered Bonds and RMBS. UK banks discussed a structure which involves only selling the AAA RMBS tranche. In this case, the calculation of funding cost is quite similar as in case of Covered Bonds. The issuers need to hold equity against the mortgage loans and overcollateralisation has to be funded on an unsecured basis. Spanish Cédulas are more expensive than most other European Covered Bonds from an issuer's perspective. This is not only due to the higher spreads at which Cédulas typically trade, but also to the high overcollateralisation of Cédulas.

Under Basel 2/CRD, Covered Bonds will continue to offer the cheapest funding tool for UK banks. In Spain, due to the high overcollateralisation in the case of Covered Bonds, funding costs for AAA RMBS and Cédulas look equal.

Risk Weighting of UK Covered Bonds vs. AAA RMBS

	Current	Basel 2 – Standardized Approach	Basel 2 – Internal Ratings Based Approach
AAA RMBS	50%	20%	7%
UK Covered Bonds	20%	10%	variable (less than 10% if the issuing bank's senior unsecured rating is A– or higher)

Generally, from a risk weighting perspective, RMBS benefit more than Covered Bonds from Basel 2/ CRD and may even end up with a lower risk weighting. This is particularly true for long dated Covered Bonds, which are penalised under the advanced internal rating based approach by a high maturity (M). However, as there are only very few long dated Covered Bonds this is not a problem compared to RMBS.

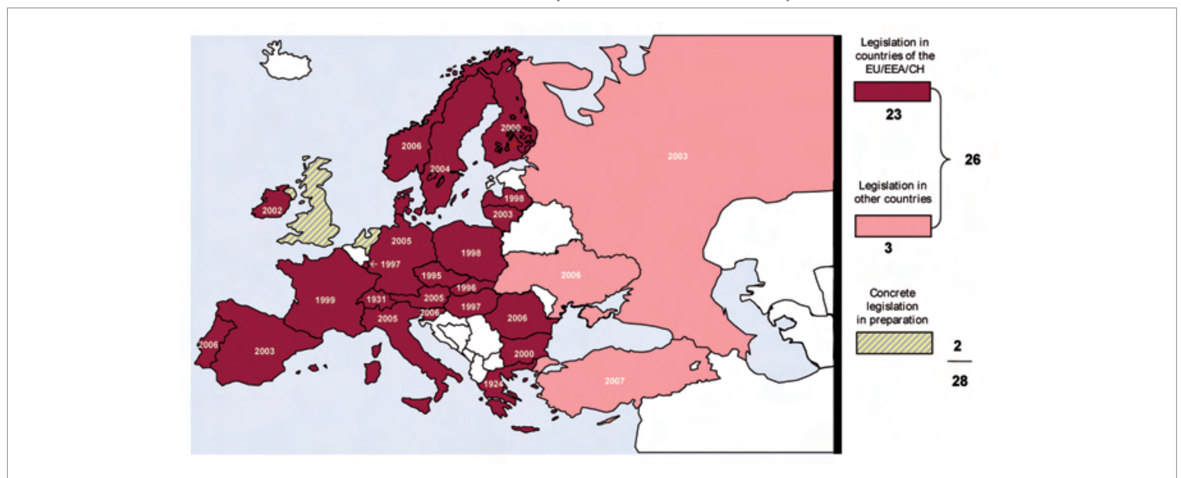
CHAPTER II - GENERIC SECTION

By Ralf Grossmann, NATIXIS
and Otmar Stöcker, Association of German Pfandbriefbanks

2.1 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 2006 amounting to over EUR 1.9 trillion.[1] In 2007, the Covered Bond market is continuing its strong growth as more and more 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. 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 February 2007)



Source: vdp

Regulatory competition amongst the different national markets has enhanced the quality of the Covered Bond instrument and diversification in the group of Covered Bond issuers now means that this group not only includes specialized mortgage banks, but increasingly diverse players, such as Dutch and UK issuers, Spanish savings banks, German universal banks etc.

In 2007, regulatory developments in national markets and the enactment of new Covered Bond legislation herald the arrival of new issuers in the marketplace. The transposition of the EU Capital Requirement Directive (CRD) into national legislation will lead to amendments of the Covered Bond legal frameworks in some countries (Ireland, France), which could give those markets fresh stimulus. Important changes of the legal frameworks have also taken place in Denmark and changes are ongoing in Spain. Italy has adopted a new Covered Bond legislation, which will most probably lead to the issuance of Covered Bonds backed by mortgage loans from Italian banks in the second half of 2007. Norway is another country where the inaugural issuance of a Covered Bond took place in 2007 and Turkey has recently set up a Covered Bond legal framework. 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.

1 Source: EMF/ECBC

2.2 HISTORY

The Covered Bond is a pan-European product par excellence. Its roots lay in the Greek mortgage and the Italian and the Dutch bonds. Decisive milestones of 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.

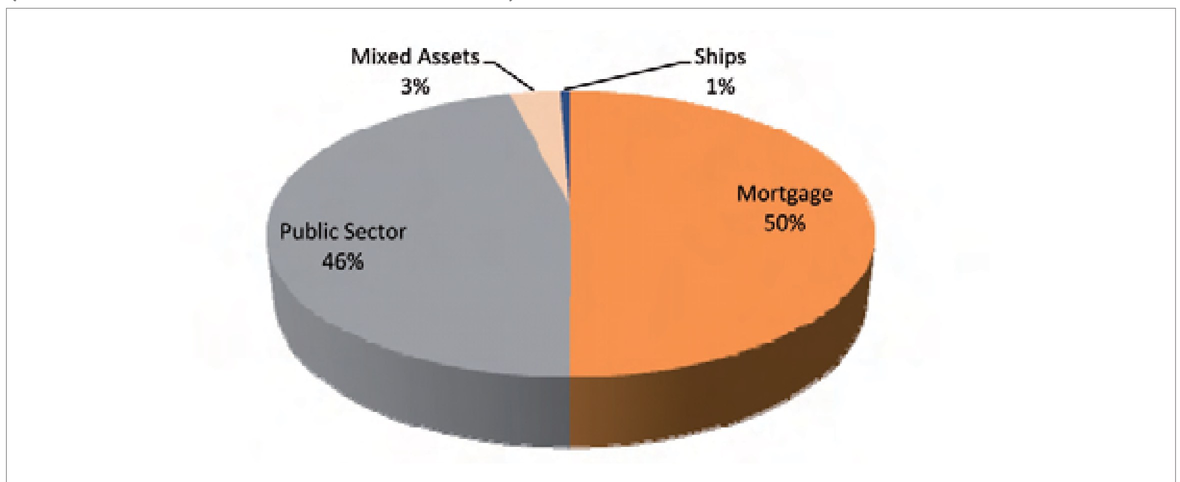
2.3 THE PURPOSE OF COVERED BONDS

The acquisition or construction of residential, commercial or agricultural property, public investment (e.g. infrastructure projects, etc…) 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.

2.4 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 (Italy, Portugal in preparation). 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, Spain, Austria and Italy (CDP). Covered Bonds backed by ship loans are not very common but exist in Denmark and Germany.

> CHART 2 – PERCENTAGE SHARE COVERED BONDS BACKED BY MORTGAGES/ PUBLIC SECTOR DEBT (BASED ON FIGURES OF VOLUME OUTSTANDING 2006)



Source: European Mortgage Federation/European Covered Bond Council figures - Covered Bonds outstanding at the end of 2006.

2.5 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
- 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 April 2007, 19 EU Member States sent notifications to the EU commission. 16 states notified the EU commission on bonds and authorised issuers fulfilling the criteria of Article 22(4) UCITS mentioned above. 3 states (UK, Netherlands, Italy) have so far only sent negative notification, which should be changed as soon as they have set up Covered Bond legislation. The UK and The Netherlands, where Covered Bonds are issued on the basis of contractual frameworks, have officially put forward the intention to examine the possibilities for a legal Covered Bond framework, to make them compatible with the UCITS directive. Several states did not send any notification, although they have a Covered Bond legislation and issues. This result is somehow astonishing 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/securities/ucits/instruments_en.htm.

2) CRD

Another cornerstone of Covered Bond regulation at EU level is the new Capital Requirement 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 Chapter I of this Fact Book.

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

According to the CRD, Covered Bonds benefit from privileged credit risk weightings only if they fulfill the following requirements:

2 Directive 2006/48/EC.

(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

Only if these requirements are transposed by each EU Member State, privileged treatment of Covered Bonds can be obtained or maintained. 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.

2.6 A COMPARATIVE FRAMEWORK OF VARIOUS COVERED BOND SYSTEMS IN EUROPE

To date, 27 countries have special Covered Bond legislation or arranged structured Covered Bonds on contractual basis in a general-law based framework. However, not all of these countries, where laws are in place, have significant issuance activity.

The Technical Working Group of the ECBC has undertaken a comparative analysis, based on a questionnaire, which 18 European 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: Italy (Gen. framework), Latvia, The Netherlands, Austria, Portugal, the UK, Ukraine and Romania.
- Universal credit institution with a special license: Germany and Sweden.
- Specialized credit institution: Denmark, France, Ireland, Luxembourg, Hungary, Poland, Portugal, Finland, Switzerland and Romania.
- Specialized financial institution: Italy (CDP), Austria (Pfandbriefstelle)

3 Detailed information is available on the website of the ECBC.

Framework

In most European countries, the issuance of Covered Bonds is regulated by specific Covered Bond legislation. This is the case in Denmark, Germany, France, Ireland, Italy (Gen. framework), Latvia, Luxembourg, Hungary, Austria, Poland, Portugal, Finland, Sweden, Ukraine, Switzerland and Romania. In Italy (CDP), the Netherlands, the UK and partially France (BNPP) 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 (Latvia, The Netherlands, Sweden and the UK) or by a specific legal framework superseding the general insolvency law (Denmark, Germany, France, Ireland, Italy, Luxembourg, Hungary, Austria, Poland, Portugal, Finland, Ukraine, Switzerland and Romania).

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-collateralization (on a nominal or net-present value basis) plays an important rule 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 standardization 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 fulfill 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. Some systems establish by law or by contract the segregation of Covered Bonds and cover pools from the general insolvency estate (Denmark, Germany, Ireland, Italy, Latvia, Luxembourg, Hungary, The Netherlands, Austria, Portugal, Finland, Sweden, United Kingdom, Ukraine, Switzerland and Romania). In other Covered Bond systems, the protection of Covered Bondholders is achieved through a preferential claim within the general insolvency estate (France and Poland).

One important common characteristic is that Covered Bonds in Europe do not automatically become due if the issuer becomes insolvent. This is the case in 17 of the participating countries, Romania being the exception. 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 of 18 European countries, 13 fulfill the criteria of Article 22(4) UCITS. Italy (CDP), the Netherlands and the UK currently do not fulfill it and the article is not applicable to Ukraine and Switzerland. In 9 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 their way in 3 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.

2.7 FROM COMPARATIVE ANALYSIS TO COMMON ESSENTIAL COVERED BOND FEATURES

The comparative framework developed by the ECBC Technical Working Group provided the basis for the discussion of common essential features of Covered Bonds. It is the objective that those features show the common characteristics of Covered Bonds.

The ECBC Technical Working Group embarked upon the task to identify those common essential features and submitted its first proposals to the ECBC Steering Committee in May 2007:

Covered Bonds could be characterized by the following common essential features that are achieved under both special-law based frameworks and general-law based frameworks:

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

These proposals will have to be further discussed by the ECBC Steering Committee and among ECBC members before being adopted by the ECBC. In addition, the ECBC Technical Working Group will outline explanatory notes to clarify and comment on these common essential features.

2.8 SUCCESS OF THE INSTRUMENT

The European Mortgage Federation (EMF) statistics show that around 17% of the total volume of residential mortgage loans outstanding in the EU is funded through the issuance of Covered Bonds. The Covered Bond is one of the dominant components of the European capital market. The volume outstanding at the end of 2006 amounted to over 1.9 trillion EUR (Covered Bonds covered by mortgage loans, public-sector loans and ship loans), which represents an increase of about 8% vis-à-vis the previous year. The most important issuing countries are Denmark, Germany, Spain and France.

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

Chart 3 – Covered Bonds Outstanding 2006 in € Mn

	MORTGAGE	PUBLIC SECTOR	MIXED ASSETS	SHIPS	TOTAL
Germany	223 306	720 835	0	4 669	948 810
Denmark	300 367	0	0	6 672	307 039
Spain	214 768	11 590	0	0	226 358
France	43 012	49 660	61 930	0	154 602
Ireland	11 900	49 914	0	0	61 814
Sweden	55 208	0	0	0	55 208
UK	50 594	0	0	0	50 594
Luxembourg	150	29 235	0	0	29 385
Switzerland	23 096	0	0	0	23 096
Austria	3 420	13 680	0	0	17 100
Italy (CDP)	0	10 000	0	0	10 000
Netherlands	7 500	0	0	0	7 500
Hungary	5 924	0	0	0	5 924

	MORTGAGE	PUBLIC SECTOR	MIXED ASSETS	SHIPS	TOTAL
Czech Republic	5 543	0	0	0	5 543
USA WaMu	4 000	0	0	0	4 000
Finland	3 000	0	0	0	3 000
Portugal	2 000	0	0	0	2 000
Slovakia	1 861	0	0	0	1 861
Poland	453	0	0	0	453
Latvia	63	0	0	0	63
Lithuania	14	0	0	0	14
Total	956 180	884 914	61 930	11 341	1 914 365
%	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 you look at the figures outstanding as of 31.01.2006, the total outstanding for the Danish market would be EUR 40 – 50 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 "mix 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, the figures are tentative.

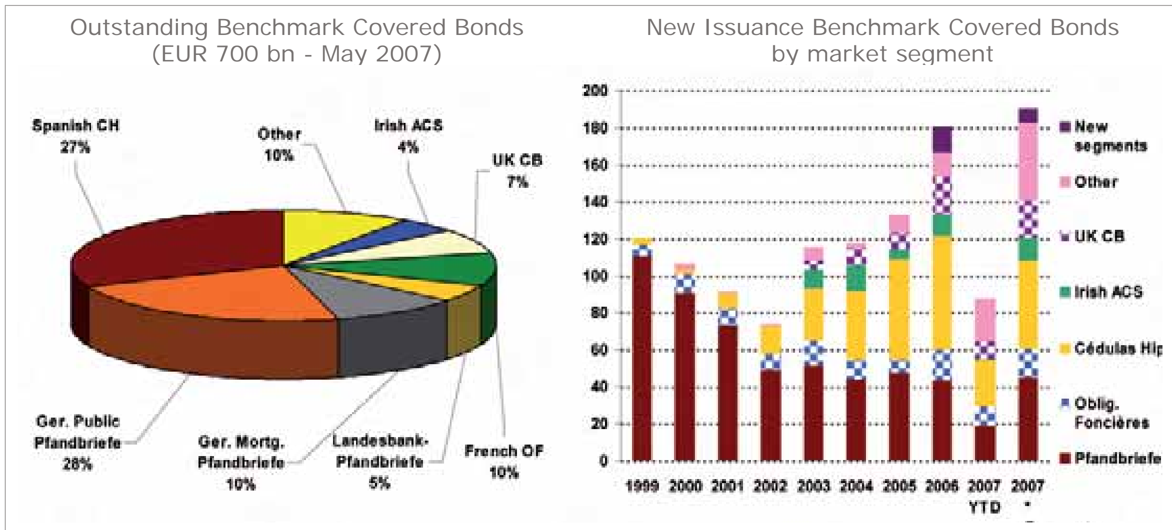
2.9 BENCHMARK COVERED BONDS

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). All Benchmark Covered Bond are quoted with narrow two-way prices by at least 3 market-makers, which enables investors and market makers to execute rather large orders easily or unwind positions. Pricing transparency in the benchmark Covered Bond market is further enhanced through the increasing importance of electronic trading platforms, like EuroCreditMTS.

Benchmark Covered Bonds are primarily issued with maturities between 5 and 10 years, but market segments with maturities of 15, 20 years and longer have gained importance recently. 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 most liquid 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 Spain, France, Ireland, Italy (CDP), Luxembourg, the Netherlands, Austria, Portugal, Finland, Sweden, the UK, Norway and the USA.

> Chart 4 – Benchmark Covered Bond Supply



Source: Market data, NATIXIS;
Other comprise Austria, Finland, Luxembourg, Italy (CDP), Netherlands, Spain (Ced.Ter.), Portugal, French CB (BNP), US Covered Bonds, Sweden

2.10 WHO INVESTS IN COVERED BONDS?

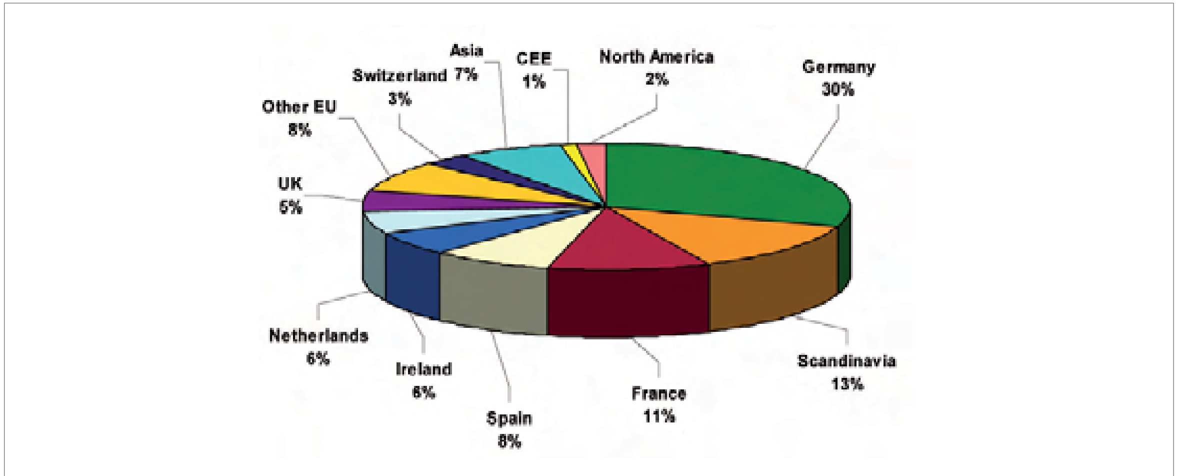
Covered Bonds are attractive financial investments because they offer excellent credit quality, high market liquidity, international diversification and a large choice of maturities. Moreover, Covered Bonds enjoy privileged treatment in different areas of EU financial market regulation.

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, which offer interesting diversification opportunities to investors.

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

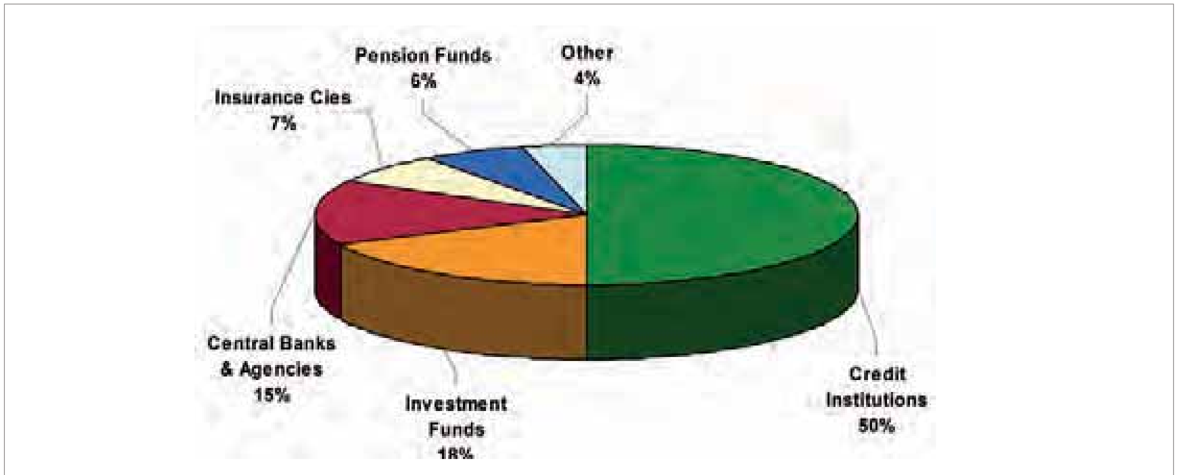
The most important development in the primary Benchmark Covered Bond market in the past years has been the trend towards longer maturities. While in 2004 new issuance in 10Y or longer-dated Benchmark Covered Bonds accounted for slightly more than 30% of total new Benchmark Covered Bond issuance, this share stood at over 50% in 2005, at 37.5% in 2006 and at over 40% in 2007 year-to-date.

> Chart 5 – Benchmark Covered Bond Primary market placement by country/geographical area (averages 2005-2007)



Source: NATIXIS; Other EU comprise: Austria, Belgium, Italy, Luxembourg, Portugal

> Chart 6 – Benchmark Covered Bond Primary market Placement by type of investor (averages 2005-2007)



Source: NATIXIS

CHAPTER 3 - THE ISSUER'S PERSPECTIVE

3.1 CZECH REPUBLIC

By Pavel Kühn, Czech Banking Association

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 estates 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.

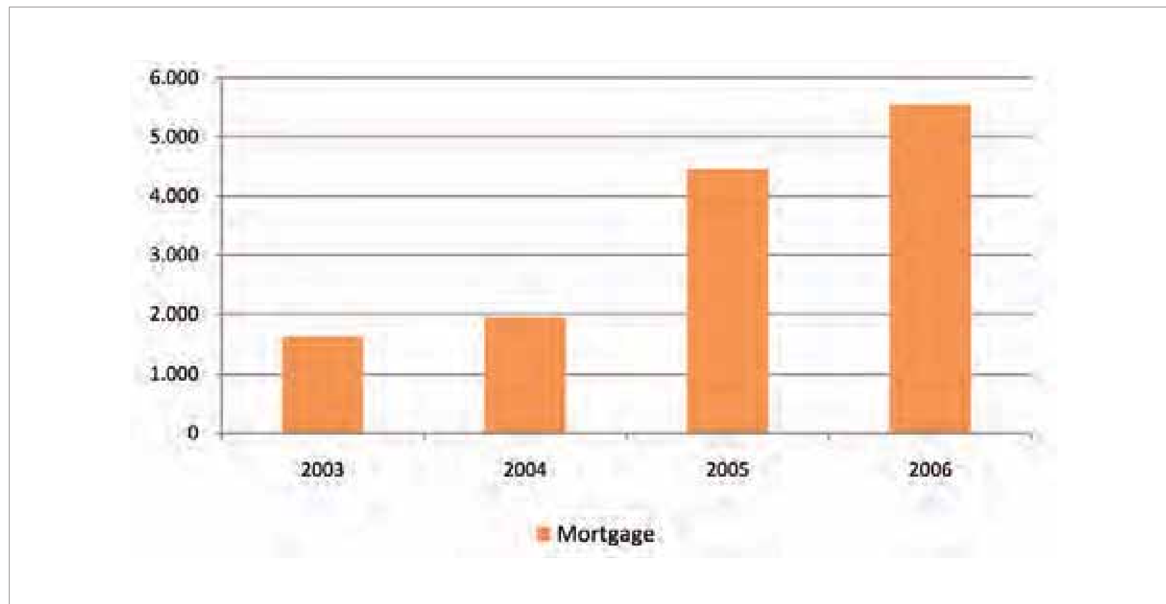
The CNB also supervises the issuer activities from the position of a Government supervisory body over the capital market. Each issuer having its MCBs in circulation is obligated to send to the CNB the reports showing its economic results and its financial situations in the determined intervals and to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

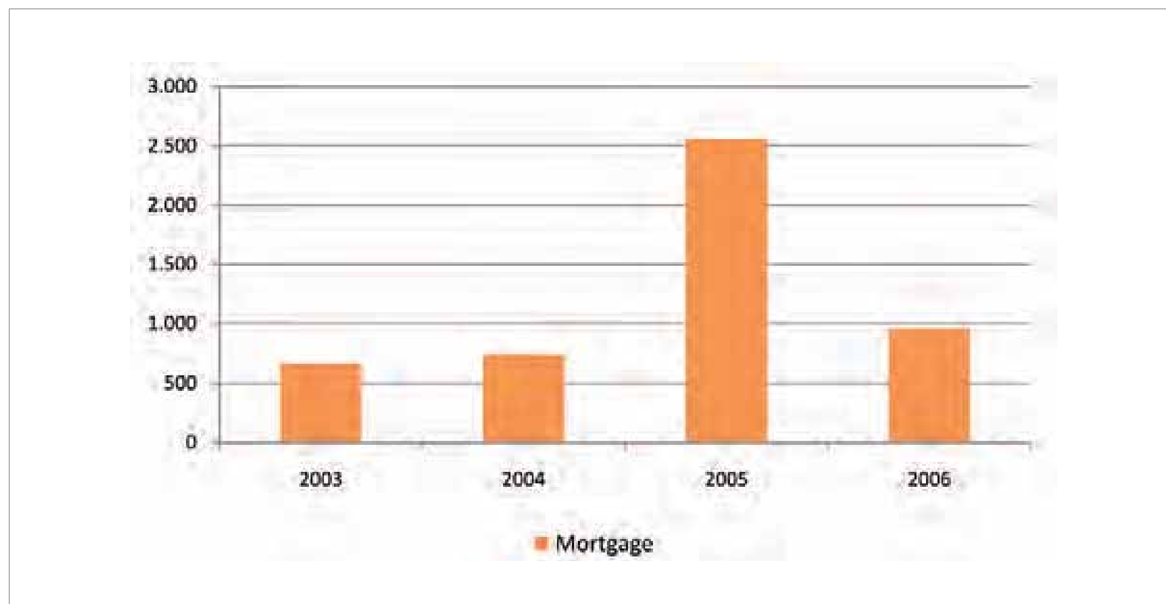
The Czech MCB legislation complies with the requirements of Art. 22 par. IV UCITS Directive.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2006 IN €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE 2003-2006 IN €M



Source: EMF/ECBC

3.2 DENMARK

By Lars Blume-Jensen, Association of Danish Mortgage Banks
and Svend Bondorf, Nykredit

I. FRAMEWORK

In Denmark the legal basis for the activity of mortgage banks is the Danish Financial Business Act (DFBA) and the Mortgage Loans and Mortgage Credit Bonds Act (MLMBA). Specific bankruptcy regulations laid down in DFBA and MLMBA prevail over general bankruptcy regulations (MLMBA §§ 22-33). Please note that the new Danish Covered Bond regulation enters into force July 1, 2007 (see § IX).

II. STRUCTURE OF THE ISSUER

In Denmark, mortgage banks issue mortgage bonds upon a license from the Danish Financial Supervisory Authority (DFSA). The mortgage bonds issued are full recourse debt instruments of the issuer.

Danish issuers operate subject to a specialist banking principle in accordance with Danish legislation in the area, confining the activities of issuers to the granting of mortgage loans funded by the issuance of mortgage bonds and other related business.

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 mortgage bond issuance. This is the case given that Danish mortgage banks are not allowed to use activities such as collecting deposits as a source of funding, cf. DFBA § 8.

The issuer holds the cover assets on his balance sheet and also holds the claims on the cover assets. The mortgage bonds are direct, unconditional obligations of the issuer and as such, there is a direct legal link between the mortgage bonds and the cover assets. Mortgage bonds and cover assets are assigned to individual capital centres but the individual mortgage bonds, however, are not linked to individual mortgages (loans). In case of suspension of payments or bankruptcy, the assets of the capital centres will be frozen, and no excess funds may be transferred from these. In an insolvency scenario, the assets of a/each capital centre constitute a separate cover pool, cf. MLMBA § 27.

The issuer has its own employees. Outsourcing of activities is allowed if control measures are deemed satisfactory by the DFSA and consumer protection regulations are observed. The valuation of property may be outsourced provided that the issuer conducts sample valuations on a regular basis and that the value of individual assets (properties) valued does not exceed DKK 4 million, equivalent to 530,000 euros. 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

Cover assets are:

> Registered mortgages on real estate

> Eligible securities (temporary substitute collateral)

> Reserve fund assets (overcollateralisation)

To serve as cover assets, mortgages must be entered in the Danish land register, which is kept by the Danish district courts.

Securities may only serve as temporary collateral. Proceeds from mortgage bond issues must be used to fund mortgage loans within 90 days from the issue. Similarly, proceeds from borrowers' loan repayments exceeding the ordinary scheduled payments to mortgage bond investors must be used to fund mortgage loans or to redeem outstanding mortgage bonds within 12 months. Accordingly, mortgage bonds are primarily secured by registered mortgages on real estate.

Eligible securities are:

> Government bonds issued by OECD member states and deposits with central banks

> Mortgage bonds issued by mortgage banks in OECD member states

> Deposits with commercial banks with a maximum term of 12 months.

Reserve fund assets placed in eligible securities may serve as collateral on a permanent basis (overcollateralisation)

There are no specific limits regarding the geographical scope of the cover assets, but Danish mortgage banks are required to notify the DFSA in case they wish to establish a branch within the EU or in a country with which the EU has entered into agreements on the financial area. The same applies if Danish mortgage banks wish to carry out cross-border activities in the above-mentioned geographic areas. Mortgage banking or the set-up of branches outside these geographic areas requires DFSA approval. Moreover, the DFSA may fix lower LTV limits than those listed under question IV, 3, below for cross-border lending, cf. MLMBA §§ 16-17.

Derivatives are allowed as hedging instruments, but they are typically not included in the cover pool. As a result of the Danish balance principle, derivatives are basically made redundant and their use is consequently limited. Derivatives are therefore not used on a general basis. The terms-to-maturity of derivatives with asymmetric payments (such as options, swaptions, etc.) may not exceed four years. Counterparty lines in general must cover derivatives.

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. Assets may exclusively be transferred to or from the cover pool on 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 ISINs and both cover assets and ISINs 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. The (Danish) 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 DFSA supervises cover asset identification.

IV. VALUATION AND LTV CRITERIA

The Danish Mortgage Credit Act contains provisions for property valuation. The basis for valuation is the mortgage-lending value. In Denmark the mortgage lending value will correspond to the open market value in the vast majority of cases, cf. MLMBA §§ 10-15 and the Executive Order on Property Valuation and Lending Assessment (own translation) (EOPVLA).

There are no provisions regulating mortgage banks' monitoring of property values on an ongoing basis. However, Danish mortgage banks continuously monitor property values as part of internal risk

management activities. This monitoring of property values is done on both a loan-to-loan basis and a portfolio basis depending on the characteristics of the assets.

Mortgaged property is valued (on-site inspection) as part of the processing of loan applications. If the customer applies for supplementary loans, a new valuation will be performed. When granting loans the LTV is assessed on a loan-to-loan basis. A basic principle of the valuation regulations is that a valuation officer of the issuer must perform valuation. Provided that a number of conditions are met, the valuation may be outsourced. The detailed conditions are set out in DFBA and MLMBA.

All valuations of mortgaged property are reported to the DFSA. The DFSA performs random checks of mortgage banks' valuations by on-site inspections. In 2005 the DFSA 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 DFSA, cf. § 3 EOPVLA.

In terms of loan to value (LTV) limits, the LTV limit is 80 percent for residential property, 70 percent for agricultural property and 60 percent for commercial and holiday property.

V. ASSET - LIABILITY MANAGEMENT

The asset-liability management of Danish mortgage banks is regulated in accordance with the balance principle. The balance principle is embedded in Danish mortgage banking legislation and enforced by the DFSA. If an issuer is unable to fulfil the requirements, the DFSA must be informed immediately. In addition, Danish mortgage banks report market risk exposures to the DFSA on a quarterly basis, cf. MLMBA §§19-21 and the Executive Order on the Danish Mortgage Bank's Issuance of Bonds, the Balance Principle, and on Interest Rate and Exchange Rate Risks (EODMBIB).

According to the balance principle there are a number of requirements which must be fulfilled at all times:

- Interest rate risk arising out of imbalances in the payments from the loan portfolio and to the funding portfolio is limited to 1% of the capital base;
- Future payments to mortgage bond investors must be covered by payments from borrowers received in advance;
- Currency risk arising out of imbalances in the payments from the loan portfolio and to the funding portfolio is limited to 0.1% of the capital base;
- Callable loans must be funded by callable bonds with matching cash flows.

The balance principle thus nearly eliminates interest rate risk, foreign exchange risk and prepayment risk.

Loans 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.

In practice, the Danish balance principle nearly eliminates prepayment risk as Danish mortgage banks are not allowed to fund callable loans with non-callable bonds).

The cover of future payments to mortgage bond investors is tested to limit issuers' liquidity and funding risk. Passing this test, the issuer will have sufficient liquidity to meet all future payments on mortgage bonds issued and will therefore not be dependent on future funding markets in order to make timely payments to mortgage bond investors.

The funding of callable loans is tested to ensure that the risk of borrowers calling their loan at par is fully passed through to mortgage bond investors. Employing the pass-through principle, issuers will remain unaffected by borrowers calling loans at par. This is also the case as a result of the funding match on individual loans. In any case, borrowers' loan payments fall due before or at the same time as the ordinary scheduled payments to bondholders.

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

Mandatory overcollateralisation of 8% on a risk-weighted basis is required by law – also at capital centre level. The overcollateralisation forms part of the cover pool. If this requirement is not observed, the DFSA must be informed without delay. In this case, the DFSA will issue an order effecting suspension of payments and, if applicable, initiate insolvency proceedings against the issuer. The DFSA 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 DFSA on a quarterly basis.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The issuer monitors the cover pool continuously. In this respect, the monitoring also applies specifically to Danish mortgage banks that their internal auditors report directly to the board of directors. Data from every single loan offer and thus all property valuations for new lending purposes are reported to the DFSA on a quarterly basis.

There is no special cover pool monitor officer. Instead, the internal auditors are required to monitor the existence of the mortgages in the capital centre on a current basis.

Banking supervision is carried out by the DFSA. The DFSA 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 DFSA may revoke the operating licence and dismiss the management of the issuer, cf. DFBA §§ 373-374.

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

Cover assets, i.e. mortgages and eligible securities, are assigned to specific capital centres, which constitute the cover pools of the bonds issued in accordance with Danish legislation. Mortgages must be entered in the Danish land register to become eligible as collateral. 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 - who is subject to the supervision of the DFSA - 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. The single loans (mortgages) are legally linked to one or more specific ISINs. The loans and ISINs are connected in the capital centre. Thus, each capital centre consists of specific named ISINs and specific mortgages.

If insolvency proceedings have been initiated, a liquidator appointed by the DFSA will administer the cover assets. Mortgage bond investors have a secured claim on the cover pool which ranks prior to all other creditors. Derivative counterparties rank pari passu to other creditors. The liquidator may re-establish the issuer, if possible, and is not necessarily required to dissolve the enterprise, cf. DFBA §§ 231-235.

The issuer will continue to exist as a legal entity under the administration of the liquidator until the claims of all mortgage bond investors have been met in full, cf. MLMBA § 32.

Mortgage bond investors have a preferential position (a secured claim) in an insolvency scenario. The preferential position ensures that a bankruptcy scenario will only in exceptional cases affect mortgage bond investors, thereby rendering mortgage bonds bankruptcy remote, cf. MLMBA § 27.

The bankruptcy regulations applicable to Danish mortgage banks contain detailed guidelines, which must be observed in an insolvency scenario, cf. MLMBA § 32). Key points of the guidelines are:

- A liquidator will be appointed by the DFSA to administer all financial transactions of the issuer;
- The liquidator will be instructed to meet all payment obligations on mortgage bonds issued in due time notwithstanding a suspension of payments of the issuer;
- All new lending activities of the issuer will be suspended;
- The liquidator may issue mortgage bonds to refinance maturing mortgage bonds and subordinated debt to raise liquidity;
- Payments on loans will not be accelerated, and therefore payments from borrowers will fall due according to the original payment schedule;
- The liquidator may not meet the claims of other creditors before all payment obligations on the mortgage bonds issued have been met in full. (MLMBA § 32).

Mortgage bonds do not accelerate automatically. Payments fall due according to the original payment schedule, cf. MLMBA § 32. Derivatives may be terminated at the discretion of the liquidator and it is for this reason that derivatives are generally not used to hedge imbalances in the lending and funding

portfolios. In addition, derivative counterparties rank pari passu to other creditors i.e. after mortgage bond investors.

The liquidator is instructed by legislation to meet all payment obligations on mortgage bonds issued on a timely basis. A judicial moratorium would be in breach herewith, cf. MLMBA § 32.

If payments from cover assets (mortgages and overcollateralisation of minimum 8%) are insufficient to meet the payment obligations on the mortgage bonds issued, the liquidator has the authority to raise additional loans. If this fails, the issuer will ultimately default on its payments. The liquidator may raise loans to meet the payments for holders of mortgage bonds and other securities and provide security for such loans in the form of other assets than the cover pool mortgages, i.e. the reserve fund assets. The lender will have a first priority secured claim on the assets provided as security but not on the mortgages, cf. MLMBA § 32.

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 on the mortgage bonds issued. Only the issuer as mortgagee, not investors, is entitled to foreclose on cover assets. Cash flows from cover assets must be used to meet the payment obligations on mortgage bonds issued.

Both mandatory and voluntary overcollateralisation form part of the cover pool and are thus insolvency remote.

Mortgages are generally not transferable under the terms of the mortgages. Transfer of mortgages would require the consent of the debtor in each individual case.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Danish mortgage bonds fulfil the criteria of UCITS 22(4) and therefore enjoy a 10% risk weight. The mortgage bonds are also eligible in repo transactions with the Danish Central Bank (Danmarks Nationalbank). Compliance with the criteria of the CRD is currently being investigated by a working party chaired by the DFSA.

In Denmark the investment legislation allows pension funds etc. higher levels of investment of their assets in mortgage bonds than 5 %. (DFBA (regarding Insurance Companies) and Act on Investment Associations and Special-Purpose Associations as well as other Collective Investment Schemes etc.).

IX a. NEW DANISH COVERED BOND REGULATION ENTERS INTO FORCE JULY 1, 2007

In connection with the implementation of the new Capital Requirement Directive (CRD) in Denmark, new Covered Bond Legislation has been adopted by the Danish Parliament. The new regulation which enters into force on 1 July, 2007 brings some fundamental changes to the existing Danish Covered Bond system. However, details on the new regulation are currently being finalised and a comprehensive description will be included in the ECBC Fact Book next year.

IX b. ENLARGEMENT OF THE GROUP OF ISSUERS

Before 1 July, 2007 the EU rules allowing a more favourable treatment of particularly secure bonds have, with respect to Danish issuers, only applied to mortgage bonds issued by Danish mortgage banks and bonds issued by Danmarks Skibskredit A/S and KommuneKredit. As of 1 July, 2007 the new regulation implies an enlargement of the group of issuers thus covering all credit institutions. This means that commercial banks are also given the ability to issue Covered Bonds, which is the overall

aim of the new regulation. The Danish Financial Services Authority (FSA) may license mortgage banks as well as commercial banks and ship financing institutions to issue Covered Bonds.

In the past, only mortgage banks were allowed to issue mortgage bonds (Realkreditobligationer, RO). Now commercial banks will also be able to issue Covered Bonds (Særligt Dækkede Obligationer, SDO) funding mortgage loans. However, mortgage banks continuously possess the exclusive right to issue mortgage Covered Bonds (Særligt Dækkede RealkreditObligationer, SDRO).

This results in three types of Danish mortgage bonds: (1) the (old) Realkreditobligationer (RO) issued by mortgage banks, (2) the (new) covered mortgage bond (SDRO) issued by mortgage banks and fulfilling the current as well as new legal requirements, and (3) the (new) Covered Bond issued by commercial banks or mortgage banks (Særligt Dækkede Obligationer, SDO). In addition, all Realkreditobligationer issued before 1 January, 2008 maintain their Covered Bond status in accordance with the grandfathering option under the CRD.

Some of the fundamental changes of the new regulation are:

IX c. BALANCE PRINCIPLE

Mortgage banks and commercial banks will have the possibility to choose between 2 balance principles – the General Balance Principle and the Specific Balance Principle.

The specific balance principle is almost identical to the existing principle. There will be minor changes e.g. regarding establishing/closing capital centres and the possibility to repay loans by bonds other than the underlying bonds has been improved.

The general balance principle will regulate the same types of risks as the specific balance principle and at the same time give mortgage banks and commercial banks more flexibility regarding managing liquidity risk, for example.

IX d. COLLATERAL

SDO's must be issued with collateral in most of the types of assets listed in the CRD, though mortgage banks are not allowed to issue SDO's with collateral in ships.

IX e. FINANCIAL INSTRUMENTS

Financial instruments linked to the assets will also benefit from the preferential status.

IX f. LOAN TO VALUE

The present loan limits and demands for maturity and repayment profile of the mortgage credit legislation are maintained in the new regulation. As far as loans for residential property are concerned, mortgage banks and commercial banks can however avoid limits relating to maturity and the repayment profile, if the loan is within the loan limit of 70 per cent (as of 2009 75 per cent).

Continuous compliance with LTV limits on a loan-by-loan basis is required. If commercial banks or mortgage banks need to establish top-up collateral, the banks may raise loans to meet this requirement.

IX g. SUPPLEMENTARY LOANS

It will be possible to raise supplementary loans (senior debt) to the continuous LTV compliance, where the senior debt creditors get a secondary secured position in the capital centres (ranked after the bond owners and certain counterparties on financial instruments).

IX h. REGISTERS AND CAPITAL CENTRES

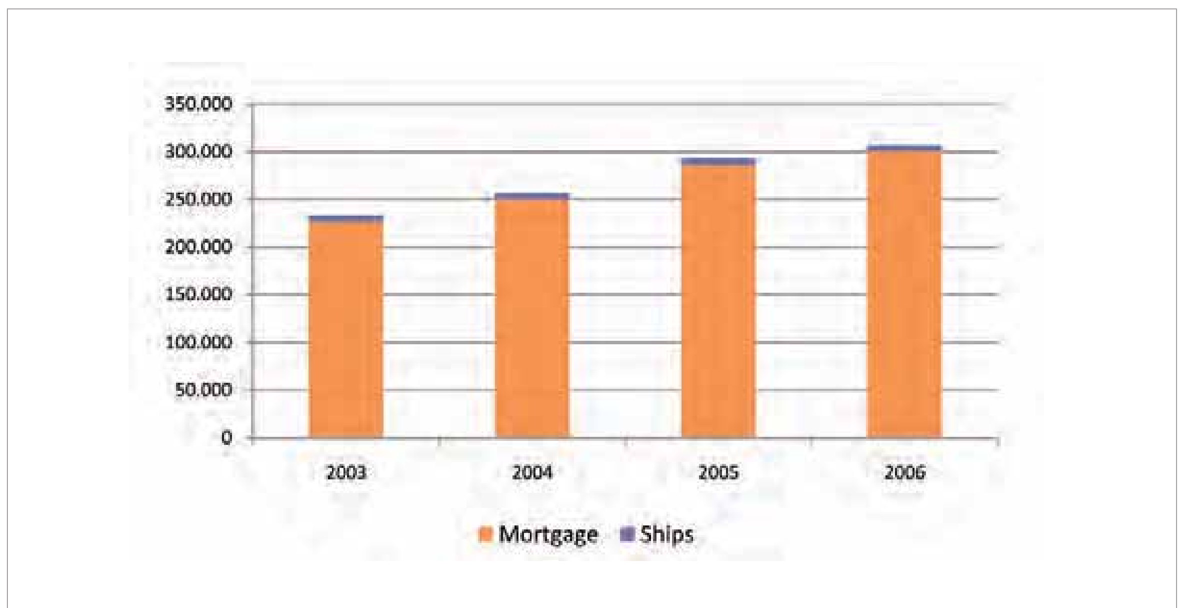
A commercial bank with a licence to issue Covered Bonds must establish and maintain a register of the assets, which provide collateral for the Covered Bonds issued.

Mortgage banks do not have to set up a register, but they must have a capital centre for issues in exactly the same way as is currently required for mortgage bonds.

IX i. JOINT FUNDING WILL BE POSSIBLE

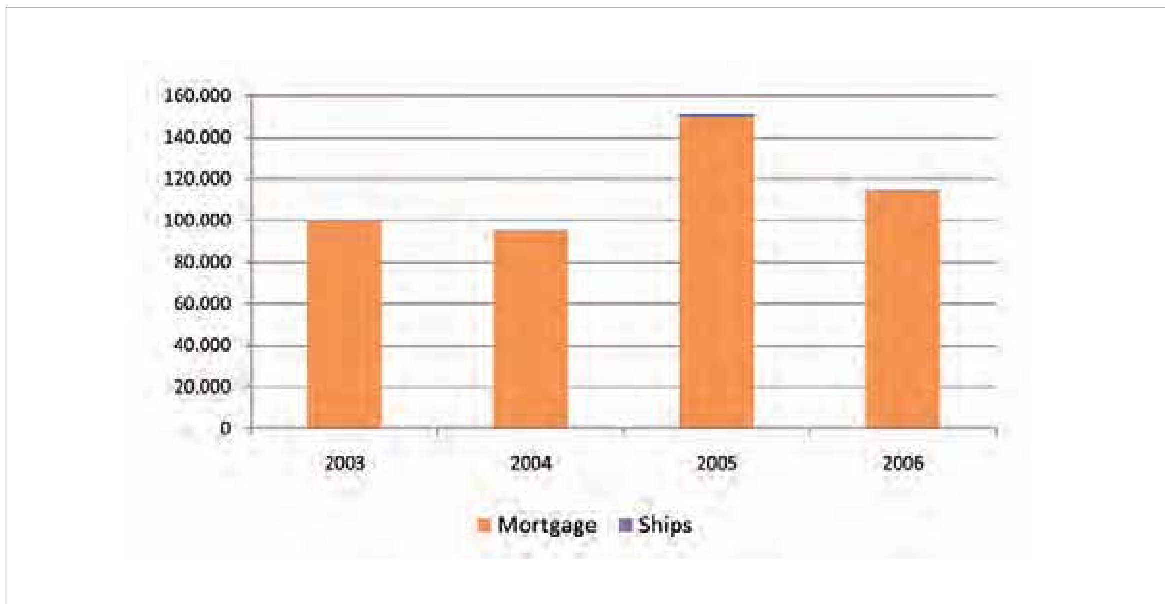
The legislation will allow for the possibility of joint funding, i.e. several institutions joining to issue Covered Bonds to achieve larger sizes of issuances.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2006 IN €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE 2003-2006 IN €M



Source: EMF/ECBC

Issuers: At present mortgage Covered Bonds are issued by: 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. In addition, Danish Ship Finance is the only Danish issuer of Covered Bonds backed by ship loans.

3.3 GERMANY

By Wolfgang Kälberer and Otmar Stöcker
Verband deutscher Pfandbriefbanken

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.

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 aim 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 illiquidity 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

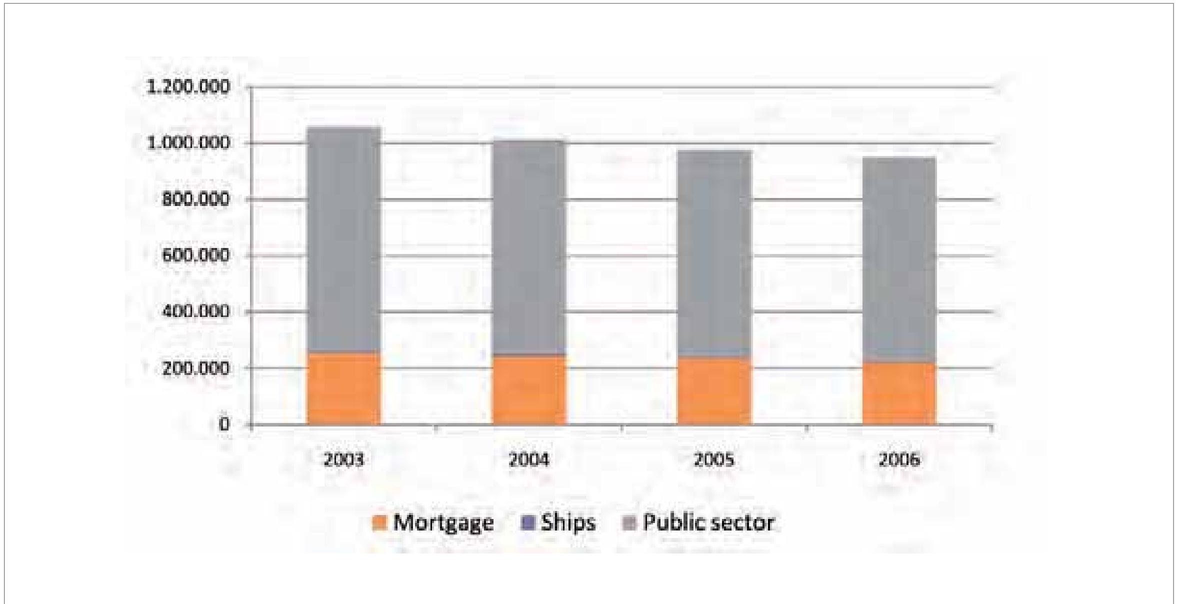
The risk weighting of Covered Bonds (German Pfandbriefe and foreign Covered Bonds) is regulated by Article 20a Kreditwesengesetz (KWG) and the Solvabilitätsverordnung (SolvV), transposing the Capital Requirements Directive into German law.

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).

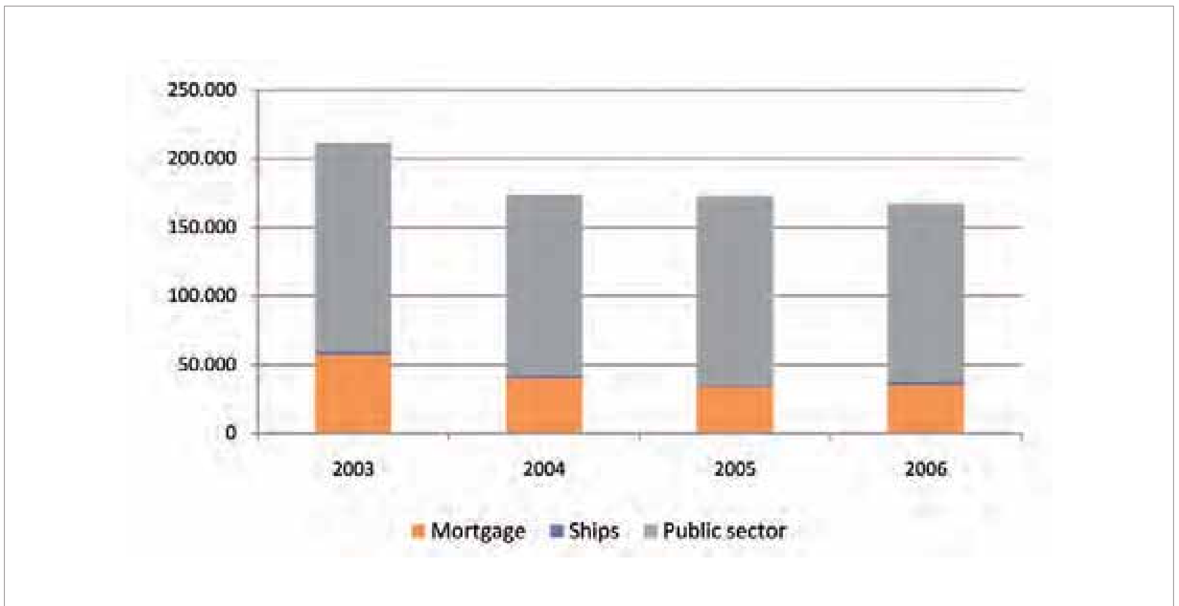
Furthermore, German investment legislation allows investment funds to invest up to 25% of the fund's assets in Pfandbriefe and furthermore in Covered Bonds issued by credit institutions complying with the requirements of Art. 22 par. 4 UCITS Directive (Article 60 par. 2 German Investment Act)

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2006 IN €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE 2003-2006 IN €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), circa 10 Landesbanken (regional public banks) and 5 specialised public sector banks. 4 Pfandbriefbanken do currently issue ship Pfandbriefe.

3.4 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") and the Royal Decree 685/1982, of 17th of March, 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") 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). 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.

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. This right is guaranteed by the entire mortgage loan book registered in favour of the issuer. The effectiveness of this right it 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 fundwill 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

The cover asset pool 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.

In order to determine the maximum amount of CH issued and outstanding for a particular issuer, the Law 2/1981 establishes requirements for mortgage loans that constitute the cover asset pool.

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.

(ii) The mortgage that guarantees the loan or credit must be a first-ranked mortgage.

(iii) The loan or credit guaranteed may not exceed 70% of the mortgage lending value of the asset mortgaged, except for the financing of the construction, reconstruction or acquisition of residential premises, in which case it may reach 80% of such appraisal 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".

(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.

Usually, the Cover Assets are located in Spain and it is market practice for the issuer to hedge the interest rate risk by using the corresponding derivative instrument.

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 appraisal value, the issuer shall, pursuant article 26 and 29 of the RD 685/1982, 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 90 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.

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 Cover 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 90% of the aggregated outstanding principal of the eligible cover 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 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 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.

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) 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). The definition as stated by the Insolvency Law implies the application of the special rule of payment without enforcement of the collateral.

The Insolvency administration is not entitled to adopt any decision against said legal provision and has to use the proceeds from the issuer's mortgage loan book to satisfy CH principle and interest payments on their respective due dates without delay of payments.

2. The Insolvency administrators are obliged to pay such amounts as long as the cash flows produced by the Cover Assets are sufficient to meet the CHs payments pursuant to article 84.2.7° of the Insolvency Law.

In this respect, the Insolvency Law provides a clear definition of the claims of CH holders as special privileged claims without enforcement of the collateral. It also provides an unequivocal classification of the claims of CH holders, as claims against the insolvency estate and clear identification of the cover assets, which are reserved to meet the claims of the CH holders.

Thus, the clarity of the provision leaves no room for a different interpretation. In other words, the same legal provision that states the privilege, states the extent and limits of the same.

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 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.

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.

As the Insolvency Law is quite recent, there is no case law on the capacity of the administrator of the cover pool to use a loan to acquire liquid assets, but in principle there are no obstacles to this course of action.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk-weighted of the CHs has to comply with the requirements of the Law 2/1981 and RD 685/1982 is 10%. The CHs upon being listed on a recognised secondary market (as AIAF) are eligible for investing the assets of the UCITS up to 25% of its net worth.

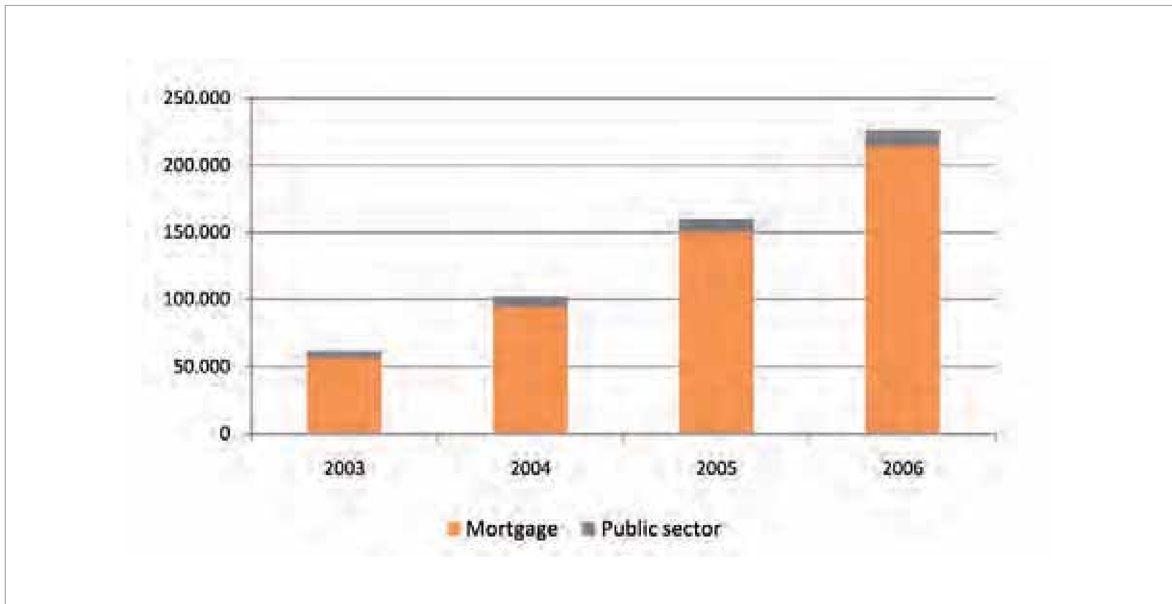
Provided that the requirements of the Law 2/1981 are met, the CHs are eligible as "Covered Bonds" pursuant Annex VI, Part 1, Paragraph 68 (a) to (f) of the Capital Requirements Directive (CRD) (approved but in process of being published).

Moreover, in accordance with "unofficial consolidated version of proposal set out above including all amendments agreed between the Council and the European Parliament" dated 18 October 2005, "recasting Directive 2000/12/EC of the European Parliament and the Council and Council Directive 93/6/EEC on the capital adequacy of investment firms and credit institution, the CHs meet the criteria of paragraph 65 (d) of its Annex VI and, therefore, are to be considered as "cover bonds". *(Please, note that in this respect a material change is not foreseen on this approach once published).*

The CHs are also eligible in repo transactions with the Spanish central bank and the European Central Bank provided that comply with the requirements of the Law 2/1981.

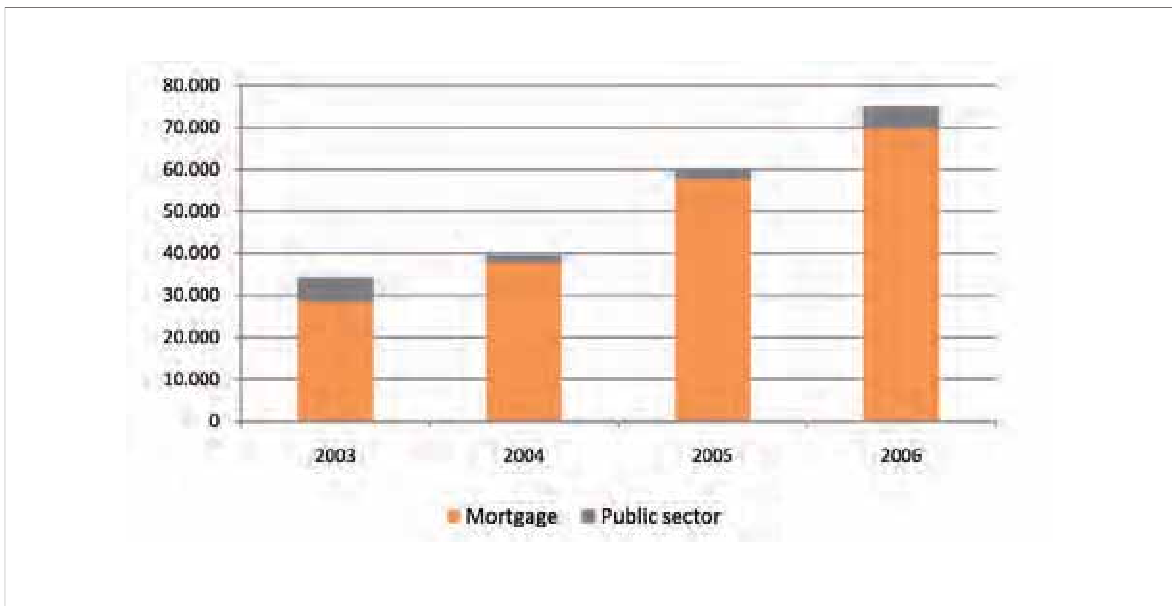
Finally, the CHs upon being listed or applied for listing are eligible: i) for investment by insurance companies of their technical provisions obligations; ii) for the investment by mutual guarantee companies; iii) for investment by Pensions Funds.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2006 IN €M



Source: EMF/ECBC /AIAF

> FIGURE 2: COVERED BONDS ISSUANCE 2003-2006 IN €M



Source: EMF/ECBC /AIAF

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

Issuers: The Spanish market consists of 16 issuers.

3.5 FRANCE

By Francis Gleyze, Caisse Centrale du Crédit Immobilier de France,
Henry Raymond, Caisse de Refinancement de l'Habitat – CRH, and Simon Martin, BNP Paribas

Sociétés de crédit foncier and Caisse de Refinancement de l'Habitat are governed by a special legal framework which was recently updated according to the implementation of the European Capital Requirement Directive N° 2006/49.

The issuer of structured covered bonds, BNP Paribas Covered Bonds, is governed by the French general legal framework and in particular the implementation of the European Collateral Directive N° 2002/47.

A - OBLIGATIONS FONCIERES

By Francis Gleyze, Caisse Centrale du Crédit Immobilier de France

I. LEGAL FRAMEWORK

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

Sociétés de crédit foncier are specialized credit institutions governed by articles L.515-13 and seq. of the French Monetary and Financial Code (The "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 these operations by issuing *obligations foncières*, which benefit from a legal privilege (the "Privilege").

SCF may also issue or contract other debts benefiting or not from the Privilege.

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

II. COVER ASSETS

Only eligible assets and replacement assets - as defined by law - are authorized on the SCF's balance sheet. All assets on the balance sheet are part of the cover pool.

Eligible assets are:

- loans guaranteed by a first-ranking mortgage or equivalent guarantee;
- loans granted to finance real estate and guaranteed by a credit institution or an insurance company that does not belong to the group of the relevant *société de crédit foncier.* The total amount of these loans cannot exceed 35% of the total amount of the assets of the *société de crédit foncier* ;
- exposures to or 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 ;
- other public sector entities and multilateral developments banks as more described in Article L.515-15 of the Code.

> senior units of securitisation funds or equivalent entities subject to the Law of a member State of the European Community or party to the European Economic Area whose assets are composed, at a level of at least 90%, of of these loans and exposures.

Replacement assets, which are limited to 15 % of the amount of the outstanding covered bonds issued by the *société de crédit foncier*, 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 1 credit quality assessment).

III. PRIVILEGE

Pursuant to article L.515-19 of the Code, holders of *obligations foncières* and other privileged debts have preferred creditor status and the right to be paid prior to 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 common bankruptcy Law, has the following characteristics.

> The sums deriving from the loans, exposures, similar debts, securities, senior units of securitisation funds, financial instruments after settlement if applicable, and debts resulting from deposits made with credit institutions by sociétés de crédit foncier are allocated prioritarily 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 the 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 eighteen months prior the insolvency proceedings (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* can never be extended to the *société de crédit foncier* As a result, *sociétés de crédit foncier* are, under a special law resulting from a deliberate decision of the legislator, the only French companies being totally bankruptcy remote and enjoying full protection from the risks of default by their parent company or the group to which they belong,

V. COVERAGE RATIO

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

From a regulatory standpoint, the coverage ratio is calculated by applying different weights to 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 the *société de crédit foncier* complies with the law and regulations, and specifically,
- 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,
- that all assets are effectively eligible, and in the case of mortgage assets, that they are properly valued.

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 company 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 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 AND LOAN TO VALUE

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, *sociétés de crédit foncier* inform twice a year, at 30 June and 31 December, the French banking regulator of the amount of its coverage ratio.

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.

Loan to value does not exceed 80% when the loans are granted to private persons for the acquisition of residential properties, and 60% for commercial purpose. These LTV requirements also applies to senior units of mortgage securitization.

X. COVERED BONDS LIQUIDITY

The three French *sociétés de crédit foncier* have together signed with 23 banks a specific standardized market-making agreement, which has become a national agreement under the control of the Euro Debt Market Association (AMTE).

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, 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 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 other loans are eligible. No replacement assets are allowed.

III. PRIVILEGE

Pursuant to article 13 of act 1985-695 (complemented), when the guarantee of the French government is not accorded (this guarantee is not any longer granted today), 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 theses 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 supra, 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 than these 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. Two of CRH 'issues have a size over 4 euros 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 ISSUED BY BNPP CB

By Simon Martin, BNP Paribas

BNP Paribas ("BNPP") has established a covered bond instrument which, while not structured under the Obligation Fonciere legislation, incorporates all the features characterising these low risk instruments found across Europe and recently the US.

ISSUANCE STRUCTURE

The issuer in the BNPP covered bond programme is a specialist credit institution called "BNP Paribas Covered Bonds" (BNPP CB) which is a subsidiary of BNP Paribas and regulated by the Banque de France. It is subject to the standard credit institution capital requirements, and restricted in its memorandum of association in the business activities it can perform. The proceeds from the covered bonds are lent on a full recourse basis to BNPP and secured on the residential home loans.

LEGAL FRAMEWORK

BNPP CB is a company independent from the borrowing bank. Bankruptcy proceedings or liquidation of the borrowing bank, holding BNPP CB's equity, cannot be extended to BNPP CB.

BNPP's covered bond security structure uses the advantage offered by the implementation of the recent European Collateral Directive into French law to achieve undisputed segregation of the assets for the benefit of investors by operation of legislation, whilst achieving greater flexibility for BNPP. The residential loans are kept on the balance sheet of BNPP and ownership of the residential loans would be transferred to the issuer unconditionally and immediately upon the occurrence of a credit event. This ensures that the covered bonds benefit from a contractual privilege within the context of the French commercial code. Leaving the loans on-balance sheet allows servicing and administration of the loans to remain with the individual branches of BNPP, which is the business model used by BNPP and other major French lenders.

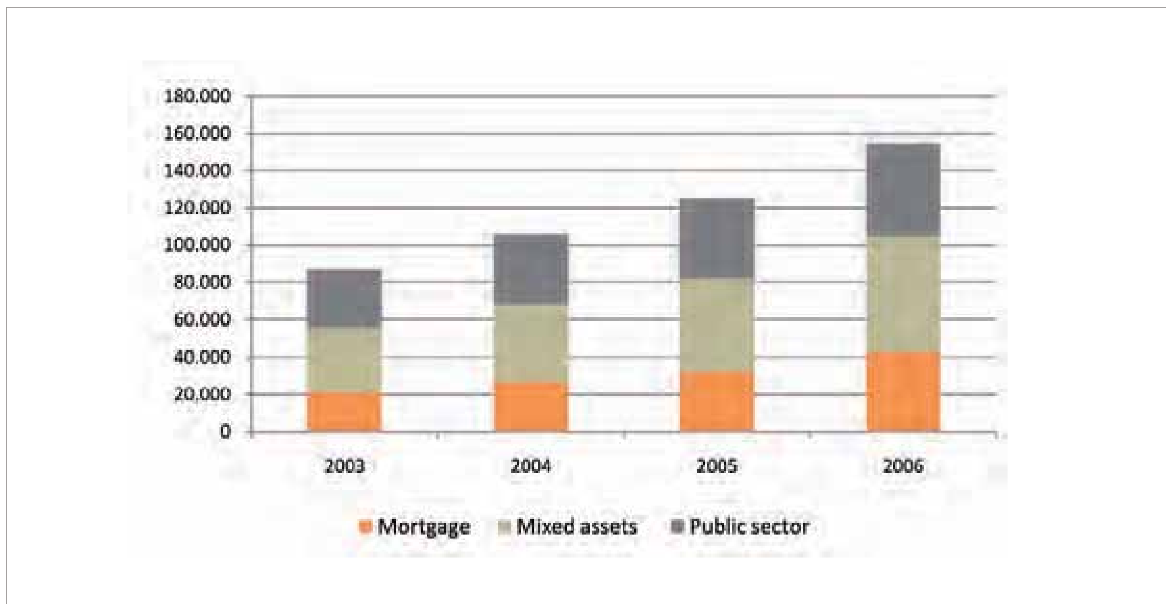
COVER ASSETS

The French residential loan market is moving away from mortgages (which entail high transaction costs) towards loans guaranteed by a financial institution such as Credit Logement, and more than half the loans granted in 2006 were guaranteed rather than mortgages (up from 20% 7-8 years ago). The BNPP covered bond structure allows unlimited usage of this type of residential home loans. An independent Asset Monitor checks on a regular basis that the cover pool meets a specified Asset Cover Test that has been determined in conjunction with the three rating agencies.

MARKET RISKS

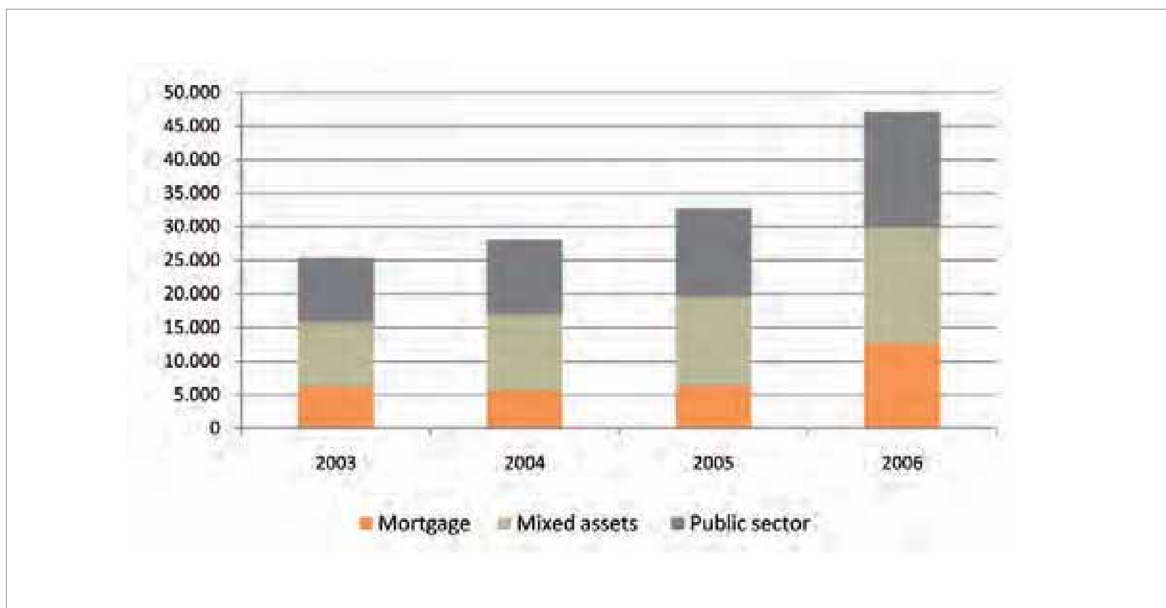
The issuer will hedge all market risks should BNPP lose certain rating requirements as stipulated by the rating agencies. This protects investors against adverse currency and interest rate risks should BNPP not be sufficiently rated to absorb these risks.

Figure 1> Covered Bonds outstanding 2003-2006 in €m



Source: EMF/ECBC

> figure 2: Covered Bonds outstanding 2003-2006 in €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 six Covered Bond issuers in France: Compagnie de Financement Foncier (CFF), CIF Euromortgage, Dexia Municipal Agency, Caisse de Refinancement de l'Habitat (CRH), BNP Paribas and Credit Mutuel.

3.6 IRELAND

By Nick Pheifer
Depfa ACS

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 (the "Amendment")) 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 either a designated public credit institution (authorised to issue public credit covered securities) or 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 a combination of these.

The ACS Issuer holds the assets backing the ACS on its balance sheet. The collection of either mortgage 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 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 'overcollateralisation'). 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.

The changes to the ACS Act introduced under the Amendment can for the most part be categorised as follows: Changes required to ensure that the ACS will qualify as Covered Bonds for the purposes of the Capital Requirements Directive (the "**CRD**" or Recast Codified Banking Directive); technical changes which clarify provisions of the ACS Act or facilitate the more flexible operation of the requirements of the ACS Act; certain new features, such as facilitating the issue of a commercial mortgage credit securities backed by a separate pool of commercial mortgages. Regulations setting out the operation of the commercial mortgage covered securities have yet to be completed and so the operations of the commercial mortgage covered securities are not set out in this chapter.

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 issuing business.

Under the ACS Act its business activities are restricted to dealing in and holding public credit or 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 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 a designated mortgage credit institution the aggregate prudent loan to value (LTV) of its 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 in respect of money borrowed or raised (whether in the form of a security that represents other public credit that is securitised or not) of central governments, central banks, public sector entities, regional governments or local authorities from any of the eligible jurisdictions (see below) or obligations of any multilateral development bank or international organisation which qualify as such for the CRD. 'Financial obligation' includes an obligation given as a guarantor or surety, and may be indirect or contingent.

'Eligible jurisdictions' are any country within the EEA plus the following six "non-EEA countries": USA, Japan, Canada, Switzerland, Australia or New Zealand.

The financial obligations of the non-EEA countries must also comply with the CRD creditworthiness and risk weighting standards to be eligible as cover assets. Financial obligations of central governments and central banks from non-EEA countries must carry a Step 1 creditworthiness standard. Financial obligations of public sector entities, regional governments and local authorities from non-EEA countries must carry a Step 1 creditworthiness standard together with a risk weighting standard equivalent to exposures to credit/investment institutions or central governments and central banks. Where the financial obligations of the non-EEA countries do not meet the Step 1 creditworthiness standard they may still be included in the cover pool provided they meet the Step 2 creditworthiness standard and do not exceed 20% of the aggregate nominal or principal amount outstanding of the ACS in issue.

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 eligible jurisdictions.

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 eligible jurisdictions.

'Substitution assets' can also be included in either the mortgage credit cover pool, the public credit cover pool or the commercial mortgage credit cover pool with a limit of 15% of the total prudent market value of the cover pool and provided they meet at least the CRD credit worthiness standards. Substitution assets are deposits with an eligible financial institution.

Assets which comprise cover assets in part may also be included in the cover pool but that part which does not qualify as cover asset shall be excluded from the financial matching requirements and the contractual or mandatory overcollateralisation.

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 and 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 and mandatory level of overcollateralisation 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.

III. VALUATION AND LTV CRITERIA

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 overcollateralisation 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.

IV. ASSET-LIABILITY MANAGEMENT

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

Duration matching: The weighted average duration of the cover pool cannot be less than that of the ACS that relate to the cover pool. In addition, for a public credit ACS Issuer, the weighted average duration of the cover pool may not exceed the outstanding ACS by more than 3 years.

Overcollateralisation: The present value of the cover pool must be at least 3% greater than the total of the present value of the ACS in issue. (For contractual levels of overcollateralisation 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. Any collateral posted under a hedge contract will not form part of the cover pool for the purposes of financial matching or contractual or mandatory overcollateralisation but must be maintained on a separate pool hedge collateral register and will be protected as cover assets in the event of issuer insolvency.

Overcollateralisation

A minimum of 3% overcollateralisation of cover assets in the cover pool is required by law calculated on a present value basis. In addition Each ACS Issuer has committed to a minimum level of 5% overcollateralisation 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 contractual and mandatory overcollateralisation. Upon an ACS Issuer insolvency the ACS holders will benefit from any cover assets which make up the overcollateralisation.

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 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

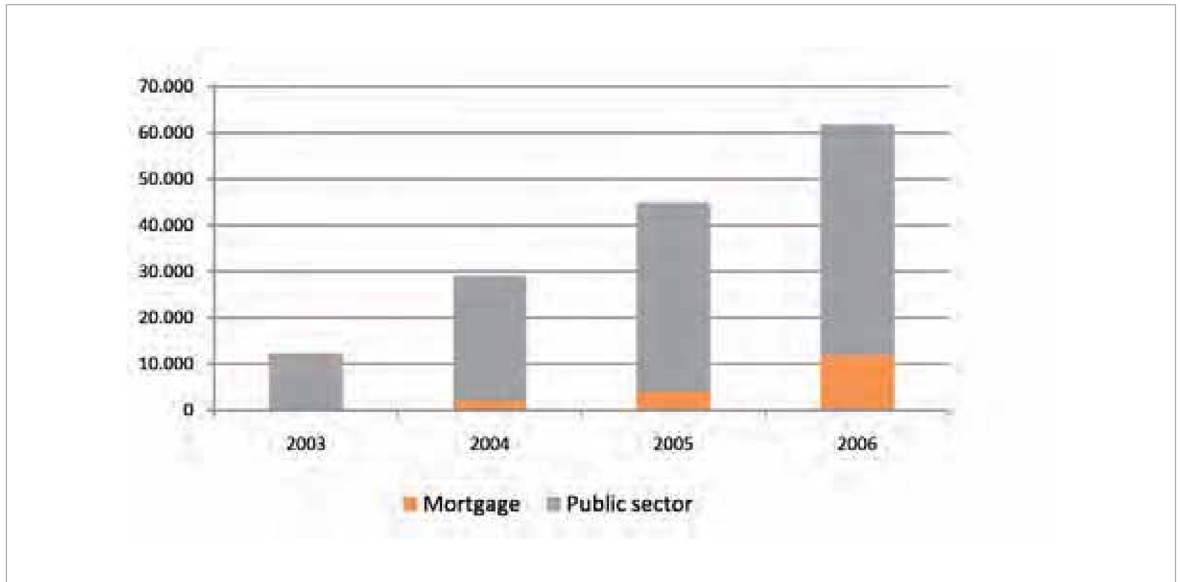
ACS holders are preferred creditors in relation to the cover assets (ranking after the CAM and the NTMA and equally with the hedge counterparties). Cover assets included in a cover pool do not form part of the assets of the ACS Issuer for the purposes of insolvency until such time as the creditors benefiting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

V. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

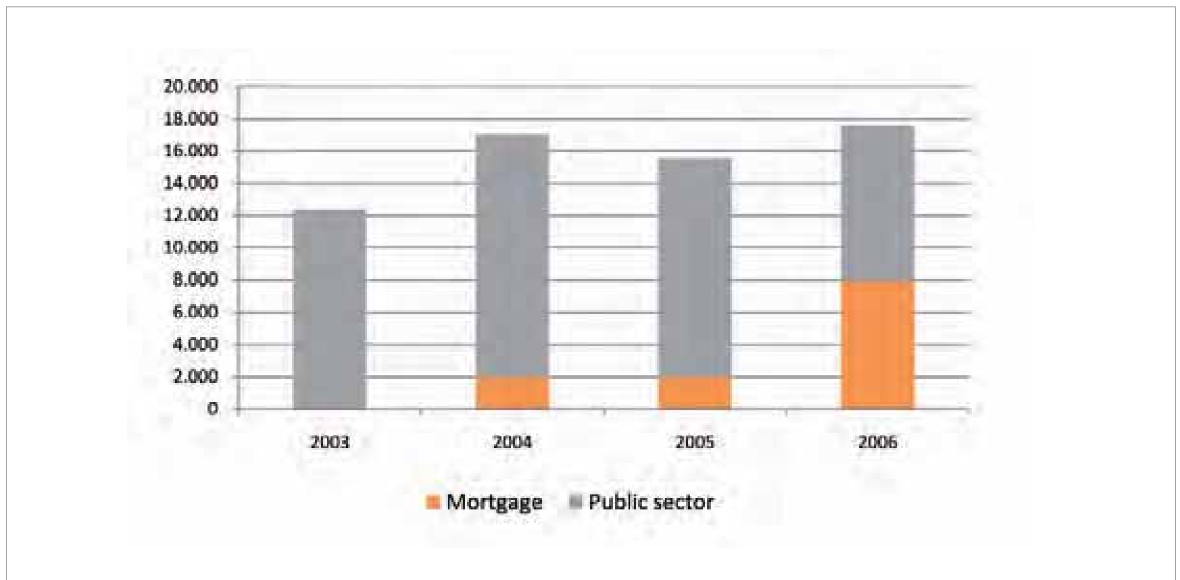
The ACS meet the requirements of UCITS 22(4) and the criteria for the preferential risk weighting of Covered Bonds set out in the CRD.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2006 IN €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE 2003-2006 IN €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).

3.7.1 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

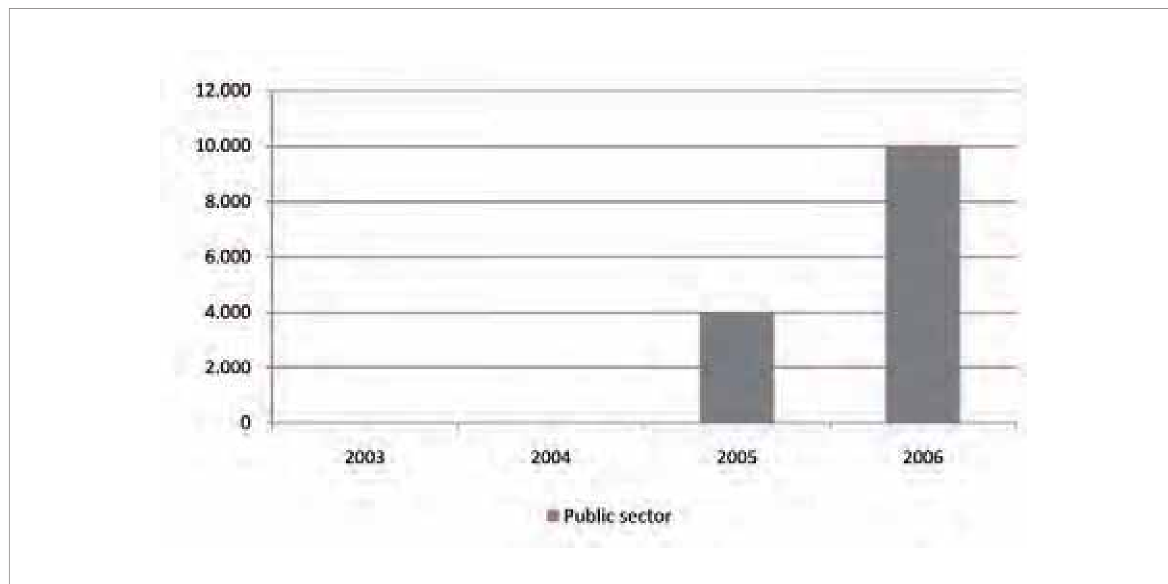
Insolvency of the cover pool is the only reason that might trigger an acceleration of Covered Bonds. In the event that the payment of interest and the repayment of principal is not made when due under the Covered Bonds in respect of any series, all series of Covered Bonds become due and payable.

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.

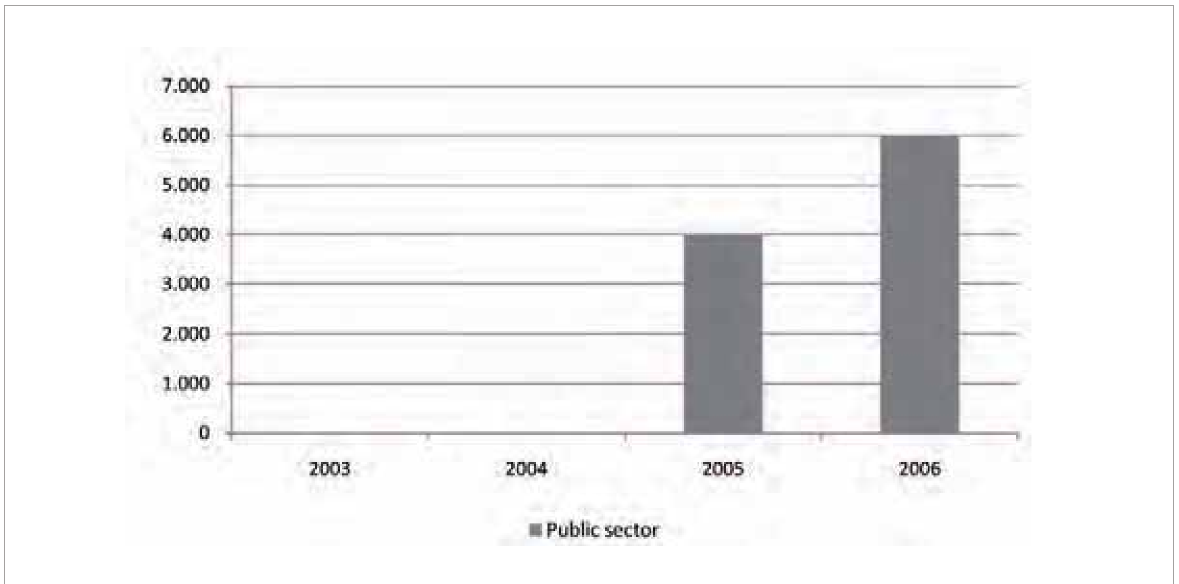
CDP's Covered Bonds are eligible in repo transactions with the ECB.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2006 IN €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE 2003-2006 IN €M



Source: EMF/ECBC

3.7.2 ITALY (GENERAL FRAMEWORK)

By Alfredo Varrati
ABI

I. FRAMEWORK

The Italian Legislator enacted on May 2005 new regulation (Law n. 80/2005), by means of which two specific articles (article 7-*bis* and article 7-*ter*) have been inserted into the existing Italian securitization law (Law n. 130/1999), providing for Covered Bonds.

Pursuant to paragraph 5 of the first of the two abovementioned articles, on the 14th of 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 the last procedural step, which has formally allowed Italian banks to start issuing Covered Bonds, the Bank of Italy enacted its implementing measures on the 17th of 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 the compliance with the obligations of the bank provided for by the same article 7-*bis*, also through auditors.

II. STRUCTURE OF THE ISSUER

Pursuant to the abovementioned article 7-*bis*, the structure of a Covered Bond transaction is as follows:

- 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;
- 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);
- the bank transferring the assets (or another bank) issues Covered Bonds;
- 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 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 be fulfilled also by transferring banks (i.e. cover pool providers), should they be different from the issuing ones.

There are no business restrictions to the issuer's activity, hence there is no special banking principle 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 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 different regulatory capital levels of the issuer (see Table 1)

1.1.1 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 secondary legislation enacted by the Italian Ministry of Economy, assets must at least equal liabilities both on nominal and NPV basis, 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 a 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 overcollateralisation, maintain the ratio of issued bond to cover assets up to the contractually-agreed limit;

> respect the abovementioned 15% limit for eligible supplementary assets.

V. 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 is always sufficient to pay the coupons on the Covered Bonds, and the overall cost of the transaction.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

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) the respect of the predetermined ratio between outstanding Covered Bonds and cover assets; iii) the respect of transfer limitations and asset integration requirements; iv) the performance of any derivative agreement entered into in order to hedge risks.

It is also established that issuers shall perform such operations also through an "asset monitor" specifically appointed by the bank. As provided for by the Bank of Italy, the asset monitor must be an "audit firm", reporting at least once a year to the Board of Directors and to the internal audit department of the bank. No specific reporting to the Bank of Italy is prescribed.

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 Bank of Italy's *Centrale dei Rischi*).

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

As provided for by 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 assets 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 Bond holders 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 Bond holders (as well as other counterparties) and will represent Covered Bond holders 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 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 Bond holders, swap counterparties and transaction costs.

In case the proceeds obtained as a result of the liquidation procedure were insufficient to meet the obligations to bondholders in full, investors would still have an unsecured claim against the issuer for the shortfall.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

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%.

3.8 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

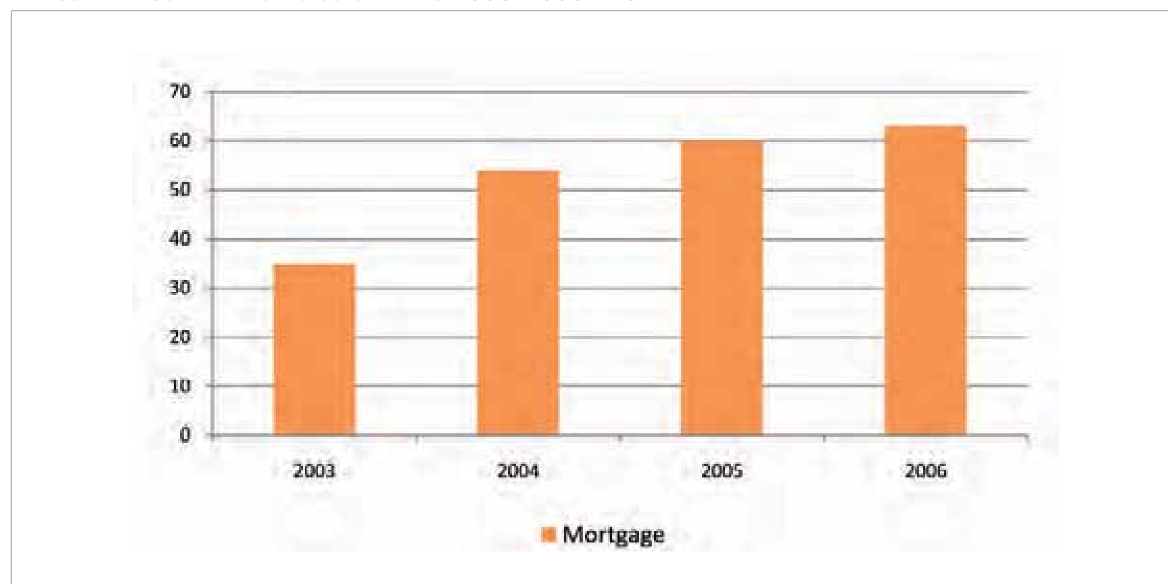
The HKZL and the Law on Credit Institutions provide that the cover assets in a case of insolvency of issuer are transferred to other bank chosen by the FCMC. The bank to which the cover assets are transferred, also takes responsibility for all the obligations arising from outstanding mortgage bonds.

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%.

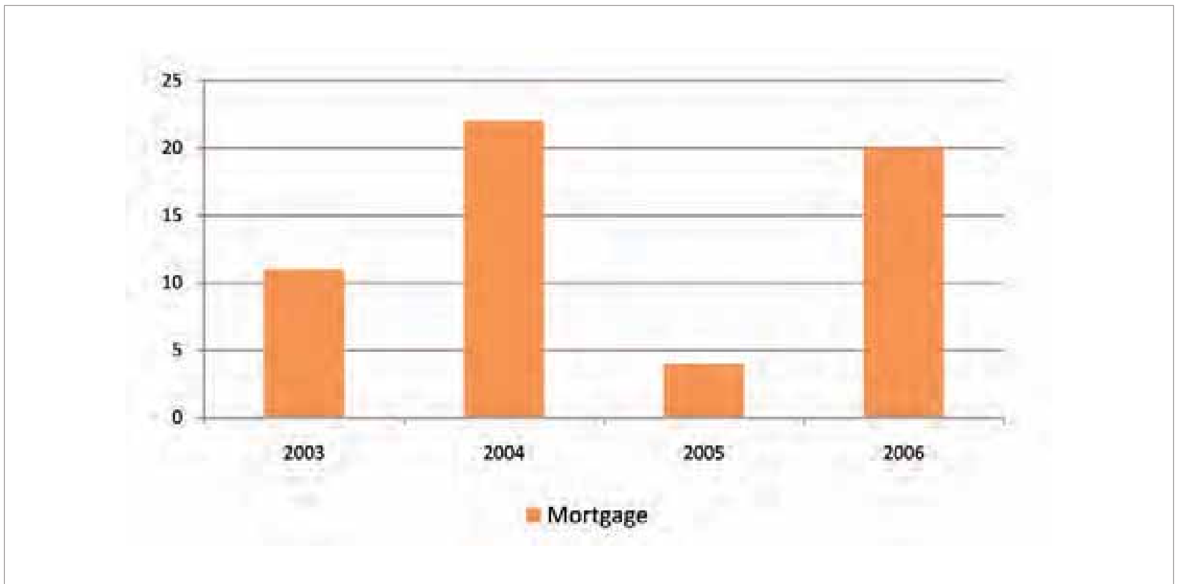
Latvian investment legislation allows mutual funds to invest up to 25% of their assets in mortgage bonds and pension funds – up to 10% of their assets.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2006 IN €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE 2003-2006 IN €M



Source: EMF/ECBC

3.9 LUXEMBOURG

By Frank Will
Royal Bank of Scotland

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.

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 the mortgage Covered Bonds and the second for the cover assets of the 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) like in a securitization. All obligations arising from Lettres de Gage are direct, unconditional obligations of the issuer. In the case of issuer insolvency, the cover pools are segregated by law from the general insolvency estate and are reserved for the claims of the Lettres de Gage holders. There is no direct legal link between a single asset in the cover pool and an outstanding Lettre de Gage. Interest and principal payments of the outstanding Lettres de Gage Hypothécaires and Lettres de Gage Publiques (including any derivatives benefiting from the preferential treatment) are backed by the assets in the respective cover pools.

Lettres de Gage issuers employ their own staff. According to the Financial Sector Act as banks they need to have sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms which restrict the extent of outsourcing legally possible. In addition, the way of permitted outsourcing is described in detail in different CSSF Circulars.

III. COVER ASSETS

The eligible cover pool assets are defined in Article 12-1 of the Financial Sector Act of 5 April 1993. 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. ABS/MBS are, in principal, not permitted in the cover pool. However, if the respective structure complies with the definition of the principal activities of Lettres de Gage issuers as defined by law, it could be considered cover-pool eligible.

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 four Lettres de Gage issuers that a broad range of information should be provided on a voluntary basis in the interest of bond holders.

IV. VALUATION AND LTV CRITERIA

The property valuation methods are defined by a CSSF Circular 01/42 and are based on the mortgage lending value of the property. A special auditor, who may not simultaneously hold the position of company auditor, has the responsibility of determining whether the property valuation has been undertaken according to the valuation rules.

The LTV limit for 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.

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.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

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 eventually 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.

The supervisory authority 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. They are entitled to demand relevant reports and intercede if liquidity problems have been identified at a bank.

Rating agencies do not play any mandatory role in the monitoring process. The issuers comply with the rating agencies' requirements on a voluntary basis.

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

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 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.

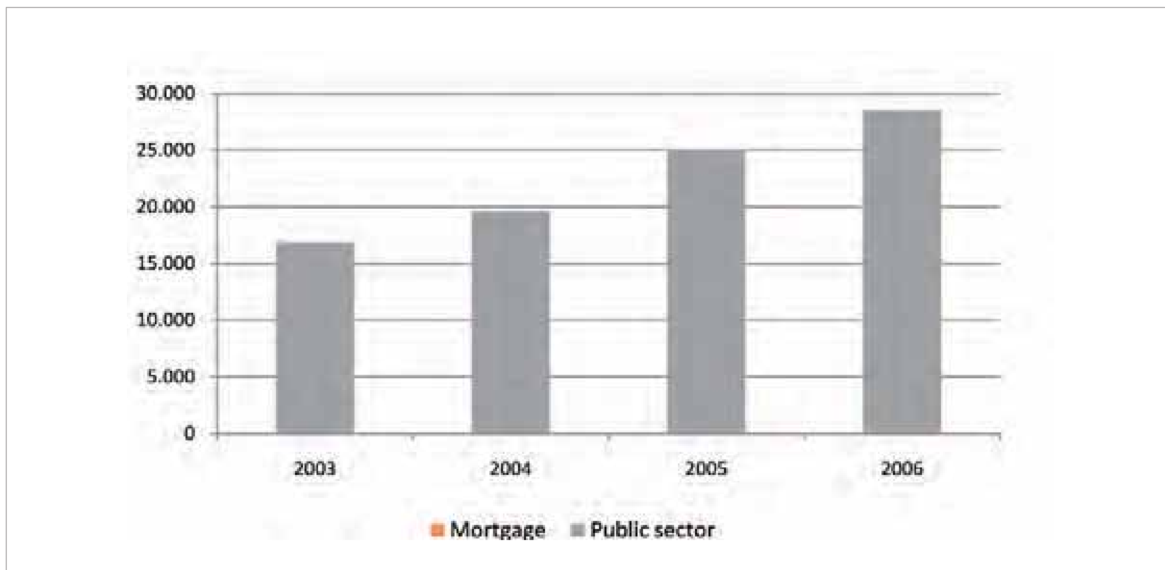
VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

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. 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 the issuers to make their outstanding Lettres de Gage 'CRD compliant" by limiting their cover pool exposure.

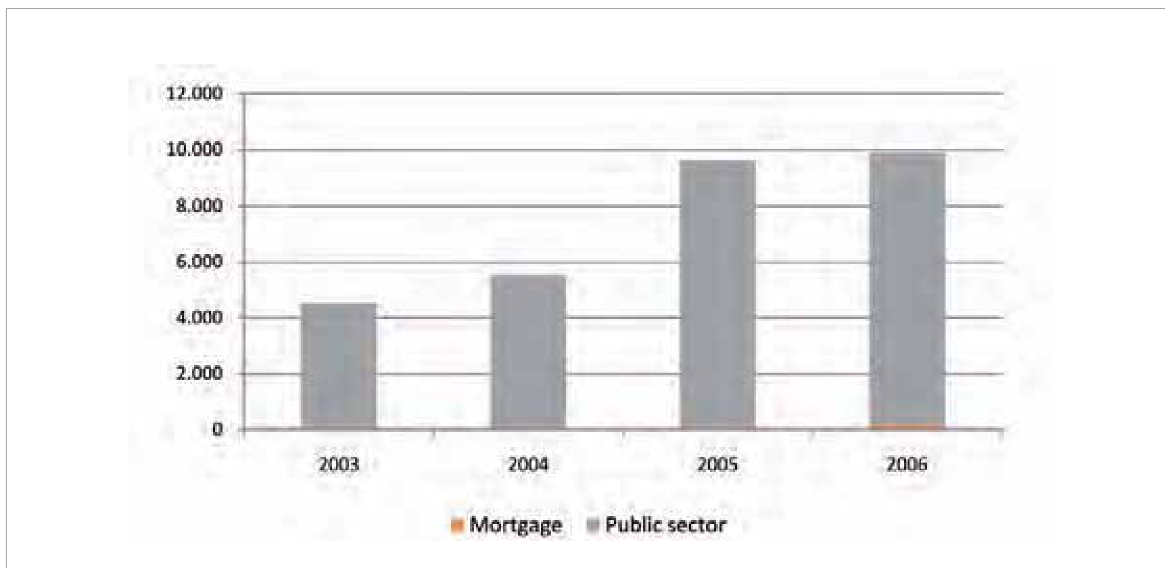
Lettres de Gage are principally eligible for repo transactions with the European central bank. But this applies only to Lettres de Gage issued in Euro and in New Global Note format for Euro-System eligibility.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2006 IN €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE 2003-2006 IN €M



Source: EMF/ECBC

Issuers: There are four issuers in Luxembourg:
- >Erste Europäische Pfandbrief- und Kommunalkreditbank AG in Luxemburg (EEPK)
- >EUROHYPO Europäische Hypothekenbank S.A
- >Hypo Pfandbriefbank International S.A. (HPBI) and
- >NORD/LB Covered Finance Bank S.A.

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 (hereinafter: "**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 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 (6) 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.

As from 1 January, 2007 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 Hungarian Financial Supervisory Authority (hereinafter: "**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 Hungarian Financial Supervisory Authority. Within the scope of his coverage supervision activities, the Coverage Supervisor may not be instructed by the mortgage bank.

The Hungarian Financial Supervisory Authority 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.

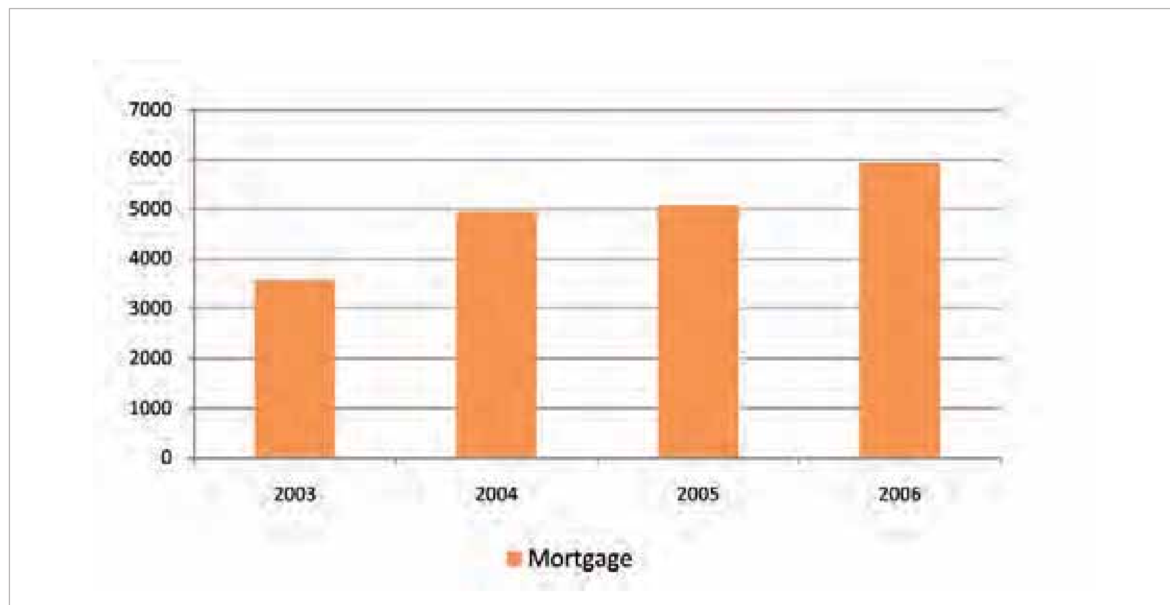
Hungarian legal provisions also provide for a wide-range of measurements, including extraordinary measurements, to be taken by the HFSA prior to any insolvency situation.

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

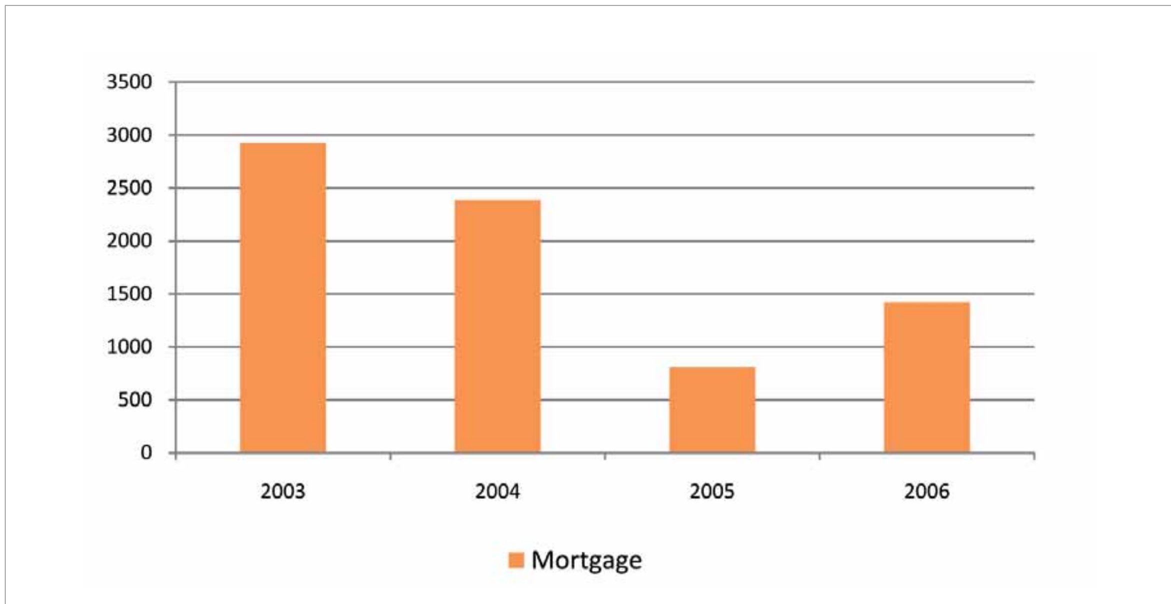
Hungarian mortgage bonds comply with the requirements of Art. 22 par. 4 of the UCITS Directive as well as with those of the CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f) as have been reported to the Commission in accordance with Article 63 of the Directive 2000/12/EC and published on its website. Hungarian mortgage bonds are not yet ECB-eligible, due to the fact that Hungary is not a Eurozone country yet.

> FIGURE 1: COVERED BONDS OUTSTANDING 2004-2006 IN €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE 2004-2006 IN €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). Moody's Investors Service assigns "Aa2" rating and stable outlook to Hungarian Forint- and FX-denominated mortgage bonds issued by OTP Mortgage Bank Ltd. and FHB Mortgage Bank Ltd.

3.11 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.

On 5 September 2006, the Ministry of Finance announced that it will start with preparations for Covered Bond legislation, which (depending on Parliament) could be in force by mid-2008.

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.

Being a structured instrument, the LTV limit can be chosen. The ABN AMRO programme has 130% Loan-to-Foreclosure-Value ("LTFV") limit for 5% of the pool and 125% LTFV limit for the remainder of the pool at the time of origination (if not guaranteed under the National Mortgage Guarantee (NHG)). For NHG guaranteed loans the maximum loan amount is set at Eur 250,000. The ACHMEA Hypotheekbank programme has 125% Loan-to-Foreclosure-Value ("LTFV") for loans in the covered (if not guaranteed under the NHG).

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.

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.

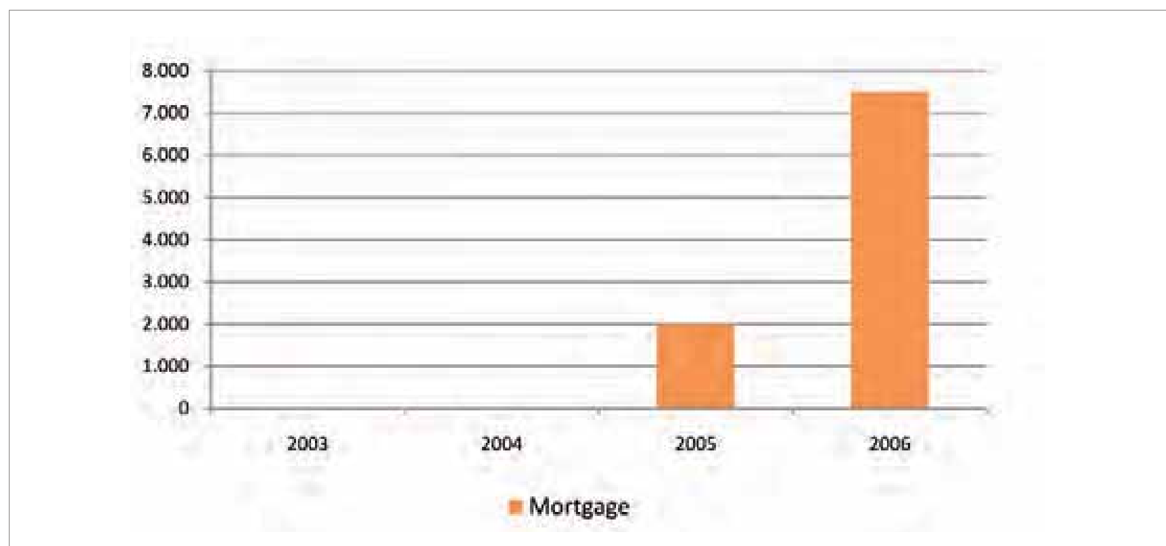
VIII. risk-weighting & compliance with european legislation

The ABN AMRO Covered Bonds comply with the requirements of Art. 22 par. 4 UCITS Directive as well as with those of the CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f), with the exception that there is no specific legislation and therefore are currently 20% risk-weighted.

The ACHMEA Hypotheekbank Covered Bonds do not comply with the requirements of Art. 22 par. 4 UCITS Directive and those of the CRD Directive, Annex VI, Part 1, Paragraph 65 a) to f) (the programme allows mortgages with LTV > 80%) and are therefore 20% risk-weighted.

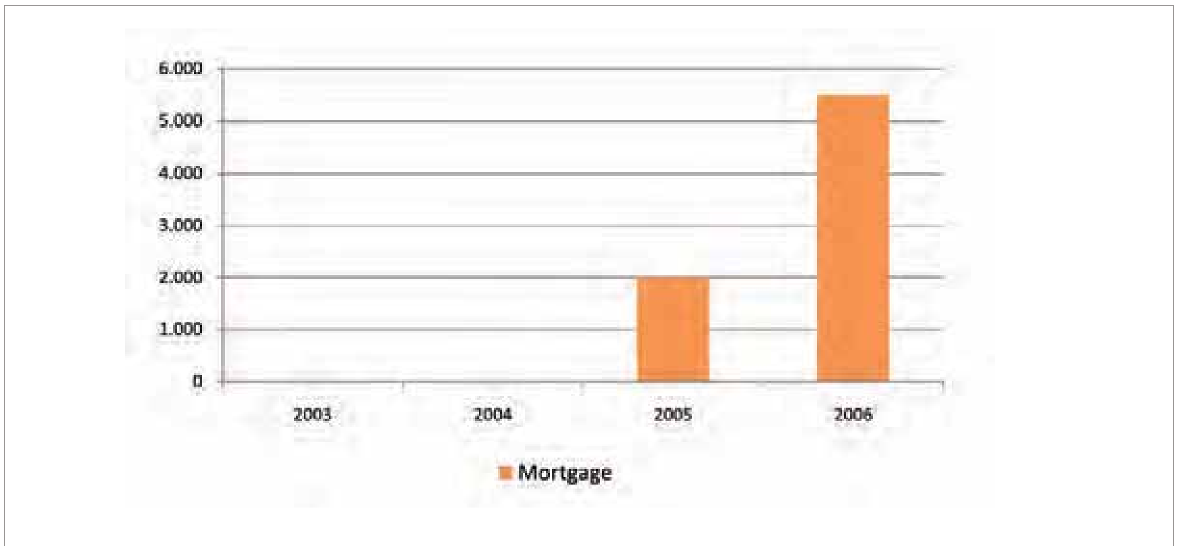
The Covered Bonds are Repo eligible by the Dutch Central Bank and the Central Bank recognises other Covered Bonds and assigns them a 10% risk-weighting.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2006 IN €M



Source: EMF/ECBC

> figure 2: Covered Bonds issuance 2003-2006 in €m



Source: EMF/ECBC

3.12 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.

3.13 POLAND

By Agnieszka Drewicz-Tułodziecka and Piotr Cyburt
Polish Mortgage Credit Foundation

I. FRAMEWORK

The legal basis for Covered Bond issuance in Poland is the "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 credits 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, the Organisation for Economic Cooperation and Development (OECD), 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) purchasing receivables of other banks arising from their credits secured with mortgages and receivables from loans not secured with mortgages referred to in point 2)
4) issuing mortgage bonds on the basis of the mortgage bank's receivables arising from: granted credits secured with mortgages; and purchased receivables of other banks arising from their credits secured with mortgages;
5) issuing public mortgage bonds on the basis of:
6) a) the mortgage bank's receivables arising from its credits not secured by mortgages referred to in point 2);
7) 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, **other than 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 also be executed in foreign currencies upon obtaining the relevant authorization.

Under the LZ Act, the range of activities that can be performed by a mortgage bank is specified in a closed catalogue as mentioned above. Particularly, mortgage banks cannot collect deposits from individual savers. The limited business scope 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 business.

The issuer holds the cover assets on his balance sheet. The Covered Bonds are direct, unconditional obligations of the issuer.

III. COVER ASSETS

All Covered Bonds must be fully secured by cover assets. There are two specific classes of the Covered Bonds: *hipoteczne listy zastawne* (mortgage Covered Bonds) and *publiczne listy zastawne* (public Covered Bonds); registered in two separate cover registers.

- The cover register for mortgage bonds.

  The LZ Act provides for a cover register for the mortgage assets, which will be used in the mortgage cover pool.

  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 have restructured 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).

- 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:

  (i) 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 OECD, except for states which are currently in the process of restructuring or have 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

  (ii) credits granted to entities listed in point 1); or

  (iii) credits secured by a guarantee or surety of local government units, up to the secured amount and credits granted to such local government units.

In regard to geographical scope, lending is restricted to mortgages, against the right of perpetual usufruct or the right of ownership to a property, situated in Poland.

For public Covered Bonds, there is a wider scope including the following countries and institutions as eligible for the cover: The 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 or have 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 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 detail the assessment of the mortgage lending value and impose a duty to have a database for real estate prices on the bank.

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 nominal sum of the bank's receivables secured with mortgages, which form the basis for the mortgage bond issue.
2. The bank's income from interest on its mortgage-secured receivables, referred to in paragraph 1, may not be lower than the amount of the bank's payable interest on outstanding mortgage bonds.

The Act also ensures 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 the 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 a 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 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).

Article 449 of the Bankruptcy and Rehabilitation Law stipulates that in case that the separate bankruptcy estate does not fully satisfy the Covered Bond holders, the remaining balance shall be satisfied from the whole bankruptcy estate funds. Technically, the additional amount for satisfying the mortgage bondholders shall be transferred from the bankruptcy estate funds to the separate bankruptcy estate funds. Thus, Covered Bond holders get preference over all other creditors of the mortgage bank.

According to art. 446 Bankruptcy Act, the declaration of bankruptcy of a mortgage bank does not infringe maturity dates of its obligations towards Covered Bond holders. Thus, Covered Bonds do not accelerate.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Covered Bonds are risk weighted 20%.

Polish "list zastawny" meet the criteria of UCITS 22(4) as well as of the CRD Directive, Annex VI, Paragraph 68 a) to f). The implementation process of the CRD Directive into Polish law might result in a 10% weighting of Polish Covered Bonds.

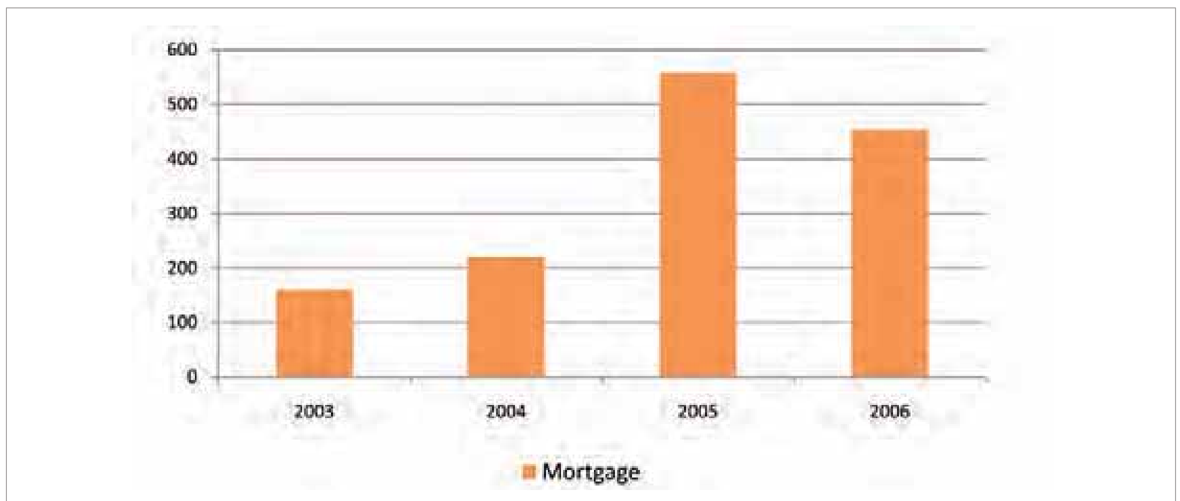
In Poland, the investment regulations pertaining to the limits for Covered Bonds are as follows:

- Banks: no limits
- Insurance companies: up to 40% of the technical-insurance reserves (up to 10% in Covered Bonds which are not allowed to public trading)

> Investment Funds / Open Funds: 25% of the assets may be invested in Covered Bonds issued by one mortgage bank. However, the total investment in Covered Bonds may not exceed 80% of the fund's assets. In addition, the 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) cannot exceed 35% of the fund's assets.

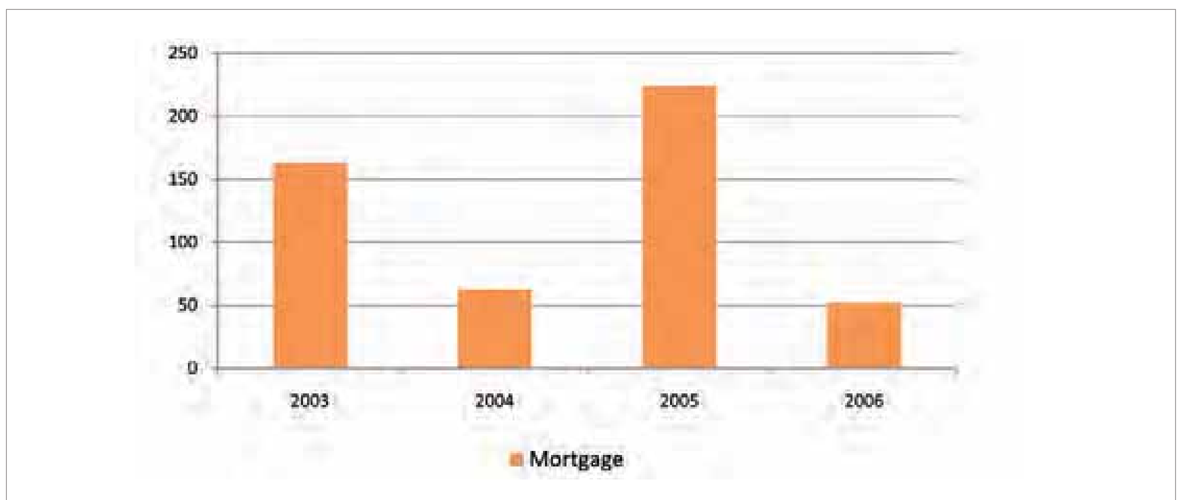
> Pension funds: up to 40% of the total asset value.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2006 IN €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE 2003-2006 IN €M



Source: EMF/ECBC

In Poland, only specialised mortgage banks are entitled to issue "list zastawny" (Polish Covered Bonds). The current "list zastawny" issuers are: BRE Bank Hipoteczny S.A., BPH Bank Hipoteczny S.A. and Śląski Bank Hipoteczny S.A.

3.14 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 (Avisos e Instruções) of the Central Bank), 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[2] 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.

2 There are no restrictions to its business activities

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);

> 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.

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 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.

3 Notice n.º 5/2006

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;

4 Notice n.º 6/2006

> Interests eligible for Eurosystem credit transactions shall be accounted according to the value resulting from the rules regarding valuation margins defined by the Eurosystem or, if lower, according to its nominal value, including accrued interest;
> Covered Bonds and public sector Covered Bonds shall be accounted according to the corresponding outstanding principal, including accrued interest.

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

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

The actual amount of the liabilities arising from the issuance of mortgages Covered Bonds or public sector Covered Bonds cannot be higher than the actual amount of the portfolio allocated to such bonds, taking into account any derivative instruments put in place. The ratio established shall be able to comply even when 200 basis points parallel movements of the curve are considered.

Each issuer must deliver in writing the specific and individual policies in written form for risk management, namely exchange risk, liquidity risk, interest rate risk, counterparty risk and operational risk and any other procedures aimed at ensuring compliance with the applicable regulatory regime and with any devised risk limitation policies set by the issuer.

The Bank of Portugal may also make use of its regulatory role to require additional steps by the issuers to meet with all the asset-liability criteria that it sets out.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The Board of the issuer will appoint an independent auditor who must be registered with the Portuguese Securities Commission, with the task of defending the interests of the bondholders and verifying the compliance to applicable legal and regulatory guidelines. An annual report must be published. The Bank of Portugal will review its content and may make use of its regulatory role to request additional information[5].

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

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

The Bank of Portugal and the Portuguese Securities Commission (CMVM) are responsible for banking and capital markets supervision. The law grants powers to the Bank of Portugal to regulate and supervise

5 Regulatory Instrument n.º 13/2006

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.

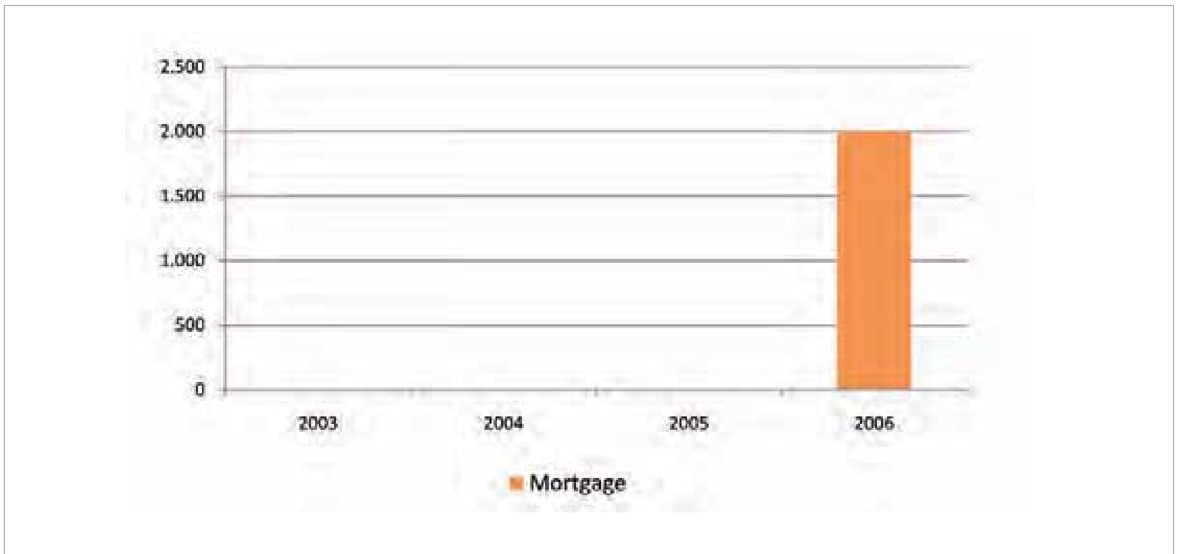
VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

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 pool will be 20%.

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

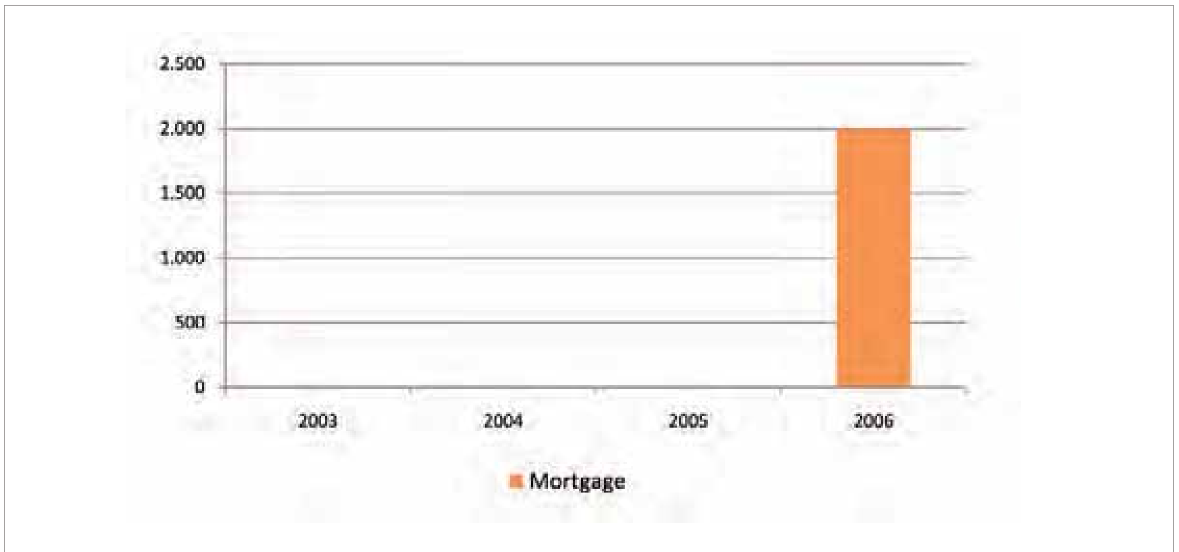
6 Notice n.º8/2006
7 Designated Credit Institution
8 Notice n.º7/2006

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2006 IN €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE 2003-2006 IN €M



Source: EMF/ECBC

3.15 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[9] 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

9 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:

- the pool is homogenous comprising of only one type of mortgage loan according to their investment destination;
- the weighted average of the maturities of the mortgage loans included in the cover pool securing an issue is higher than the maturity of the mortgage bonds secured by such a cover pool; the weighted average of maturities shall be calculated by weighting the outstanding life time of the loans included in the cover pool with the nominal value of the loan as at the date of issue;
- 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;
- 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;
- each mortgage loan in the cover pool meets the general eligibility criteria provided by this law and the performing criteria established through the prospectus;
- the nominal value of a mortgage loan 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;
- the amount representing the principal granted through a mortgage loan agreement has been fully disbursed to the beneficiary;
- 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;
- the receivables deriving from the mortgage loans are not subject to a security interest in favor of any other person;
- the mortgage loan must not register delayed payments exceeding 61 days;

- 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%) withat 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.

3.16 FINLAND

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

I. FRAMEWORK

In Finland, the legal basis for Covered Bond issuance is the mortgage bank act (MBA) 1240/1999. It was passed by the Finnish Parliament in 1999 and has been amended in October 2000.

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. 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 overcollateralisation. In practice, the Finnish issuers so far established a minimum level of overcollateralisation 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. ASSET - LIABILITY MANAGEMENT

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 overcollateralisation.

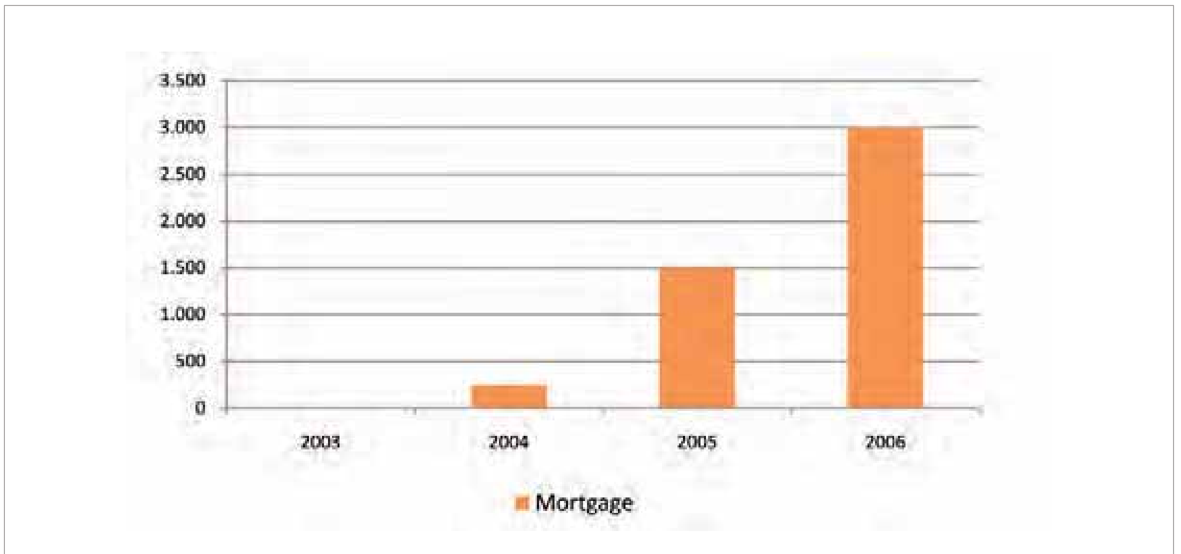
VII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

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

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

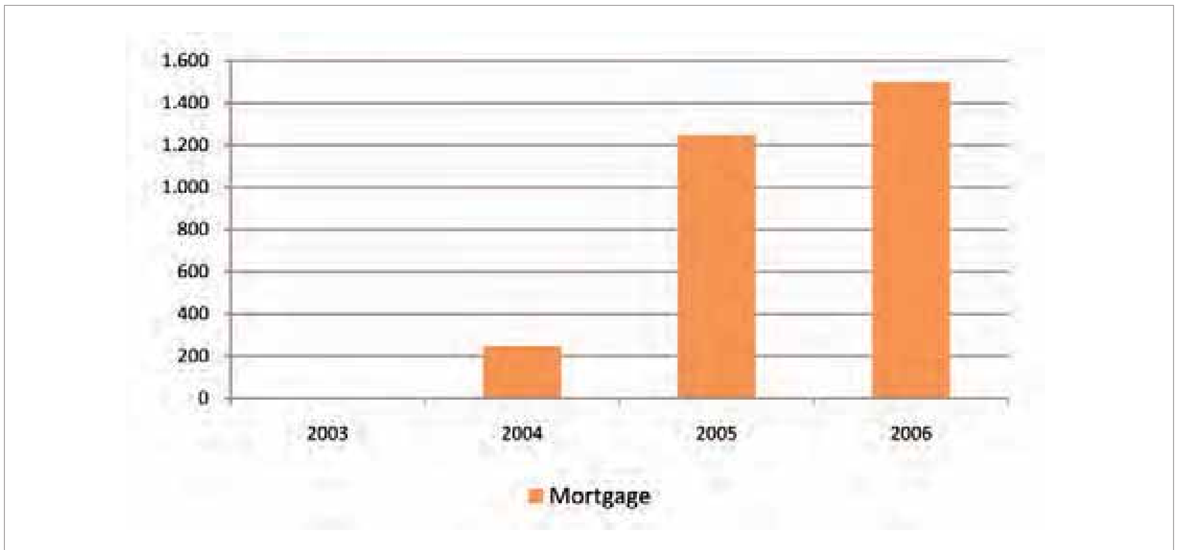
As far as the domestic issuers are aware, there are no further specific investment regulations regarding Finnish Covered Bonds.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2006 IN €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE 2003-2006 IN €M



Source: EMF/ECBC

3.17 SWEDEN

By Regina Koelsch, UBS
and 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')[10]. 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')[11] 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

10 Lag 2003:1223 om utgivning av säkerställda obligationer [Law Concerning the Issuance of Covered Bonds].
11 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)[12]. 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[13]:

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

12 Countries belonging to the European Economic Area are the 25 EU countries plus Norway, Iceland, Liechtenstein.
13 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[14];
- > 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[15]. 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).[16]

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):

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14 The law does not provide for any explicit geographic restriction.

15 These assets are congruent with Chapter 3, first paragraph, A of the Capital Adequacy and Large Exposure Act (SFS 1994:2004).

16 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).[17] 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.[18]

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.

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

18 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.[19] 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 defined 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.

19 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 jeopardised, which would be difficult to prove unless outstanding Covered Bonds were due to mature imminently.

Swedish Covered Bonds are eligible for repo transactions with the Swedish Central Bank. Moreover, Swedish Covered Bonds denominated in euros qualify as eligible collateral with the ECB.

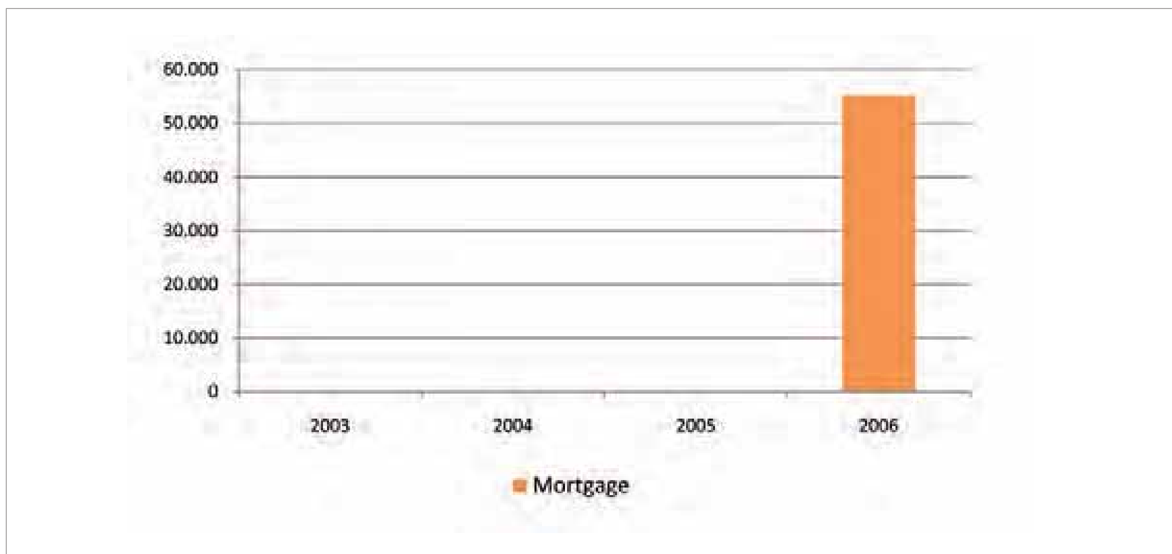
Derivatives that are part of the cover pool used not to benefit from any special capital treatment. They carried the same risk weighting as the credit institution counterparty. The implementation of EU CRD into Swedish law grant derivative contracts included in the cover pool the same capital treatment as Covered Bonds.

Foreign Covered Bonds enjoy the same preferential capital treatment in Sweden if the foreign supervisory authority of that Covered Bond issuing institution has also assigned those Covered Bonds preferential risk weightings (principle of mutual recognition).

The law regulating insurance companies in Sweden (Försäkringsrörelselagen 1982:713) makes no distinction between mortgage bonds and Covered Bonds. Swedish insurance companies can invest up to a maximum of 10% in the Covered Bonds of a single issuer. A government proposal increasing this share to 25% was presented in June 2007. This amendment is expected to enter into force on 1 April 2008.

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.

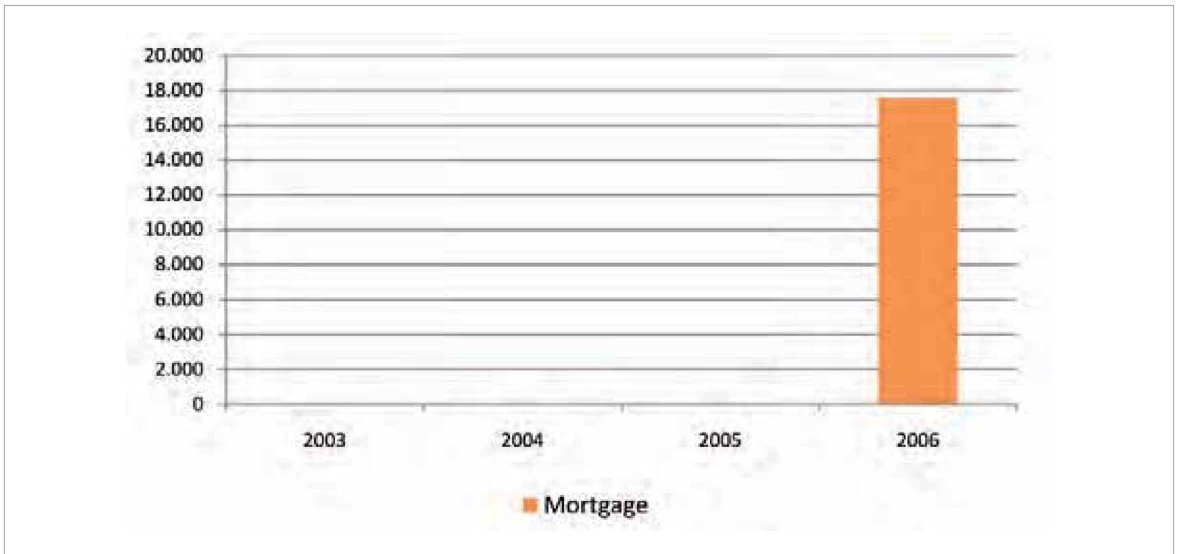
> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2006* IN €M



Source: EMF/ECBC

* 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 (Outstanding volume at the end of 2005: 92.8 bn Euro) 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 have 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 2003-2006* IN €M



Source: EMF/ECBC

* Outstanding volume at the end of 2005: 92.8 bn Euro

Issuers : The Swedish market is dominated by five issuers: Stadshypotek, Swedbank Hypotek, Nordea Hypotek, SBAB and SEB Bolan. The majority of their exposure is to domestic residential mortgages, with the remainder consisting of commercial property loans and public sector loans.

3.18 UK

By Fritz Engelhard, Barclays Capital
and Neil Sankoff, HSBC

I. FRAMEWORK

In the UK, general legislation is used to structure the Covered Bonds. On 23 July 2007, the UK Treasury and the UK Financial Services Authority (FSA) published a joint consultation document entitled «Proposals for a UK recognised Covered Bonds legislative framework». The consultation paper sets out draft legislation which is scheduled to come into force on 1 January 2008. Under the legislation, the FSA will act as special public supervisor of Covered Bond programmes which meet the requirements of the legislation. It is expected that all existing UK Covered Bond structures will be capable of meeting these requirements.

II. STRUCTURE OF THE ISSUER

All issuers to date have been financial institutions regulated by the FSA. Issuers have to meet the requirements set by the regulator, but within these regulations there are no restrictions on the business activities of the issuers. At present, the FSA restricts total Covered Bond issuance to 20% of the relevant institution's total assets.

The Covered Bonds are direct, unconditional obligations of the issuer; however investors also have a claim over a pool of cover assets in the event of the insolvency or default by the issuer. The cover assets are held in a special purpose entity, a limited liability partnership (LLP), which guarantees the issuer's Covered Bonds and provides security over the cover assets to a security trustee on behalf of the investors. There is no direct legal link between the mortgages and the Covered Bonds. If there is a call on the guarantee, 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.

Legal segregation of the mortgages from the issuer's insolvency is achieved through the sale of the mortgages to the LLP. The purchase price paid by the LLP 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 (and legal title perfected in favour of the LLP) following the occurrence of certain trigger events, such as the downgrade of the issuer below investment grade.[20] 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.

III. COVER ASSETS

In all but two UK programmes the collateral consists of residential mortgages. There is one programme (HBOS) where the collateral consists of loans to housing associations and another programme (Anglo Irish Bank Corporation / UK branch) where the collateral consists of a portfolio of UK commercial mortgage loans. As UK banks issue off a structured Covered Bond programme, geographical restrictions on cover pool assets have been self imposed. However, to date all Covered Bond programmes focus on UK mortgage assets. The LTV limit varies across the different programmes (see figure 1). It is important

20 In case of the Covered Bonds issued by Anglo Irish Bank Corporation plc, interest in the mortgage loans is transferred through a declaration of trust. Whilst legal title of the mortgage loans remains with the originator, the LLP is entitled to act in the name of the originator and enforce the mortgage loans in a stress scenario.

to note that higher LTV loans are included in the pool, but loan amounts exceeding the respective cap are not taken into account when calculating the appropriate loan balance within the asset coverage test (see explanation below). In all but one programme, the maximum single loan exposure was limited to £1mn. The programme of Anglo Irish Bank Corporation plc stipulates that the maximum single tenant exposure should not exceed 5% of the total cover pool. Loans which are in arrears are either repurchased by the originator or subject to specific haircuts (see figure 1).

Substitution assets can be included in the cover pool. In most[21] 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 Capital Requirements Directive. 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+[22], triple-A rated RMBS notes and government debt.

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. In case of the Covered Bond programme of Anglo Irish Bank Corporation plc, the values of the respective commercial properties have to be updated annually, and in case the originator is rated below triple-B plus, on a semi-annual basis.

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). The minimum level of overcollateralisation (OC) indicated in figure 1 may be increased from time to time if the credit quality of the mortgages in the collateral pool decreases, as determined by a quarterly WAFF / WALS test. In addition, the Asset Coverage Test imposes additional minimum OC requirements to mitigate set-off risk, redraw risk on flexible mortgages, and potential negative carry. In the case of a breach of the asset cover test, the issuer is obliged to restore the balance by transferring additional loans or by providing cash 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. In case of the Covered Bond programme of Anglo Irish Bank Corporation plc a test breach notice is served and the LLP will be required to sell its interest in selected mortgage loans.

An amortisation test is designed to ensure that the assets are sufficient to enable the LLP to repay the Covered Bonds. It only applies after an issuer event of default has occurred and therefore Covered Bond holders will be relying on the guarantee. The test fails if the amortisation test aggregate loan amount falls below the outstanding balance of all the Covered Bonds.

V. ASSET - LIABILITY MANAGEMENT

Within all UK Covered Bond programmes there are contractual provisions which stipulate that exposure to interest rate and currency risk have to be neutralised. In addition, downgrade triggers for swap

21 15% in case of the Covered Bond programme of Anglo Irish Bank Corporation plc
22 In the Covered Bond programme of Anglo Irish Bank Corporation plc only the Moody's rating is relevant

counterparties, the pre-maturity test, maturity extension rules and the amortisation test all ensure cash-flow adequacy.

Most UK Covered Bond transactions have a soft-bullet maturity. Following the serving 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[23] in order to allow for a realisation of cover assets.

In the case of the programmes of HBOS and HSBC[24], 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 account banks, 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 a reserve fund to retain an amount sufficient to meet the next interest payment on each series of Covered Bonds from available revenue receipts. This amount is retained in a GIC account. If subsequently there is an issuer event of default, the contents of the Reserve Fund will form part of available revenue receipts to be used by the LLP to meet its obligations under the Covered Bond guarantee. In case of the Covered Bond programme of Anglo Irish Bank Corporation plc there is no reserve fund, as there is liquidity protection from excess spread and the provision of overcollateralisation.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The issuer/originator is responsible for the monthly pool monitoring, while the asset coverage test calculation is checked by an independent auditor on an annual basis[25]. In addition, as explained above, UK authorities are currently preparing a specific UK Covered Bond regime. Within the proposed framework, the FSA will have specific supervisory and enforcement powers. It can halt covered bond issuance by removing a covered bond issuer from the list of UK Recognised Covered Bond issuers. It also will have the power to require issuers to top up the asset pool if it is not satisfied that the assets contained within the asset pool are sufficient to cover all claims attaching during the whole period of the validity of the bonds. Finally, 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 ratings, which should provide investor comfort with respect to rating stability should the mortgage market weaken.

23 18 months in case of the Covered Bond programme of Anglo Irish Bank Corporation plc
24 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.
25 In case of the Covered Bond programme of Anglo Irish Bank Corporation plc, pool monitoring and surveillance is done on a monthly basis at inception of the programme.

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

There is no specific register as such, but the cover assets are all owned by the LLP, a special purpose vehicle. The mortgage assets are sold to the LLP, and the sale agreement specifies which assets are owned by the LLP, and thus are segregated from the bankruptcy estate of the issuer. Any other assets (swaps, substitution assets) are also owned by the LLP. The issuer is responsible for ensuring any restrictions with respect to the collateral are met.

The payments under the Covered Bonds are guaranteed by the LLP following an issuer event of default. The LLP is reliant on the proceeds derived from the assets it holds to make these payments. If these proceeds were insufficient to meet the obligations to bondholders in full, investors would still have an unsecured claim against the issuer and group guarantors for the shortfall.

There are a number of trigger events in the Covered Bond structure, the first being an issuer event of default. This can occur in a number of situations including the following:

> Failure to pay any interest or principal amount when due by the issuer and the group guarantors;

> Bankruptcy or legal proceedings being taken against any of these parties;

> Failure to rectify any breach of the asset coverage test; or

> Failure to rectify any breach of the pre-maturity test.

An issuer default does not accelerate payments by the LLP to Covered Bondholders, however it is the catalyst for the security trustee to start proceeding against the issuer and group guarantors while the asset pool is wound up in an orderly fashion.

The second event of default is the LLP event of default. This arises after an issuer event of default if the LLP failed to make any payments when due, if insolvency proceedings have been started against it, or the failure of the amortisation test. This event 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.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

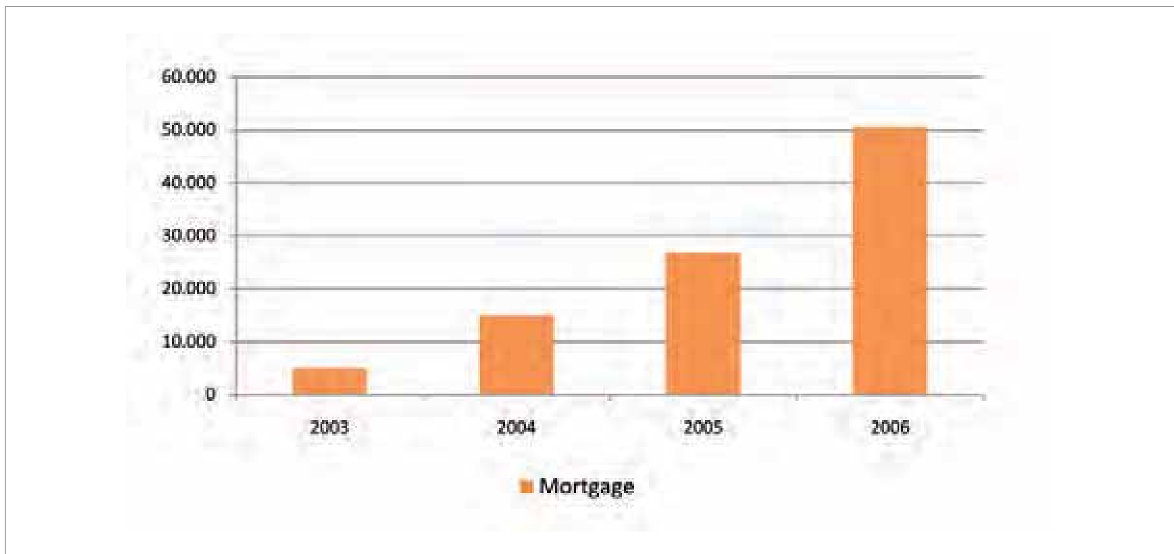
In the UK and abroad UK Covered Bonds are currently 20% risk weighted under the CRD Standard Approach, as if they were unsecured securities issued by a regulated financial institution. The UK Treasury and the FSA are currently in the process of establishing a Covered Bond regime in order to render UK Covered Bonds compliant with the CRD Directive, Annex VI, Part 1, Section 12 Paragraph 68 a) to f) (see «I - Framework» above). Therefore, from January 2008 onwards, UK Covered Bonds will likely benefit from a similar preferential treatment as Covered Bonds from other EU jurisdictions. In this context, it is also worth mentioning that HM Treasury has underlined that it is considering implementing national discretions regarding broader limits for investments in covered bonds for collective investment schemes as well as life and non-life insurance companies.

> FIGURE 1: OVERVIEW – UK COVERED BOND PROGRAMMES

	HBOS	Northern Rock	Bradford & Bingley	Abbey National	Nationwide	Yorkshire	HSBC	Anglo Irish
Programme Volume in € bn	25	10	10	12	14	7.5	15	2
LTV cap	60%	75%	75%	75%	75%	75%	75%	60%*
House price index	Halifax	Halifax	Halifax	Halifax	Nationwide	Avg. of Halifax & Nationwide	Halifax	Not applicable
Asset percentage applied in ACT	92.5%	90.0%	91.0%	91.0%	93.0%	93.5%	92.5%	83.0%
Overcollateralisation	108.1%	111.1%	109.9%	109.9%	107.5%	107.0%	108.1%	120.5%
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	Not applicable
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; 18 month maturity extension
Asset monitor	KPMG	PWC	KPMG	D & T	PWC	PWC	KPMG	KPMG

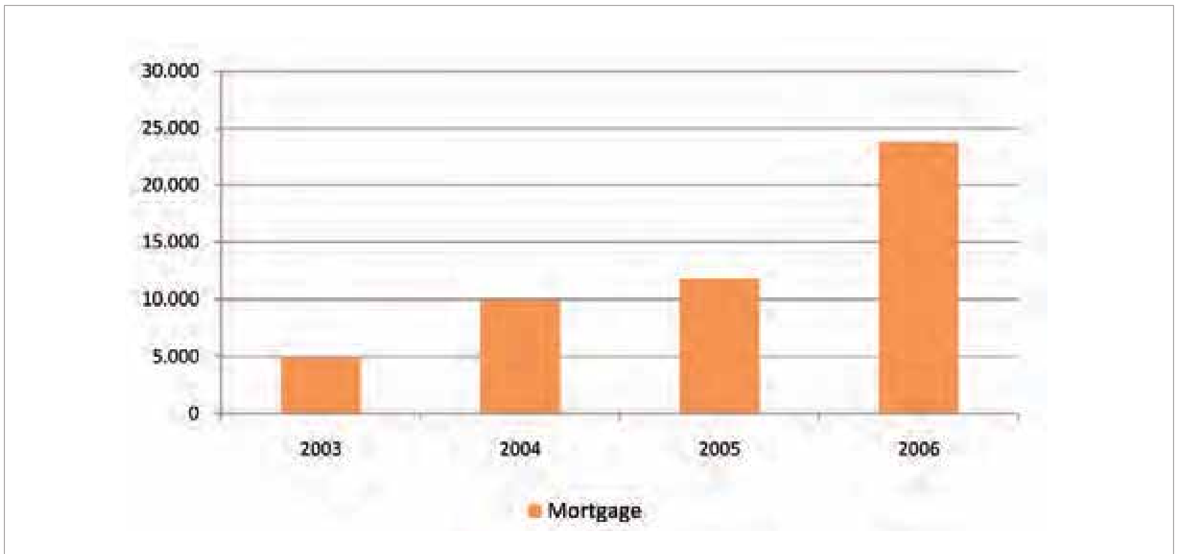
Note: *The Anglo Irish programme has also the restriction that the weighted average original LTV should not exceed 80% **for designated series only. Source: Transaction documents.

> FIGURE 2: COVERED BONDS OUTSTANDING 2003 – 2006IN €M



Source: EMF/ECBC

> FIGURE 3: COVERED BONDS ISSUANCE 2003 – 2006 IN €M



Source: EMF/ECBC

Issuers: To date, the UK has eight Covered Bond issuers: HBOS, Northern Rock, Bradford & Bingley, Abbey National, Nationwide, Yorkshire, HSBC and Anglo Irish Bank Corporation. In all but two UK programmes the collateral consists of residential mortgages. There is one programme (HBOS) where the collateral consists of loans to housing associations and another programme (Anglo Irish Bank Corporation / UK branch) where the collateral consists of a portfolio of UK commercial mortgage loans.

3.19 NORWAY

Stein Sjølie, Finansnæringens Hovedorganisasjon
and Bernd Volk, Deutsche Bank

Introduction

The Norwegian housing loan market is primarily a banking market. Existing bond-issuing institutions are relatively small and mostly aimed at commercial mortgages. 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. Appropriate laws and regulations have been adopted and thus cleared the way for Covered Bonds in Norway. Necessary amendments to the Financial Services Act (Articles 2-28 to 2-35) were adopted by March 2007, and a complementary regulation by the Ministry of Finance (MoF) entered into force 1 June.

Specialist banking principle

From the beginning it was assumed that the best way to make use of Covered Bonds in Norway is by establishing dedicated mortgage credit institutions. These specialized credit institutions, so called Kredittforetak, are restricted in their business activities, mainly limited to origination or holding of mortgages and public sector loans 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 may establish a mortgage institution as a wholly owned subsidiary. Alternatively, a mortgage credit institution may be established as an independent institution with several shareholders. 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.

Eligible assets

According to the Act the cover pool may consist of the following assets:

a. Residential mortgages

b. Commercial mortgages

c. Loans secured on other registered assets (subject to further regulations)

d. Public sector loans

e. Assets in form of derivative agreements

f. Substitute assets

Similar to the French and Swedish legal framework for Covered Bonds, mixed pools of public sector and mortgage assets are allowed. The mortgage loans have to be collateralised with real estate within the EEA or OECD, and the public sector loan borrowers have to be located within the EEA or OECD. 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. In the Norwegian legal framework for Covered Bonds, lending is geographically restricted according to risk classes.The MoF regulation uses quality steps as referred to in CRD. Generally, the Norwegian law sticks closely to CRD.

For residential mortgages the maximum LTV is 75 %, and for commercial mortgages 60 %. In case of the first issuer, DnB NOR Boligkreditt, only residential mortgage loans are in the cover pool. Moreover, DnB NOR Boligkreditt committed itself contractually that only residential mortgage or public sector loans will be used in the cover pool. 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. This creates some hidden overcollateralisation. The valuation of the property according to the prudent market value has to be completed by an independent appraiser. The mortgage institution must monitor both the development of the LTV of the individual assets as well as the market for the underlying assets, according to the act, and in accordance with the CRD. Loans secured on other mortgageable assets (e.g. infrastructure investments, ships) may be added to the regulation in the future. The valuation of cover pool assets (including derivatives and substitute assets) and also the Covered Bonds has to be done at market values.

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.

Substitute assets and derivative agreements

In addition to mortgages and public sector loans, the cover pool is allowed to contain substitute assets up to 20 % of the pool, or up to 30 % with the consent of the supervisor. The substitute assets ought to be secure and liquid. Derivatives ensuring the balance principle are allowed to be part of the cover pool. If the derivative agreement is NPV positive, it will be part of the cover pool, if negative, the derivative counterparts will have a preferential claim over the pool, pari passu with the holders of Covered Bonds. The MoF Regulation details quality requirements (i.a. ratings) and other restrictions for the substitute assets and derivative agreements, in line with the CRD.

Matching regulations

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 MoF Regulation, the cover pool assets and the Covered Bonds have to be evaluated by the prudent market value, i.e. the net present value of the cover pool shall at all times exceed the net present value of the secured liabilities. 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. No mandatory overcollateralisation (OC) is stipulated, but any voluntary OC is protected if it is registered in the cover register. Equally, the mortgage credit institution shall ensure that the payment flows from the cover pool enable the institution to honour its payment obligations. As mentioned above, the mortgage institution may enter into derivative agreements in order to secure the

balance principle and payment obligations. The counterparts in derivative agreements will benefit from the same preferential claim over the pool as the bondholders, in case of bankruptcy. As a corollary to this, the counterparts in the derivative agreements will be under the same restrictions as the bondholders with respect to a declaration of default. In addition to this, the mortgage institution will have to adopt strict internal regulations with respect to liquidity risk, interest rate risk and currency risk. The law does not explicitly require hedging all currency risk. However, as the Norwegian Krone 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 100bp parallel shifts and twists of the yield curve (divided into maturity classes). Also, stress tests for the whole balance sheets are required. With respect to liquidity requirements, the law states that cash flows from collateral assets must at all time meet scheduled payments of the Covered Bondholders and derivatives' counterparts. Secondary legislation states that an issuer must not take on more liquidity risk than can be considered prudent. Thus, it is up to the issuers to set the liquidity limits. DnB NOR committed itself that the cash flow of the cover pool and Covered Bonds (including redemptions) will be positive on a 6 months horizon.

Register and inspector

The mortgage institution shall maintain a register of the Covered Bonds it issues, and of the cover assets assigned thereto, including derivative agreements, to oversee that the register is correctly maintained. 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.

Timely payment

As long as the cover pool fulfils the matching requirements, the bondholders and counterparties in derivative agreements have the right to timely payment, even in case of default by the issuer. The preferential claim also applies to payments that accrue to the institution from the cover pool. And, as long as they 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.

Bankruptcy proceedings

The asset segregation and bankruptcy proceedings in the old legislation were not satisfactory. The bondholders and derivatives counterparties only had a pledge to cover pool in favour of the mortgage institution. In the revised Act, the preferential right to cover assets is explicitly stipulated. Hence, in case of insolvency of the mortgage institution, the bondholders and derivatives counterparts have a statutory preferential right to the cover pool. Furthermore, 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 (bostyrer) 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. In 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 counterparts.

Norwegian Covered Bonds with 10% risk weighting

UCITS 22 (4) is applicable to EEA countries. This is stipulated in article 36 in the contract of the European Economic Area. The legal framework for Norwegian Covered Bonds fulfils the requirements of UCITS 22 (4). Norwegian Covered Bonds also fully comply with CRD. Hence, Norwegian Covered Bonds are 10% risk weighted in Norway. To get a privileged risk weighting in EU member states, the respective Covered Bonds have to be notified to the European Commission. The notification is a formal act only. The EU Commission does not check the requirements itself. This is the responsibility of the national financial regulator. Under Basel II/CRD, beside the UCITS 22 (4), Covered Bonds have also to fulfil the requirements of CRD to get a privileged risk weighting. As the Norwegian legal framework for Covered Bonds is one of those which stick most closely to CRD, a risk weighting of 10% under the Basel II/CRD standard approach in EU member states is expected.

Norwegian Housing Market

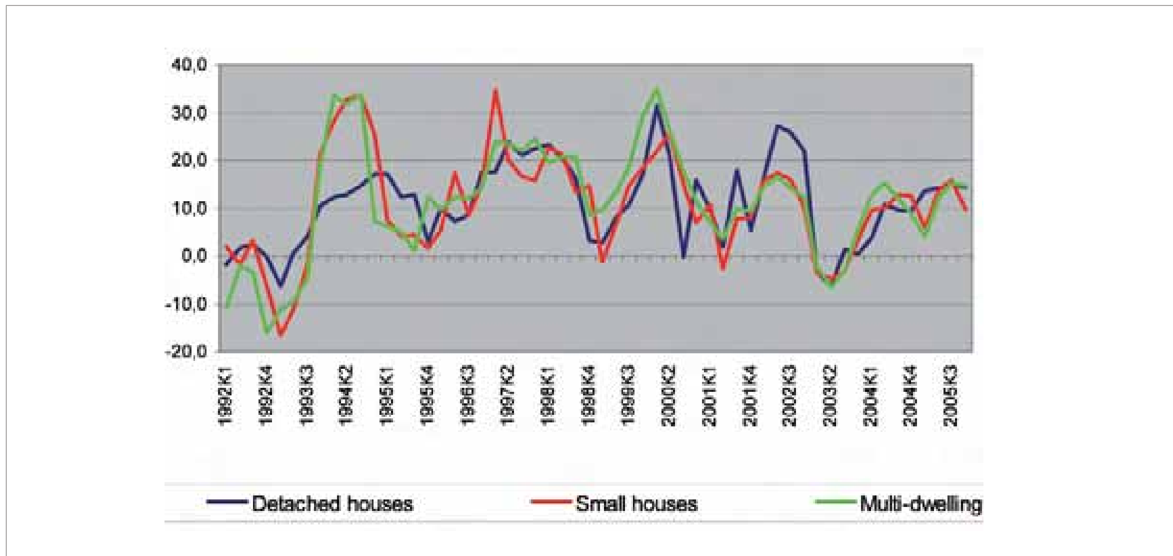
According to the Population and Housing Census from 2006 there were 2.2 million dwellings in Norway, covering a resident population of 4.7 million inhabitants. Approximately 54 percent of the dwellings were detached houses. Houses with two or more dwellings, linked and terraced houses account for 21 percent of total buildings, and just 21 percent are multi-dwelling houses. The large majority of dwellings, some 77 percent, are owner-occupied, either directly or through housing co-operatives. The percentage of homeowners is somewhat lower in the large cities, but even in the capital, Oslo, 70 percent of dwellings are owner-occupied. Accordingly, most residential mortgages are loans to households, and traditionally the loans are refinanced each time a dwelling changes hands. The mortgage loans are personal debt, and the property is taken as collateral. Mortgages account for 77 percent of household debt.

The total mortgage market amounts to around NOK 1,150 bn (EUR 140 bn). Over 85% of mortgage lending is originated by banks. Norway is a floating interest market. Over 90% of the mortgages are floating rate. Rates on floating rate mortgage can be reset at any time and at the bank's own discretion, by giving debtors 6 week notice.

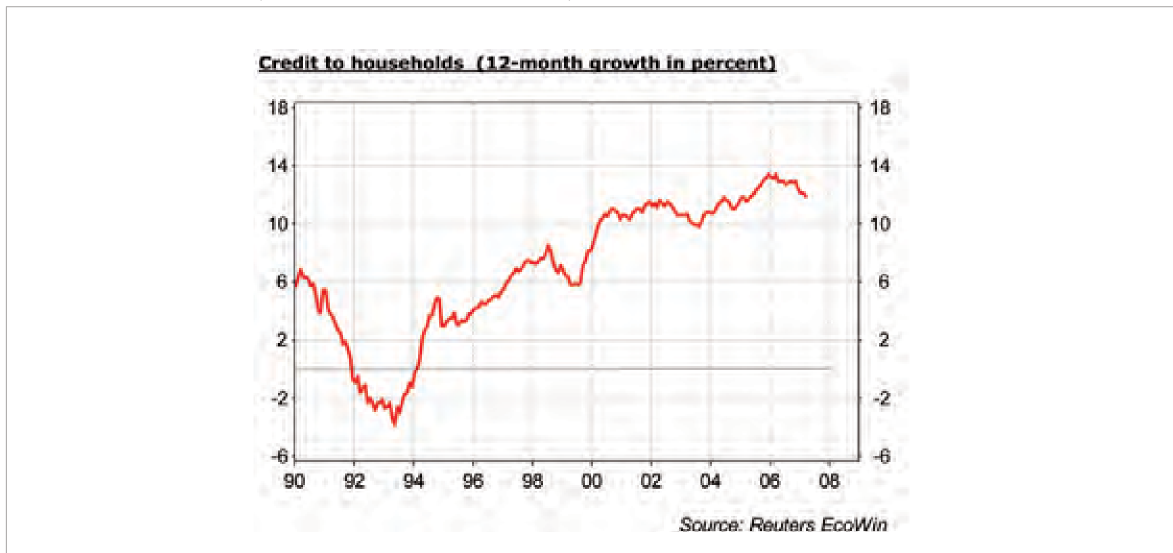
In recent years banks have introduced loan products that facilitate mortgage equity withdrawal – credit lines secured on dwellings. These loan products increased strongly through 2006. Traditionally most household borrowings, including mortgages, are at adjustable interest rates. As interest rates are expected to rise, the proportion of fixed-rate mortgages may increase.

House prices have risen continuously over the past fifteen years. Increased competition in the mortgage market, immigration, domestic migration to more urban districts and expectations of low interest rates in the long term, have contributed to the house price rise.

House prices (change % last 4 quarters)



Credit to households (12-month growth in percent)



Source: Reuters EcoWin

3.20 SWITZERLAND

By Regina Koelsch, UBS,
Andreas Flatt, 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.[26] 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:

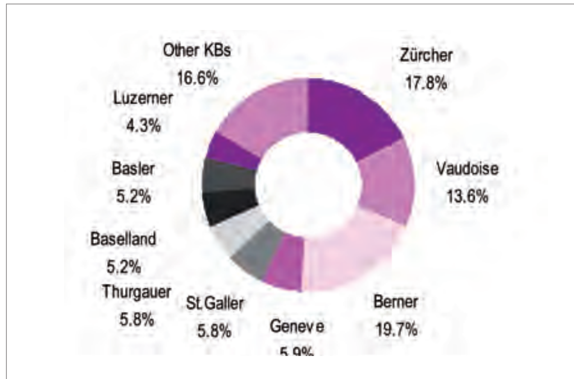
- The institution must be established as a joint-stock company or cooperative.
- The institution must have at least five members.
- The institution must have at least a minimum paid-in capital of CHF 5 million.
- The government (*'Bundesrat'*) must approve the institution's Articles of Association or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

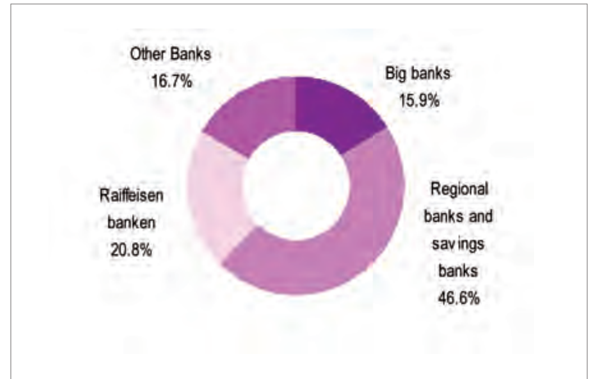
26 Two of PBZ's member banks do not benefit from a cantonal guarantee, namely Banque Cantonale de Genève (BCG) and Banque Cantonale Vaudoise.

Chart 1: Shareholders of PBZ



Source: PBZ, as per 31.3.2007

Chart 2: Shareholders of PBB



Source: PBB, as per 31.3.2006

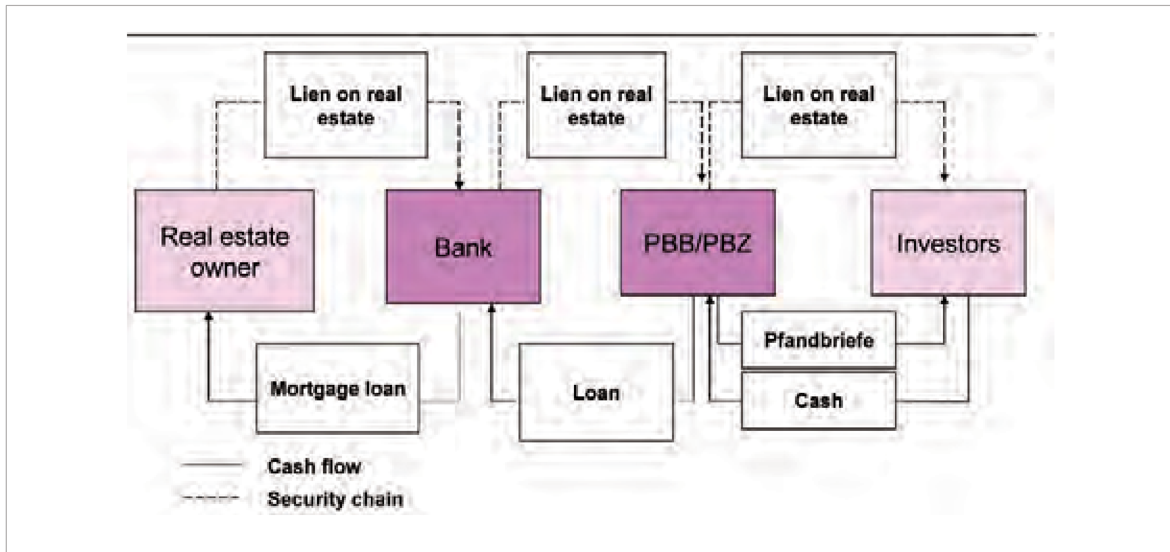
Neither institution has a general banking licence, and the PfG strictly limits their business activities to the following areas ('specialised banking principle') (PfG Art. 5):

- 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).[27]

27 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.[28] 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 10).

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

28 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.[29]

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.[30] 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

29 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).

30 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.[31] 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

31 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.

own funds and maintain a portfolio of 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).

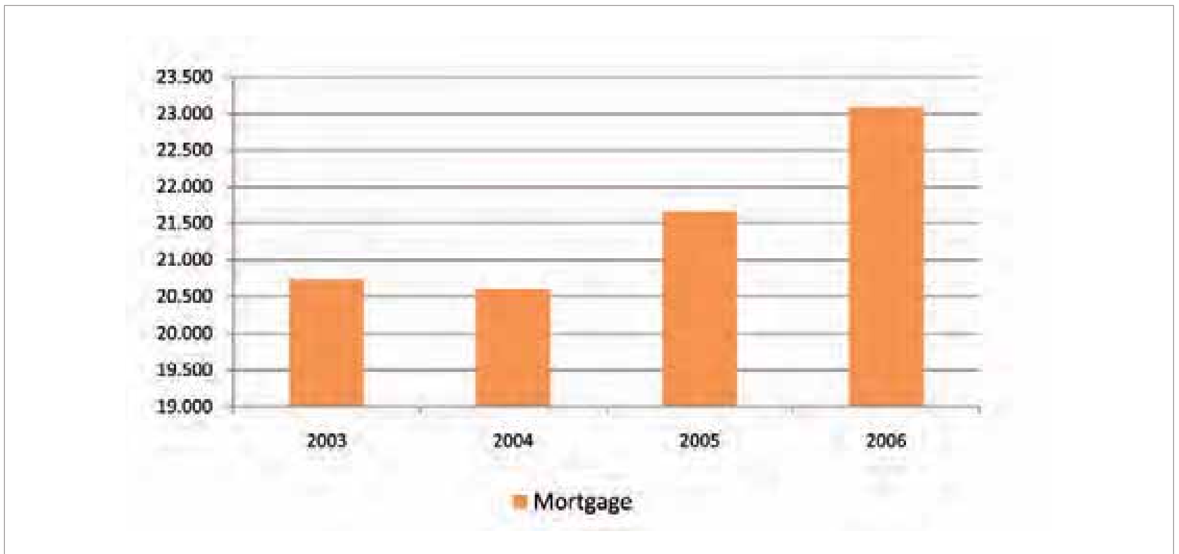
Covered bonds issued by foreign OECD banks enjoy the same risk weighting as senior unsecured debt securities or interest receivables of such counterparties in Switzerland. Hence, covered bonds have a risk weighting of:

- 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.

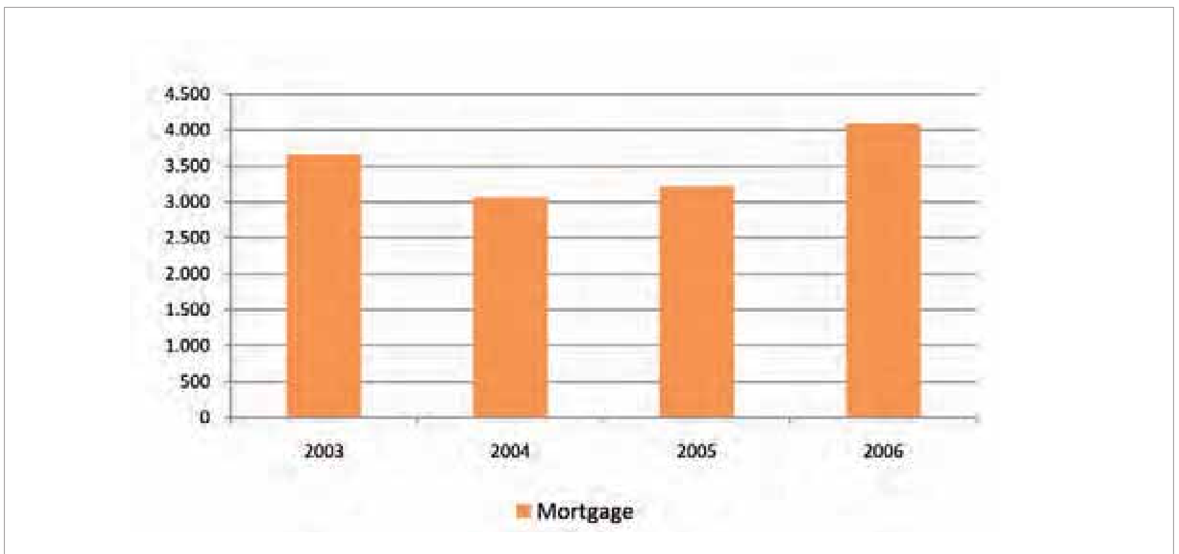
The Swiss Pfandbriefe are eligible for repo transactions with the Swiss National Bank.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2006 IN €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE 2003-2006 IN €M



Source: EMF/ECBC

3.21 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 overage weighted interest of the Covered Bonds must exceed the overage 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.

3.22 UNITED STATES

By Chris Ginieczki[32]
Washington Mutual

FRAMEWORK

In the United States, Covered Bonds are structured obligations that benefit from an established US legal framework rather than formal legislation adopted by a government body.

PROGRAM STRUCTURE

To date, only two US banking institutions have sponsored Covered Bond programs. The existing structure utilizes a two-tier approach, whereby Covered Bonds are issued via a trust. Such Covered Bonds are principally secured by mortgage bonds that are issued by a sponsor bank. Each series of mortgage bonds securing the related Covered Bonds are expected to produce funds sufficient to make payments due on the applicable Covered Bonds. The two-tier structure is designed to primarily protect holders of Covered Bonds against prepayment risk in the event of the insolvency of the sponsor bank.

MORTGAGE BONDS

Mortgage bonds are issued in unique series and constitute direct and unconditional obligations of the mortgage bond issuer. Each series is a senior obligation of such sponsor bank and ranks pari passu without priority among themselves. In addition, the mortgage bonds are secured principally by a dynamic pool of residential mortgage loans which remain on the mortgage bonds issuer's balance sheet. To secure its obligations with regard to mortgage bonds, the mortgage bond issuer grants to the mortgage bond indenture trustee a first priority perfected security interest in the mortgage assets underlying the mortgage bonds. Following the occurrence of a mortgage bond acceleration, which is triggered by an event of the default under the mortgage bond indenture, the mortgage bond indenture trustee may enforce its rights over the cover pool on behalf of the holders of mortgage bonds. Because the cover pool secures all of the outstanding mortgage bonds, each series has recourse to its pro rata share of the cover pool.

COVERED BONDS

Covered Bonds may be issued in one or more series and represent limited recourse obligations of the issuer. Each series of Covered Bonds is secured by a related series of mortgage bonds which are purchased by the issuer from the mortgage bond issuer using proceeds generated by the issuance of Covered Bonds. The issuer will also enter into one or more swap agreements with one or more swap providers. The primary purpose of these swap agreements is to mitigate against currency and interest rate risk. Prior to an acceleration of a related series mortgage bonds, a Covered Bond issuer will exchange with each applicable swap provider payments of interest and principal on the mortgage bonds for amounts to pay for interest and principal on the Covered Bonds.

Following a mortgage bond acceleration, the mortgage bond indenture trustee may enforce its rights over the cover pool and liquidate the residential mortgage loans comprising the cover pool. The Covered Bond issuer will invest the proceeds received from the liquidation of the mortgage loans into such an investment vehicle. These investment vehicles, which may, for example, take the form of a guaranteed

32 Chris Ginieczki is a First Vice President and Group Manager in Washington Mutual's Treasury Group. This material has been prepared for information purposes only and is not intended and should not be considered as legal or tax advice. Readers should consult with their own legal and tax advisors.

investment contract, are established at the time of issuance. When applicable, the investment income from the investment vehicle will then be paid to the issuer and it will exchange with each applicable swap provider the investment income it received for amounts to pay for interest and principal on the Covered Bonds. Therefore, through the use of an investment vehicle, acceleration of a mortgage bonds does not automatically result in the acceleration of a related series of Covered Bonds.

COVER ASSETS

To date, for the two US bank sponsored Covered Bonds programs, the cover pool is comprised of residential mortgage loans. The types of mortgage loans included in the cover pool may change over time; however, the cover pool may only contain loan types that have been approved by the rating agencies. The cover pool must also comply with any other eligibility criteria required by the ratings agencies, and mortgage loans must satisfy customary loan-level representations and warranties as set forth in the mortgage bond indenture.

Subject to certain limitations, substitution assets can be included in the cover pool so long as written notice is given to the mortgage bond indenture trustee and no event of default has occurred and is continuing. Substitution assets generally may include obligations of government entities and institutions that are 0%, 10% or 20% risk weighted by the Capital Requirements Directive and other highly-rated instruments. The aggregate value of substitution assets may not exceed 10% of the total assets of the cover pool.

ASSET-LIABILITY MANAGEMENT

The mortgage bonds are floating rate United States dollar denominated obligations, while the Covered Bonds are typically fixed rate and denominated in Euros. This interest rate and currency risk is mitigated by each swap agreement entered into between the issuer and one or more Covered Bond swap providers. In addition to providing protection on the possible variances between payments received under mortgage bonds and payments required under Covered Bonds, a swap provider may be required to make payments in other limited circumstances.

Under the terms of each swap, a Covered Bond swap provider is required to pay for interest and principal on the Covered Bonds even if the investment income received from the investment vehicle is less than the payments of interest and principal that would have received from the related mortgage bonds. The Covered Bond swap provider may be also obligated to make payments on the Covered Bond for a limited time period if mortgage bond interest payments have not been paid by the mortgage bond issuer and the Federal Deposit Insurance Corporation (FDIC) is acting as conservator or receiver of such mortgage bond issuer.

The applicable final terms may provide that the maturities of some series of Covered Bonds may be deferred. The length of such deferral can vary depending on the related series of Covered Bonds, but is designed to allow for sufficient time for the mortgage bond indenture trustee to enforce its rights over the cover pool and liquidate the pool of mortgage loans in an orderly manner. During this extension period, the cover bond issuer is required to pay interest on a monthly basis at a floating rate. Such deferral will occur automatically if the issuer fails to pay the final redemption amount in full on the maturity date and provided other conditions are met.

In order to mitigate against prepayment risk and the liquidation value risk of the cover pool, the sponsor bank is obligated to perform an asset coverage test (ACT) calculation on a monthly basis. The ACT requires that the adjusted aggregate loan amount is greater or equal to the aggregate unpaid principal amount of the outstanding mortgage bonds. The adjusted aggregate loan amount is the sum of the value of the cover pool, as adjusted by the rating agencies as discussed below, the amount of collections of principal of mortgage loans and the principal balance of any substitution assets in the cover pool.

OVERCOLLATERALISATION

Overcollateralisation of the assets in the cover pool is described by the asset percentage, which measures the allowable advance rate on the cover pool. The asset percentage may be adjusted in accordance with the various methodologies prescribed by each of the agencies to provide a cover pool sufficient to maintain the then current ratings of the Covered Bonds and can be adjusted over time. The resulting asset percentage is the lowest figure from the rating agencies then rating the Covered Bonds.

COVER POOL VALUATION AND LTV CRITERIA

Mortgage loan valuation and loan-to-value (LTV) limits are formally governed under the ACT. Within the ACT calculation, the mortgage property is valued using an indexed valuation. The index valuation examines the prior and current valuation of the mortgage property using the Office of Federal Housing Enterprise Oversight House Price Index for the applicable geographic area. The Office of Federal Housing Enterprise Oversight is an independent entity within the U.S. Department of Housing and Urban Development. The House Price Index is designed to indicate price movement of single-family homes in various regions of the US. The House Price Index is updated every three months. If the prior period's valuation is higher than the current valuation, the current valuation is used as the indexed valuation. When the prior period's valuation is lower than the current valuation, the indexed valuation will equal the prior period's valuation plus 85% of the increase of the current valuation over the prior period's valuation.

The value of the cover pool is calculated as the lower of two calculations within the ACT. The first calculation is the sum for each loan of the lower of (1) the unpaid principal balance of the mortgage loan and (2) the indexed valuation multiplied by 75%. The second calculation is the sum for each loan of the lower of (1) the unpaid principal balance of the mortgage loan and (2) the indexed valuation. The lower resulting lower figure in the second calculation is then multiplied by the asset percentage.

COVER POOL ASSET MONITOR AND BANKING SUPERVISION

To date, each mortgage bond issuer has entered into an asset monitor agreement with its relevant mortgage bond indenture trustee. Under this agreement the asset monitor verifies the arithmetic accuracy of the ACT calculation once a year; however, the asset monitor is required to test ACT calculations more frequently if the mortgage bond issuer is downgraded or the ACT is breached.

In addition, on a quarterly basis (or as otherwise required by the rating agencies), the sponsor bank is required to send to each rating agencies detailed loan level performance data. Upon review of such data, the rating agencies can adjust the asset percentage, or advance rate, in order to maintain the ratings of the Covered Bonds.

The two current sponsors banks are subject to regulation by one of more of the Federal Reserve Bank (Fed), the Office of Thrift Supervision (OTS) and Office of the Comptroller of the Currency (OCC). The OTS and the OCC are bureaus of the US Department of Treasury.

The current issuers of Covered Bonds have been established as special purpose vehicles. As such, neither issuer is subject to the Fed, OTS, or OCC regulations.

HOW ARE SECURITY OVER COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS ACHIEVED?

Cover pool assets remain on the balance sheet of a sponsor bank. Although no specific Covered Bond statutory framework has been adopted in the United States, the Uniform Commercial Code (UCC) provides the legal framework to pledge assets through a first priority perfected security interest. A security interest over the cover pool is obtained by a contractual grant of a security interest by the mortgage bond issuer which identifies pledged mortgage loans in the mortgage bond issuer's records. Therefore, there is no sale or conveyance of ownership of the mortgage loans which are assigned to the cover pool. The mortgage bond indenture trustee has been granted a first priority security interest in the assets comprising the cover pool.

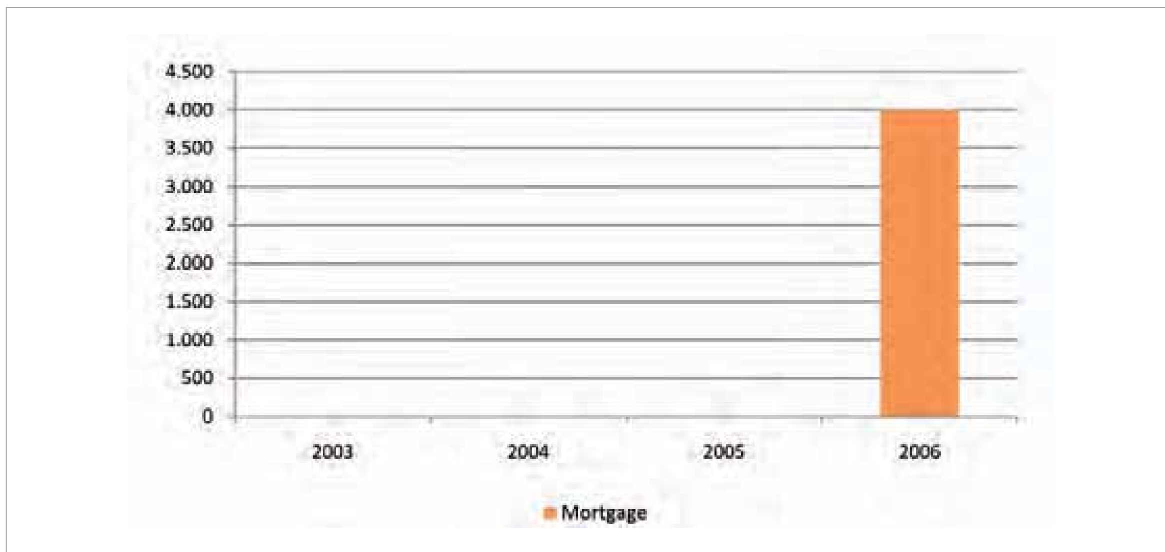
Both of the existing Covered Bond issuers are subject to the United States bankruptcy code. However, each issuer has been established as a bankruptcy remote special purpose entity and the only creditors of these entities are the Covered Bond holders, the Covered Bond swap providers and a Covered Bond indenture trustee.

Banks in the United States generally are not subject to the United States bankruptcy code. Instead, banking supervisors in the United States, namely the OTS and OCC, can appoint the FDIC as conservator or receiver, as the case may be, of the sponsor bank that issues mortgage bonds. If the FDIC is appointed as conservator or receiver, it can assert broad powers to either preserve the bank's assets and property as conservator, or liquidate the banks assets as receiver. In its role as either conservator or receiver, the FDIC has the power, among other things, to repudiate or affirm the sponsor bank's obligations under its mortgage bonds. If the FDIC neither repudiates nor affirms and the mortgage bonds have triggered an event or default under the mortgage bond indenture, the mortgage bond indenture trustee will be able to enforce its rights over the cover pool, subject to FDIC stay provisions then in place. If the FDIC repudiates the mortgage bonds, it is obligated to pay compensatory damages, which could result in a payment of par plus accrued interest up to the appointment date. The Covered Bond swap has been designed to provide coverage for interest shortfall amounts for a defined period as specified in each such swap agreement.

RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

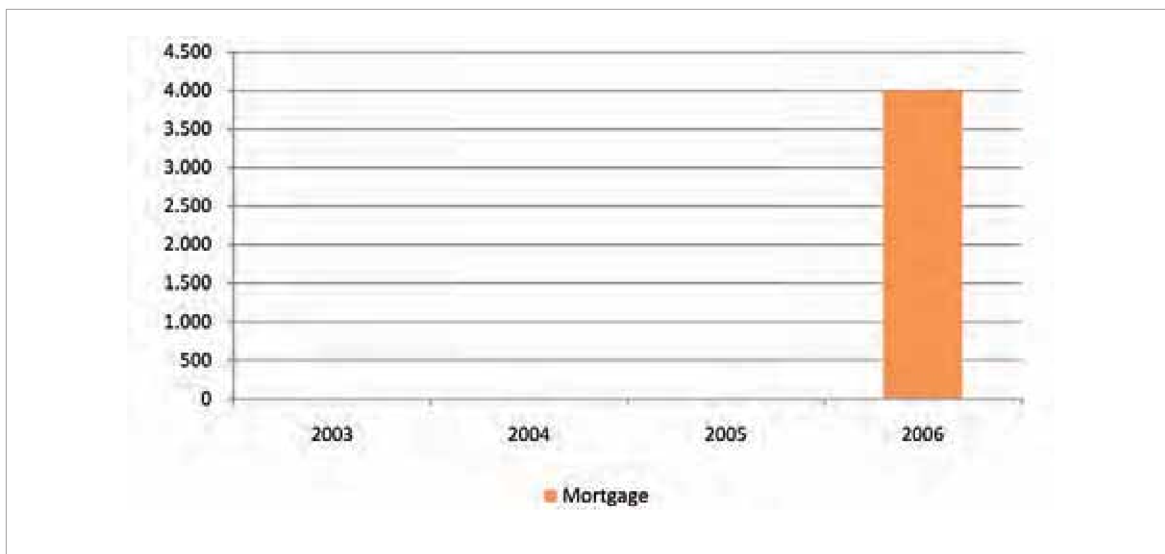
Because none of the existing Covered Bond issuers is organized under the laws of (or has its registered office in) an EU Member State, such Covered Bond issuers do not benefit from a 10% risk weighting under Article 22(4) of the UCITS Directive.

> FIGURE 1: COVERED BONDS OUTSTANDING 2003-2006 IN €M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE 2003-2006 IN €M



Source: EMF/ECBC

under Article 22(4) of the UCITS Directive.

CHAPTER 4 - THE INVESTOR'S PERSPECTIVE

By Felix Blomenkamp, CFA

4.1 WHY INVEST IN COVERED BOND?

THE DEVELOPMENT OF THE EUROPEAN COVERED BOND MARKET

The development of the German Jumbo Pfandbrief market during the mid 1990s could be regarded as the advent of a true European Covered Bond market. At that time, the huge volume of German Pfandbriefe – more than 1 trillion Euros of outstanding bonds – was sold predominantly to domestic investors. In addition to smaller, exchange traded, bearer bond issues, Pfandbriefe enjoyed (and still do) solid demand from insurance companies in the form of private placements. Although German issuers intended to distribute a larger portion of the newly created "Jumbo" issues abroad – originally with a minimum issuance size of 1 billion DEM, now with a minimum size of 1 billion Euros, the Pfandbrief continued to be regarded as a German product. This perception did not change until the launch of the Euro. With the German Jumbo Pfandbrief as a model, other European countries such as Spain, France and Ireland created similar legal frameworks for the issuance of Covered Bond products over the course of several years.

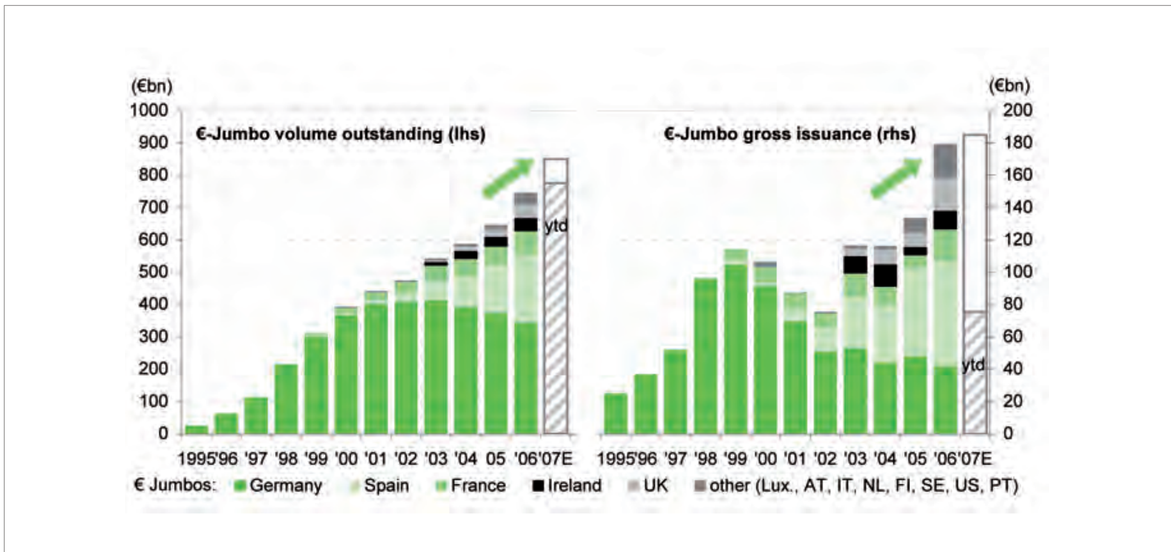
In addition to these types of Covered Bonds, based on the issuing country's law, the market developed so called "structured Covered Bonds". In contrast to predefined conditions and rules for the issuance of Covered Bonds by specific law, these bonds are constructed on the basis of private contracts based on general law. To obtain the same high rating, structured Covered Bonds use structuring technology to create a dedicated pool of assets backing an individual issue. The quality of the underlying assets as well as all other features of the bond issue can be customised by the issuer. Typically, terms and conditions are selected to receive a high (AAA) rating from the rating agencies. As these structured Covered Bonds typically exhibit size and market-making agreements similar to Jumbo bonds issued under the legal framework, the market has accepted these issues as investment alternatives in the Covered Bond universe.

This progression not only allows traditional German Pfandbrief investors to diversify their exposures, it also establishes a significant, liquid and universally recognised fixed income market segment in Europe.

This development has had a profound impact. From an investor's perspective, analysing the differing legal and structural frameworks within the various national submarkets is multifaceted: On the one hand, the varying structures call for a much more research-intensive decision-making process. On the other hand, these variations are conducive – especially to larger investors with commensurate research capabilities – to finding relative value, not only across issuers and maturities but now across jurisdictions and product types as well.

The volume of the liquid Covered Bond market has increased significantly over the past years. The jumbo market outstanding volume has more than doubled from 300 billion Euros in 1999 to almost 750 billion Euros today (see figure 1 below). In comparison, the German Pfandbrief share of the Jumbo market since 1999 has decreased in both relative and absolute terms.

> FIGURE 1: JUMBO OUTSTANDING VOLUME/ISSUANCE VOLUME



Source: Dresdner Kleinwort Wasserstein, May 2007

HOW TO ANALYSE THE CREDIT QUALITY OF A COVERED BOND

PIMCO analyses the Covered Bond market utilising a three-pronged approach:

1) Initially, the country-specific legal environment is scrutinised. Our analysis includes, but is not limited to, a thorough assessment of covered pool eligibility criteria, issuer default events and transparency requirements. With regard to structured Covered Bonds (e.g., in the UK or the US), we confirm the issue's specific contractual features. An affirmative analysis is a precondition to investment in the structured Covered Bond segment.

2) Subsequently, issuer quality is measured. This process utilises PIMCO's internal corporate research capabilities. The issuer's brand name is assessed in the course of a corporate financial analysis, regardless of Covered Bond market type. Neutral to positive assessments advance to the next stage while negative assessments do not. A negative score precludes investment in the issue.

3) Finally, the Covered Bond segment is examined, primarily cover pool quality. Diversification of pool assets with respect to size and geographical distribution as well as loan-to-value (or LTV) ratios are essential tools used in measuring cover pool quality. In addition to the pool itself, PIMCO substantiates the issuer's Covered Bond business strategy. A clearly focussed and well-defined Covered Bond strategy is, from the PIMCO perspective, tantamount to success in the market. Focussed participants are preferred to those simultaneously involved in numerous markets. Furthermore, issuance behaviour in terms of commitment to the Jumbo market is rewarded: Regular issuance ensures secondary market liquidity.

The overall assessment of a single issuer's Covered Bond is fundamentally based on an aggregate of the three aforementioned steps. The result is that a robust issuer could potentially offset a weaker regulatory environment or a high quality Covered Bond business strategy might counterbalance a less significant issuer.

COVERED BOND RELATIVE VALUE OPPORTUNITIES

The attractiveness of including Covered Bonds in a fixed income bond portfolio is assessed relative to other sectors. A neutral Covered Bond position can be gauged by comparing the position to a portfolio benchmark. The Lehman Euro Aggregate Index is a good example of such a benchmark. This index portfolio contains a Covered Bond allocation of approximately 15ù, including issues from various jurisdictions. Covered Bond under- or overweight positions can be compared to, for example, government or corporate bond allocations. Although PIMCO considers Covered Bonds to be a credit product, Covered Bonds are often used as an alternative to government bonds, due to comparable rating quality. Based on Lehman Index data, public-backed Covered Bonds outperformed government bonds with a similar duration by more than 0.25% p.a., on average, over the past eight years.[33]

The spread between a Covered Bond and a government bond for a specific maturity is key to assessing relative attractiveness. This spread can be broken down into two parts: (i) the spread of a government bond to the swap rate with the same maturity and (ii) the spread of the respective Covered Bond to this swap rate. The Covered Bond to swap spread curve is typically assumed to mirror Covered Bond credit quality shifts while the swap to government spread, classically, moves independently and is based on external market movements.

The overall spread between Covered Bonds and governments bonds can vary among different maturity buckets. If one believes the spread difference to be determined primarily by credit risk relative to a "risk free" government bond, one should assume that the yield differential of a Covered Bond to a government bond is relatively low for short maturities and relatively high for bonds with longer durations. Accordingly, it is important to identify the most attractive point on the curve for Covered Bonds from a risk/return perspective, which may lead to single-name "switching" across the maturity spectrum.

Relative value can also be identified between individual Covered Bonds with similar maturity profiles. In this case, potential switches are based upon a research assessment at odds with the market.

Overall spread movements of competing Covered Bond issuing countries is another area where relative value trades may occur. In the event that spreads of the complete range of Covered Bonds in one country trade differently relative to another country are observed, relative value opportunities may be exploited. These opportunities are driven by divergent views with respect to macroeconomic factors, such as a country's overall economic situation or its banking system relative to other countries.

CONCLUSION

The flourishing Covered Bond segment continues to attract significant attention from Europe's fixed income market. Although research capabilities must be enhanced in order to adequately assess issuer and product quality across multiple jurisdictions, the liquidity and value offered by the Covered Bond market makes for attractive investment opportunities. Indeed, relative value can be identified not only between Covered Bonds and other fixed income segments but also across the broadening spectrum of product types, frameworks and countries of the growing Covered Bond universe.

33 Source: Lehman Brothers, May 2007, Excess Return for Securitized Sub-Index p.a. from May 1999 to April 2007

PIMCO Europe Ltd
Nations House
103 Wigmore Street
London W1U 1QS
England
Tel: +44-20-7872-1300
Authorised and regulated by the Financial Services Authority

PIMCO Europe Ltd
Munich Branch
Nymphenburger Straße 112-116
80636 Munich
Germany
Tel: +49-89-1221-90
Authorised and regulated by the Financial Services Authority and the Bundesanstalt für Finanzdienstleistungen

PIMCO Europe Ltd
Amsterdam Branch
Schipol Boulevard 315, Tower A6
1118 BJ Luchthaven Schipol
The Netherlands
Tel: +31-20-655-4710
Authorised and regulated by the Financial Services Authority and AFM

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4.2 MARKET-MAKING & LIQUIDITY OF COVERED BONDS MARKETS: WHAT DO INVESTORS EXPECT?

4.2.1 NORDIC INVESTOR PERSPECTIVE

By Ulrich Frølich, Lisbeth Alber and Rasmus Majborn
Danske Capital

INTRODUCTION

Danske Capital is one of the largest asset managers in Scandinavia. One of our Alpha expertise areas is the European fixed income market, and we have generated a high level of investment expertise in the European covered bond market throughout the past years.

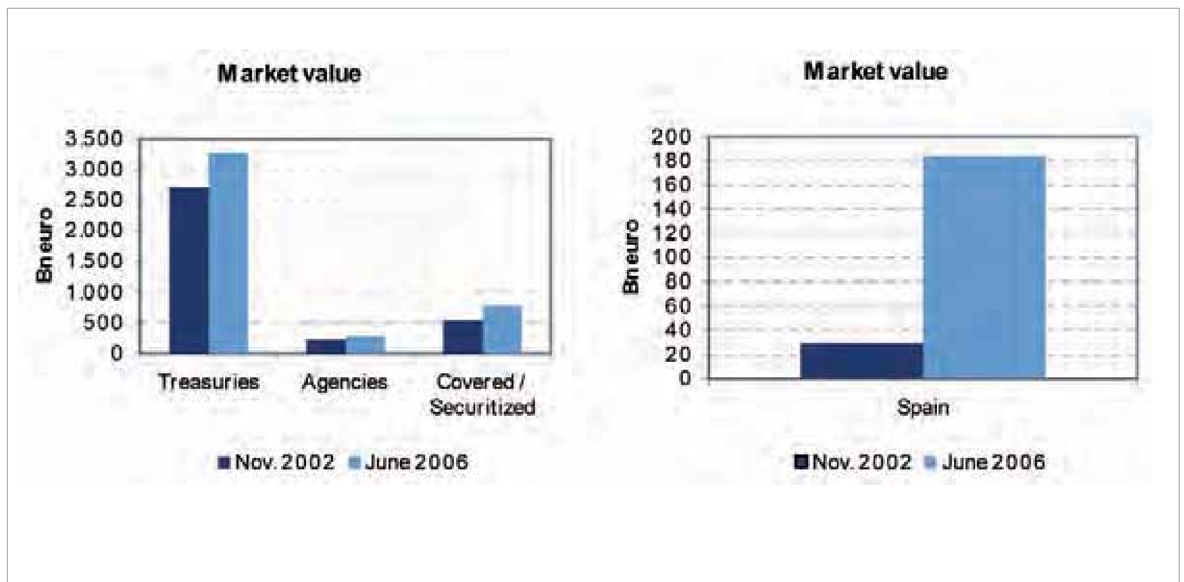
IN WHICH UNIVERSE DO COVERED BONDS BELONG IN DANSKE CAPITAL?

Covered bonds are debt instruments secured by a cover pool of mortgage loans or public sector debt to which investors have a preferential claim in the event of a default. While the nature of this preferential claim, as well as other safety features such as asset eligibility and coverage, bankruptcy remoteness and regulation, depend on the specific framework under which a covered bond is issued, it is the safety aspect that all covered bonds have in common. This feature guarantees high ratings and makes European covered bonds a viable investment alternative to European government, agency and supranational bonds.

THE INCENTIVES TO INVEST IN EUROPEAN COVERED BONDS

Over the past years, the European covered bond market in particular has been characterised by two developments: 1) the asset class has strongly outperformed government bonds 2) new covered bond frameworks and new issuers have pushed the gross supply to historical highs, in particular Spanish issuance has surged.

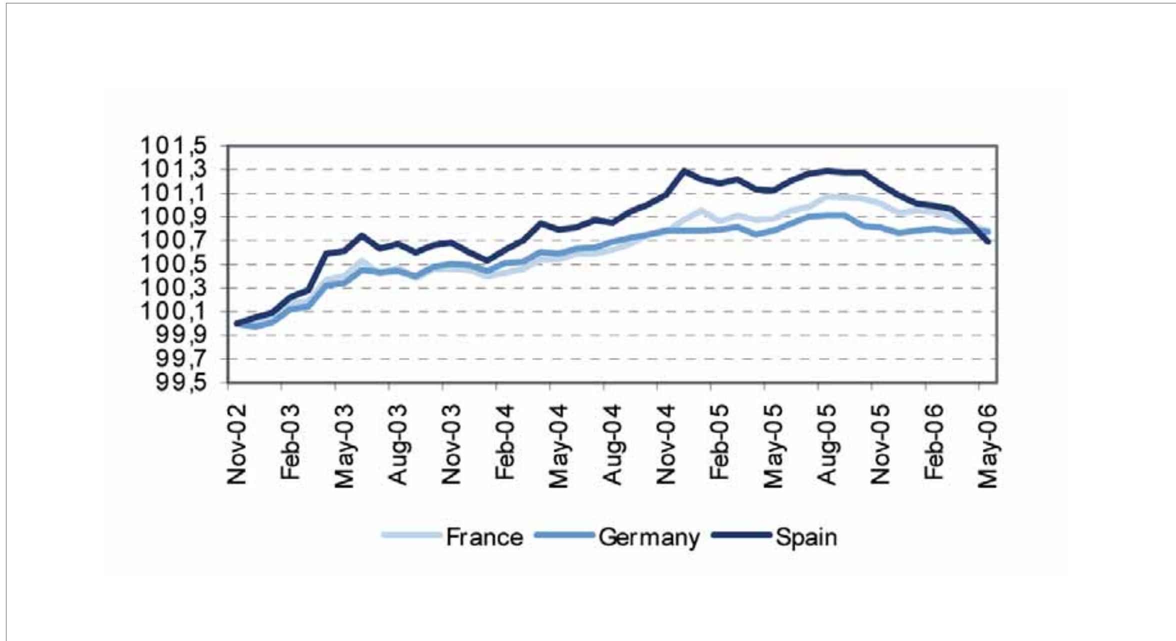
> FIGURE 1: MARKET TRENDS



Source: Lehman Brothers, Euro-Aggregate Securitized index

As a result of the trend in recent years, the investment universe has widened, thereby improving diversification opportunities. Covered bonds offer a pick-up to government bonds, a liquid market and a safety aspect that is common for all covered bonds. In addition, compared with agencies and supra-nationals, covered bonds benefit from a yield pick-up. Furthermore, in 2005 the majority of new offerings performed well even shortly after being launched. Five days after the launch date, the weighted average swap-spread performance of all newly issued covered bonds was 1bp.

> FIGURE 2: EXCESS RETURN INDES TO GOVERNMENT BONDS - OCT. 31ST 2002 = INDEX 100



Source: Lehman Brothers, Euro-Aggregate Securitized index

At Danske Capital we seek to identify and understand pricing imbalances among covered bonds in different sectors and for individual issuers within a wide range of maturities. For this purpose, we perform both a top-down and a bottom-up analysis.

INVESTING IN COVERED BONDS - A TOP DOWN APPROACH

The return on covered bonds as an alternative to government bonds is largely dependent on swap spreads, so we place a lot of emphasis on swap spread trends. With a view to analysing the swap market, we have developed proprietary swap models. The models signal expectations about future swap rates and spreads as well as fair value for the instantaneous levels.

Based on our view on swap spreads, we investigate the spread to government curves for different sectors and issuers and take the return and risk ratio into account, when narrowing the field of attractive investment possibilities. For that purpose, we calculate break evens for spread widening to assess if certain bonds are attractive versus governments and we look at beta's and historical spread volatility to analyse how sectors and issuers correlate with the swap market.

INVESTING IN COVERED BONDS - A BOTTOM UP APPROACH

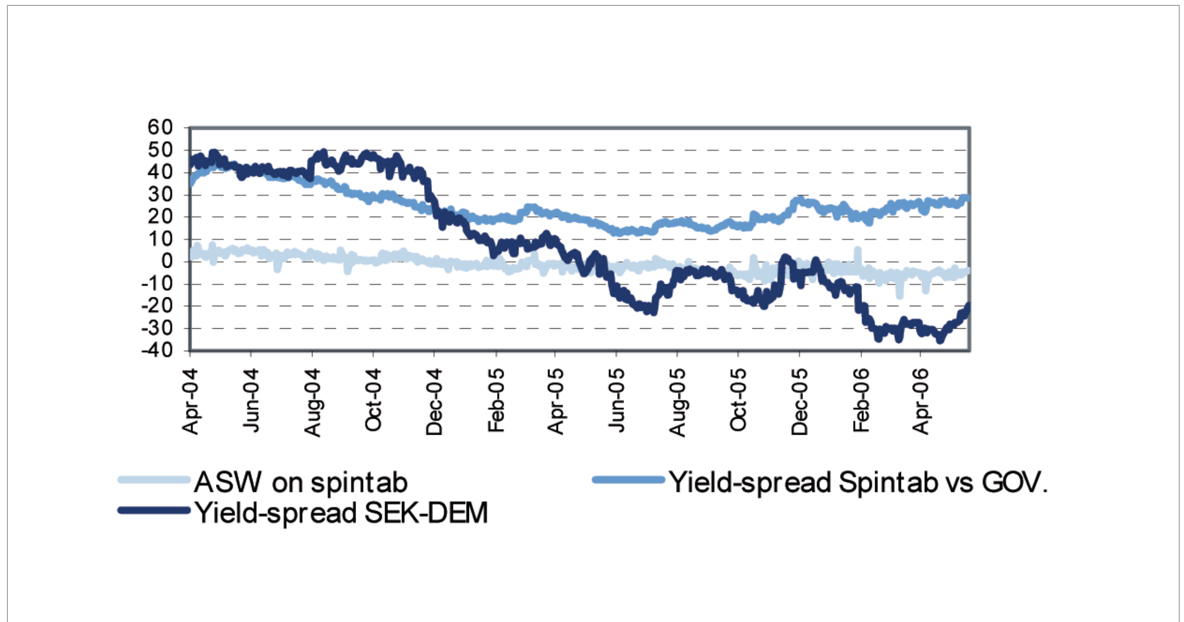
Although the European covered bond market has developed into a rather homogeneous market, pricing differences among the various issuers still persist. It is therefore important to base any investment decision on a thorough analysis which includes the slight differences between the various covered bond frameworks and the different business models of issuers. When analysing the different issuers we find it essential to focus on the following: characterisation of the issuer (ownership structure, business model etc.), rating, legal framework, quality of collateral, liquidity and pricing.

SWEDISH COVERED BONDS - A CASE STUDY

Danske Capital possesses an in-depth local knowledge of the Nordic fixed income markets, and has been active in the Swedish bond market for a considerable number of years.

By 1st July 2004, the covered bonds act was adopted in Sweden. In addition, several mortgage credit institutes announced that they were already beginning to consider a conversion from unsecured bonds to covered bonds. The unsecured issues were unrated, but were expected to receive a rating of AAA/Aaa after the transition to covered bonds. Also, the conversion to covered bonds would reduce the BIS weighting from 20% to 10%, equal to the weighting of existing European covered bonds. After the conversion to covered bonds, Swedish mortgages would be eligible for inclusion in the Pan-European bond indices. These three factors taken together were expected to cause a significant increase in the demand for Swedish mortgages.

> FIGURE 3: PERFORMANCE OF THE 'UP-COMING' COVERED BOND (SPINTAB 09)

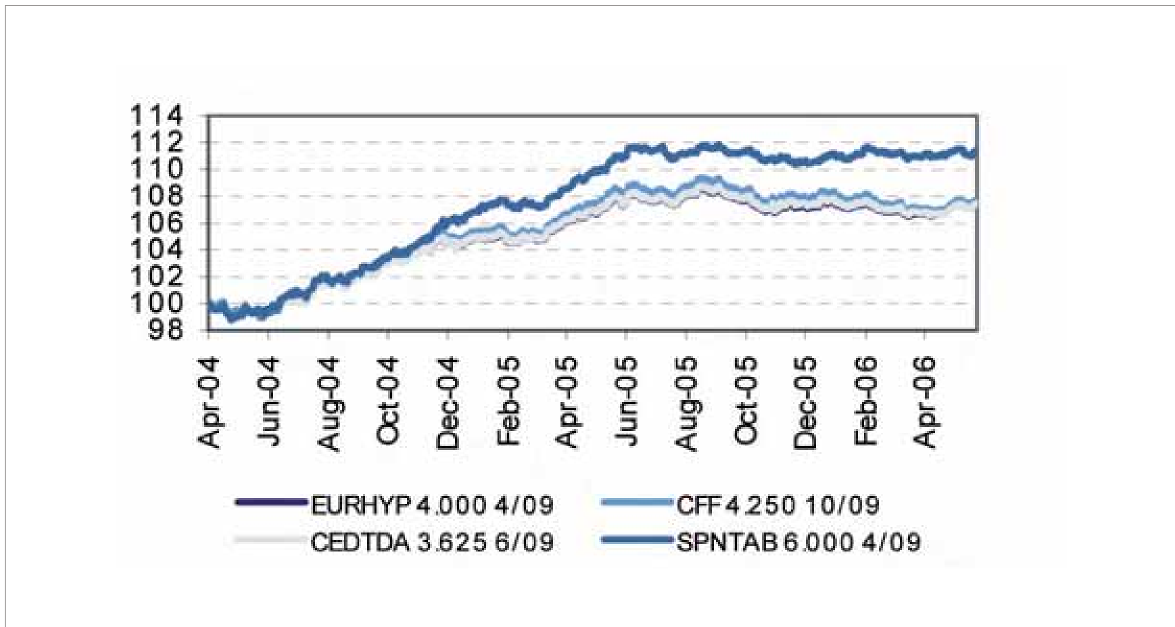


Source: Danske Bank

In April 2004 Danske Capital anticipated the above mentioned development. At the same time, we were very positive on the yield spread between government bonds in Sweden and Euroland. We therefore decided to take an off-benchmark position of up to 10% of 5Y Swedish mortgages in our European

fixed income portfolios at the expense of Euro governments. At the time of implementation, the spread between Swedish mortgages and governments was 35 bp and the spread between Swedish and German governments was 45 bp. About one year later we took profit, after a total spread compression of 62 bp between AB Spintab 6% 04/09 and German government 3.25% 04/09. The exposure to SEK was fully hedged.

> FIGURE 4: TOTAL RETURN INDEX



Source: Danske Bank

The time frame for the conversion to covered bonds has, however, been longer than previously expected. On 15 May 2006, SBAB was the first company to announce a conversion from unsecured to covered bonds to take place in the period from 8th June 2006 to 12th June 2006 at a ratio of 1:1. The issues have been rated AAA by Standard & Poors.

4.2.2 GERMAN INVESTOR PERSPECTIVE

By Torsten Strohrmann
DWS Investment GmbH

INTRODUCTION

One of the greatest inventions in the German Banking industry is undoubtedly the development of the 'Jumbo Pfandbrief' market. The step from the 'traditional' and more or less illiquid Pfandbrief to the 'Jumbo' market has led to the creation of one of the biggest bond markets in the world. Not only are appealing ratings and big issue sizes driving the demand for this type of product but so too, and equally importantly, are market makers' commitments to the creation of an international standard for this type of product, previously unknown in this dimension. Thus, transparency and liquidity are the main drivers for covered bond investors. These two aspects will be further discussed in this article.

THE RATIONALE OF THE MARKET

Market Makers' commitments define bid/offer spreads for sizes up to 15 million EUR for different maturities as follows:

- up to 4 years maturity - 5 cents;
- from 4 to 6 years - 6 cents;
- from 6 to 8 years - 8 cents;
- from 8 to 15 years - 10 cents;
- from 15 to 20 years - 15 cents; and
- from 20 years upwards - 20 cents.

In fact, electronic trading platforms are further reducing the spreads for the investor by comparing different quotes. This shows up the fierce competition that exists in market making as participants fight for turnover and high positions in league tables. Previously, it wasn't usually possible to sell Pfandbriefe short due to the lack of possible ways to cover the position. In the Jumbo market, market makers are also providing liquidity amongst themselves and in 2001 the repo market making in Jumbo Pfandbriefe was established so as to cover these short positions and so as to expand the liquidity in secondary trading. Thus, all of the ingredients needed to provide a highly liquid bond market segment were put in place and the result is that we now have a default-free product with a high degree of standardisation and regulation, big issue sizes, electronic trading platforms for clients and Euro Credit MTS for the broker market.

Despite having all of these elements in place, the market then faced – and eventually overcame - the biggest test of market making in Jumbo Pfandbriefs in the form of the AHBR case in which the market making on AHBR's Jumbo Pfandbrief was abandoned due to negative rating actions being taken following a bigger than expected loss being reported for 2005. The AHBR Pfandbriefs were not downgraded, but it can be expected that market making in these will not be re-started in the near future.

As an investor, it could be questioned why market making is required (or at least why it has to be paid for), especially if it only works in times of calm and not when investors have to trade, possibly as a consequence of bad news. But this is the issue of main concern because market makers themselves

are exposed to news flows as well as investors. When there are positive news flows, it is not expected that there will be much turnover in a particular issue and this situation can be handled quite well with bigger supply perhaps being cleared at lower prices and broken down in the market. The difficulties arise when the news flow is very negative because at such times, market makers are not always able to pass the supply through within the market and finding prices becomes extremely difficult. Equally, at such times Credit MTS or Brokers are not a solution either because there are no bids at yesterday's spreads anymore, the result being that prices are marked down. However, if even at much lower prices no buyer can be found, the inventory of a market maker becomes crowded and a temporary stop in market making activities may be one of the few remaining methods of calming down the market. This is unfortunate for investors as they are then forced to sell positions by giving a time consuming order to a broker who is in turn trying to find someone else to pass the positions onto directly. When deals are completed via a broker, both the seller and buyer are perhaps once again uncertain about the true price and the margin that the broker retains.

It is not easy to find someone to blame for this situation as there is no obligation on anyone to trade. Rather, it is much more a question of fair, responsible and reliable trading and the following three sections take a closer look at the different participants in the market.

THE MARKET MAKER

Investment banks have, amongst others, one primary target: to generate profit from fees and trading. In market making, banks could earn the bid/offer spread, but as the level of competition is huge, market making can best be described as only one element in the value chain of generating fees and profits. Establishing valuable contacts with issuers can provide market makers with access to profitable new issues, consultation and other business opportunities. Market making itself doesn't need to be understood as a profit centre in its own right, but rather as an integrated element of the whole value chain of 'origination' or 'propriety trading'. Generating profits from bid/offer spreads may not have the same priority as investments in expected profitable future business with issuers, but viewed as an integrated part of 'propriety trading' it does present another means of reducing risk and risk taking. Due to the fierce competition that exists amongst market makers, entrepreneurs and aggressive accountants are often willing to step into the profitable market with issuers so as to try and increase their market share, even if they make losses in market making. Investors are thus forced to trade at the best price with the second or third best prices therefore having a low probability of being traded. With this in mind, as a market maker the only way to achieve useful results in such a situation is to bid on certain issues more aggressively than on others and to offer those better, where it has positions it wants to sell out of the bank's portfolio. Now portfolio positioning is carried into the pricing in market making. The steering of the bank book can be combined with market making so that this becomes an integrated part of the bank's overall trading strategy. This could lead to tight bid/offer spreads for investors, but there is another side to this coin in that banks tend to aggregate risk positions by issuers, regardless of whether or not an exposure is secured. This was obvious when the market making in AHBR's Pfandbriefs was abandoned, with some market makers not being able to take additional long positions in AHBR in any kind of paper, because the nominal limits for AHBR as an issuer had been reached.

THE ISSUER

Market makers alone are not responsible for a good market making and issuers have an equal interest in a well functioning market. Issuers are obliged to perform market making so that they can reduce their refinancing costs and create a highly liquid product that is appealing to investors as they are accepting a lower yield. Thus, issuers clearly benefit from market making and they are of course obliged to control and sanction misbehaviour. Periodical 'Road Shows' aimed at investors allow issuers to gather the necessary information about the market making for their issues. Another way is to control the market making via Credit-MTS data, but market makers often perform a large number of trades in front of a new mandate for a certain issuer so as to be recognised and thus get a chance to participate in the new deal.

If an issuer is not willing to issue large bonds, the market makers become more and more reluctant to perform market making. Consequently, it is not clear if market making for AHBR's Pfandbriefs will be re-established in the near future as AHBR may not issue 'Jumbo Pfandbriefe' any more.

THE INVESTOR

Investors are demanding market making as they are the warehouse of covered bonds. The top ratings of covered bonds, combined with a yield enhancement versus Sovereigns and high liquidity are attractive features for investors. Better liquidity in comparison to the traditional Pfandbrief product gives leeway to relative value trading strategies. Consequently the turnover in covered Bonds has increased significantly since then. Traditional Pfandbriefs are still important as a risk free basis for tailor-made investment solutions. Equally, registered covered bonds (Namenspfandbrief) saw a revival in the last two years as yields approached new lows.

Different types of investor have different product requirements regarding covered bonds. Consequently, insurance companies or pension funds - as buy-and-hold investors - often prefer the Namenspfandbrief whereas banks and mutual funds take advantage of the flexibility of the liquid Jumbo products. Investors in Jumbos often view positions in liquid covered bonds as trading or relative value positions. If spreads tighten, investors become potential sellers. But if spreads move out significantly due to bad company news, selling is equally likely to occur. Investors are often measured on a daily basis, so buy-and-hold is not always an appropriate strategy if markets are tumbling. Market making works perfectly well if spreads are moving in, but if bad news is approaching, everybody wants to sell and market making reaches its limits if no buyer is found. There are occasions when the supply is suddenly so huge that no reasonable spread can clear the market in time. Of course, following news flows requires fast decision making and the quick execution of deals, but this can also lead to the wrong decision being taken. What looks like bad news following a quick review may in fact be a buying opportunity because of a misinterpretation of the data. Ex-ante research may therefore protect investors from taking the wrong decision based on data or even not having a position in a questionable name. Therefore, market makers may not always have the capacity necessary to re-sell positions in the market if it reacts wrongly to news flows.

Investors cannot influence market making directly, but through close contact with issuers they may have some indirect influence. For example, they can provide issuers with feedback that that may lead issuers to choose those market makers who investors believe provide the best service – for example, it is often already clear when the list of market makers for a deal is published whether or not market

making will work. Consequently, investors demand higher spreads for those deals with weaker market makers in the lead.

HOW TO IMPROVE MARKET MAKING?

The AHBR case showed how it is possible for market making to reach its limits when a price has to be found so as to bring supply and demand into equilibrium, but as there is no demand, it is not possible to find a price clearing the market and market making therefore stops.

Investors have to be aware of the limits of market making and of the limits of markets themselves – i.e. that when there is no demand, there is no price. Key questions here are how to develop a greater degree of understanding of these situations and whether or not there are perhaps definable circumstances which should trigger a stop in market making? In these situations the market needs to be informed very quickly and through all of the available channels that market making for a certain bond must stop. Of course, it is very important that no element of selfishness is attached to any decision to stop market making. These requirements are easily identified in general terms but it is harder to develop them in detail and much harder to implement them. Too rigid a definition of the circumstances in which market making should be stopped may even worsen the situation as liquidity could be drawn down too early; too broad a definition may be equally unhelpful as the market could find itself in a selling frenzy with all of the negative implications this entails.

A 'MARKET MAKING HEAT MAP'?

A negative news flow on a specific issuer, combined with a much higher trading volume in the inter-bank markets, could be a potential indicator that markets will encounter difficult circumstances in the not too distant future. Of course, to an extent this depends on the quality of and the speed at which information is received. As it is near impossible to collate and assess such information in real time, an alternative could be the creation of a 'Market Making Heat Map' on which each issuer or each liquid covered bond could be presented with historical market data so as to provide an indication of the stance and quality of market making. This 'Market Making Heat Map' could also be derived from observed trading volumes and spread changes as high trading volumes and high spread changes may also indicate potential future difficulties in market making. Clearly, there is no ex-ante component to such a 'Market Making Heat Map', but this tool could bring additional transparency and understanding to the market as it may identify differences in the quality of market making in different issues over time.

CONCLUSIONS

Market making as it currently exists in the covered bond sector has now been in place for more than a decade and has always been improved if and when necessary. In most cases this system works well and it is one of the main reasons why investors decide to become involved in this market. Indeed, recent work undertaken by the European covered bond Council (ECBC), vdp and ACI show the willingness of the sector to further improve the system. The increasingly large number of covered bonds with a market making commitment is a challenge to investment banks as they have to make sure that market making works for all of them. Investors should, however, be aware of the limits of market making and the possibility of this being stopped, and it is possible that fundamental analysis of market making may be a potential way in which investors can identify early on in the process those issuers to be wary of and where problems may arise, as well as to identify the possibility of cheap prices or of panic selling.

RESUMÉ

Liquid covered bonds such as Pfandbriefs are already characterised by a high degree of transparency; however investors are demanding more. In Germany the transparency requirements are now incorporated into the newly created Pfandbriefgesetz, which is an important step towards a higher degree of standardisation and visibility for investors. Issuers often already provide more information than is required of them by these standards, but there are some who are reluctant to do so on a voluntary basis. More and more regular 'Road Shows' are a further improvement demanded by investors and these are already being delivered by a large number of issuers.

The creation of the Jumbo Pfandbrief market was the beginning of a new European asset class and as issuers' transparency must be guided by transparency in market making, the future will show what investors will demand in terms of transparency in Jumbo Pfandbriefs.

CHAPTER 5 - RATING AGENCIES & METHODOLOGY

5.1 FITCH COVERED BONDS RATING METHODOLOGY

By Hélène Heberlein, Fitch Ratings

Fitch started to roll out its current 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 is an innovation.

The purpose of the Fitch Discontinuity Factor is to measure how far the Covered Bonds' probability of default can differ from that of the main debtor of recourse. Fitch has already conducted a continuity analysis for Covered Bonds that looked at an array of both legislative and contractual Covered Bonds issued out of a range of countries, and secured over both property financing and public sector assets. This gave the agency insight into the interplay of the different variables and the elements constraining Covered Bond ratings.

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 debtor of first 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.

> The 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 both systemic and cover pool and 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 (OC) 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 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 an 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 potential secondary market for the regular assets included in the cover pool, or the feasibility of borrowing against the cover pool assets.

Covered Bonds Probability of Default Matrix

Issuer	Discontinuity Factor											
Default Rating	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
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+//C CC	CCC	B-	B-	B	B+	BB-	BB-	BB	BBB-	BBB	AAA

Source: Fitch

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%

Alternative Management: 15%

Liquidity Gaps: 30%

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. The table below show these achievable ratings for a few Discontinuity Factors.

> 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 OC 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 OC available at the last reporting date: in the absence of any contractual commitment or public statement regarding the OC provided to Covered Bond investors, the agency considers the lowest OC observed in the preceding 12 months if the issuer is rated 'F2' or above. Below this rating threshold, and barring any explicit commitment from the issuer, it considers only the legal minimum OC. 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.

If the simulated OC 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 for through OC 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 does not 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, ie payments that are meant to continue to protect investors against interest rate and currency risks even after an issuer insolvency. In many Covered Bond regimes, they rank equally with Covered Bond investors. As a result, 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 specific number of notches as per the table below.

Recovery Ratings	Recovery Prospects	Recovery Range (%)	Maximum Notching	
			Investment Grade	Speculative Grade
RR1	Outstanding	91 -100	2	3
RR2	Superior	71 - 90	1	2
RR3	Good	51 - 70	1	1
RR4	Average	31 - 50	-	-
RR5	Below Average	10 - 30	-1	-1
RR6	Poor	0 - 10	-1/-2	-2/-3

Source: Fitch Ratings

Examples of Fitch Covered Bond Ratings

The IDR, Discontinuity Factor, OC 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 to which Fitch has already applied its current rating criteria. 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, a few are actually deemed equivalent to a 'AA' rating from a probability-of-default point of view, but assumptions about the 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 OC levels. However, issuers may improve their Discontinuity Factors over time, for instance by taking measures to reduce the liquidity gaps or improve their systems.

Issuer	AHBR		Catalunya	Comercial Portugues	Covered Bonds	Northern Roc
Country of the Issuer	Germany		Spain	Portugal	France	UK
Type of Covered Bonds	Legislative		Legislative	Legislative	Contractual	Contractual
Nature of Cover Assets	Public Sector	Mortgages	Mortgages	Mortgages	Mortgages	Mortgages
Applicable Issuer Default Rating	BBB-	BBB-	A	A+	AA-	A+
Discontinuity Factor	6.44%	11.69%	31.63%	7.75%	12.31%	8.75%
Maximum Rating on a Probability of Default Basis	AA	A+	AA	AAA	AAA	AAA
Overcollateralisation	6%	13%	730%	5.26%	8.11%	11.60%
Rating on a Probability of Default Basis	AA	A+	AA	AAA	AAA	AAA

The Discontinuity Factors publicly assigned by the agency to date have ranged from 6.44% to 31.63%. 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, which have also begun to use such provisions.

5.2 MOODY'S COVERED BOND RATING METHOD

By Juan Pablo Soriano, Nicholas Lindstrom and Jörg Homey
Moody's

Moody's rating approach for Covered Bonds is based on the so-called 'joint-default analysis'. This takes into account both the credit strength of the issuer and, on "Issuer Default" (the removal of support from the sponsor bank), the value of the cover pool.

The credit strength of the issuer is measured by the senior unsecured rating of the issuer (or sponsor bank as the case may be). However, it is the value of the cover pool which is typically the more important driver of a final Covered Bond rating. The considerations affecting the value of the cover pool include:

- the credit quality of the collateral in the cover pool;
- any 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.

Additional consideration will be given to any legislative provisions or any contractual commitments that may have an impact on any of the foregoing analytical aspects.

The credit quality of the cover pool is measured by Moody's collateral score. The higher the credit quality of the cover pool, the lower the collateral score. The lower the collateral score (and hence the higher the credit quality of the cover pool), the lower the level of losses that will impact the cover pool at the time of Issuer Default in Moody's expected loss-based analytical model (EL Model).

Following Issuer Default, the timely payment of principal under the Covered Bonds may rely on funds being raised against the cover pool. This is particularly the case where the duration of assets in the cover pool (i.e. "natural amortisation") exceeds the duration of the Covered Bonds. In such circumstances, Moody's assumes that funds will be raised against the cover pool, and these funds may be raised at a discount to the notional value of the cover pool. The extent of any discount will in general depend on, amongst other considerations, (i) the time available to make payments under the Covered Bonds, (ii) the quality of the cover pool, (iii) market appetite for the cover pool and (iv) the maturity date of each of the Covered Bonds. To calculate this, discount prices have been used for similar quality assets in the structured finance market. The discount applicable to the cover pool is calculated by taking the product of the stressed margin and average life of the cover pool.

The refinance value of the cover pool may also be impacted by any unhedged interest and currency rate risks. For example, Moody's EL Model looks separately at the impact of the increasing and decreasing interest rates on the expected loss of the Covered Bonds, and takes the path of interest rates that leads to the harsher 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) if suitable hedges are in place that survive Issuer Default (and typically are recorded in the cover pool register), that zero risk will be attributed to any such hedged risks/mismatches; or (iii) that some other level of hedging is in place.

Legislation directly impacts all the above factors. The value of the cover pool will be affected by requirements which relate to, amongst other matters, (i) asset eligibility criteria, (ii) the matching of

assets and liabilities, (iii) the bankruptcy-remoteness of the cover pool, (iv) the appointment of a cover pool administrator separate from the insolvency administrator (appointed to other assets of bankrupt issuer), to manage the cover pool, (v) priority rights in the cover pool in favour of Covered Bonds and (vi) the rights of Covered Bonds to claim against voluntary over-collateralised assets in the cover pool.

References:
> Moody's (2005): Special Report: Moody's Rating Approach to European Covered Bonds; 13 June 2005
> Moody's (2005): Special Report: European Covered Bond Legal Frameworks:
> Moody's Legal Checklist; 9 December 2005
> Moody's (2007): Special Report: 2006 Review and 2007 Outlook EMEA Covered Bonds: Dramatic Growth Recorded in 2006, and Trend toContinue as Market Diversifies in 2007; 18 January 2007

5.3 STANDARD & POOR'S

By Karen Naylor, Karlo Fuchs and Sabrina Miehs
Standard and Poor's

The analytical approach applied by Standard & Poor's Ratings Services (S&P) 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; S&P ratings reflect the issuers' willingness to maintain an overcollateralisation that is over and above the regulatory minimum requirement and at a sufficient level to cover prevailing risks for the target rating (usually 'AAA') of its Covered Bonds.

Covered Bonds are continuously analysed and monitored by a dedicated team of S&P Covered Bond analysts across Europe. The international team brings in an intimate knowledge of the individual markets to be able to adequately analyse the respective cover pools and to comment on rating relevant aspects. Incorporating relevant market developments into the Covered Bond rating criteria ensures that S&P Covered Bond ratings provide an adequate reflection of relevant risks for both investors and issuers.

Transparency with regard to risks in Covered Bonds already prompted legislators in Europe to introduce mandatory transparency measures but current transparency has in still room for improvement. To provide transparency on the Covered Bonds rating analysis, Standard & Poor's regularly provides jurisdiction specific assumptions for the credit risk analysis and as the first rating agency, has made the quantitative Covered Bond model (Covered Bond Monitor; CBM) available to issuers and interested market participants. Interested market participants therefore have the opportunity to gain a comprehensive overview on the applied analytic methods. Also issuers have the opportunity to estimate effects of pool restructurings on the required level of overcollateralisation (further information can be found at www. coveredbondmonitor@standardandpoors.com).

S&P welcomes the trend to address market risks in cover pools through the use of derivatives. However, to ensure that market risk is not simply replaced by the credit risk of the swap provider and to take into account the specifics of swaps used for Covered Bond transactions, S&P is exploring ways of giving credit to swaps in cover pools. The Covered Bond specific version of the S&P swap criteria is expected to facilitate the use of derivatives and should further strengthen the stability of Covered Bonds ratings going forward.

In the Covered Bond analysis S&P focuses on 4 core areas:

1 Review of the legal framework or structures to ensure that, in the event of the issuing bank's default, Covered Bond investors will be able to receive the timely payment of interest and repayment of principal and interest in accordance with the original terms and conditions of the bond. Only if S&P is convinced that this is assured in the event of the insolvency of the issuing bank, a Covered Bond rating that is predominantly based on the strength of the provided structure and not on the rating of the bank may be assigned.

2 The ongoing analysis of the quality and structure of the collateral registered in the cover pools in order to determine the expected loss in the event of default (interest and repayment of principal). Based on a thorough review of the respective cover pools and of the operational features of

the issuer's credit management, S&P applies stress scenarios that are calibrated to the specific issuer's desired rating (for example 'AAA') to determine the expected credit loss for an individual portfolio.

3 The effect on the cash flows resulting from credit losses, maturity and currency mismatches, liquidity, and interest rate risks. For most legislation enabled Covered Bonds, S&P uses 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 flow 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 than legislation enabled Covered Bonds but the analysis is performed with different models to also incorporate structural elements.

4 The ongoing adequacy of covenants, in particular overcollateralisation provided by the issuer. The adequacy is depending on the Covered Bond's target rating and determined by assessing their quantity, quality and expected permanency which typically is over and above the regulatory requirements. Dependent on the counterparty credit rating of the issuer and its business strategy, Standard & Poor's expects varying strength and permanency of such covenants.

Investors should be aware that, in the absence of a clearly communicated covenant strategy, Covered Bond ratings on 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.

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, can reduce the potential rating volatility. While contractually agreed covenants are the strongest form of a communication strategy, S&P can to some degree also give benefits for non legally binding covenants.

Independent of the quantitative and qualitative assessment of the Covered Bond structure, regular and issuer-specific monitoring further ensures that Standard & Poor's gains comfort that the issuing bank is able to maintain the adequate level of overcollateralisation required for the prevailing rating level.

Such monitoring includes that all Covered Bond issuers rated by Standard & Poor's 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. In particular weaker issuers have also to be able to demonstrate that the servicing of the assets registered in the cover pools would, in the event of issuer insolvency, be transferred to a third party not only in theory but also in practice, without jeopardizing the timely and full repayment of the Covered Bonds to the investors.

If a Covered Bond issuer fulfils the above criteria, S&P is usually in a position to assign an issue rating for Covered Bonds that is considerably higher than the issuer's individual credit rating, even as high as 'AAA'.

CHAPTER 6 - ANNEX

6.1 STATISTICS

6.1.1 CZECH REPUBLIC

Outstanding (in mln EUR)	2003	2004	2005	2006
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
Outstanding Covered Bonds backed by Ships	0	0	0	0
Outstanding of Covered Bonds by Mixed Assets	0	0	0	0
Total Outstanding	1 638	1 956	4 452	5 543
Outstanding Jumbo	0	0	0	0
Outstanding non-Jumbo	1 638	1 956	4 452	5 543
Total Outstanding	1 638	1 956	4 452	5 543
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
Outstanding denominated in EURO (stated in mln EUR)	0	0	0	42
Outstanding denominated in domestic currency (stated in mln EUR)	1 638	1 956	4 452	5 501
Outstanding denominated in other currencies (stated in mln EUR)	0	0	0	0
Total Outstanding	1 638	1 956	4 452	5 543
Outstanding fixed coupon	1 572	1 796	3 619	4 615
Outstanding floating coupon	66	160	833	928
Outstanding other	0	0	0	0
Total Outstanding	1 638	1 956	4 452	5 543
Maturity of Bonds	3,16	3,67	8,36	7,17
Issuance (in mln euro)				
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 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 (stated in mln EUR)	0	0	0	42
Issuance denominated in domestic currency (stated in mln EUR)	666	744	2 558	914
Issuance denominated in other currencies (stated in mln EUR)	0	0	0	0
Total issuance	666	744	2 558	956
Issuance fixed coupon	666	650	1 897	903
Issuance floating coupon	0	94	661	53
Issuance other	0	0	0	0
Total issuance	666	744	2 558	956
Maturity of bonds	5,02	4,53	12,35	5,49

source: Ministry For Regional Development, Securities Centre - Czech Statistical Office

CZK/EUR avrg.	31,844	31,904	29,784	28,343

6.1.2 DENMARK

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public Sector	0	0	0	0
Outstanding Covered Bonds backed by Mortgage	226 695	250 133	286 411	300 367
Outstanding Covered Bonds backed by Ships	6 915	6 330	6 915	6 672
Outstanding of Covered Bonds by Mixed Assets	0	0	0	0
Total Outstanding	233 610	256 463	293 326	307 039
Outstanding Jumbo	143 595	170 427	199 504	220 463
Outstanding non-Jumbo	82 569	79 329	86 746	79 804
Total Outstanding	226 166	249 758	286 250	300 267
Total Outstanding Public Placement	226 165	249 758	286 251	300 267
Total Outstanding Private Placement	0	0	0	0
Total Outstanding	226 165	249 758	286 251	300 267
Outstanding denominated in EURO (stated in mln EUR)	17 457	18 315	18 432	18 743
Outstanding denominated in domestic currency (stated in mln EUR)	208 709	231 442	267 819	281 523
Outstanding denominated in other currencies (stated in mln EUR)	0	0	0	0
Total Outstanding	226 166	249 758	286 250	300 266
Outstanding fixed coupon	207 483	229 462	242 592	241 851
Outstanding floating coupon	5 735	7 877	32 729	48 232
Outstanding other	12 297	11 650	10 930	10 184
Total Outstanding	226 165	249 759	286 250	300 267
Maturity of Bonds	15,2	12,6	12,8	13,0
Issuance (in mln euro)				
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	99 727	95 009	149 708	114 014
New Issues of Covered Bonds backed by Ships	318	139	1 837	960
New Issues of Covered Bonds by Mixed Assets	0	0	0	0
Total Issuance	100 045	95 148	151 545	114 974
Issuance Jumbo	9 994	9 600	14 253	4 228
Issuance non-Jumbo	51 728	44 902	73 417	64 686
Total Issuance				
Total Issuance Public Placement	99 727	95 009	149 708	114 014
Total Issuance Private Placement	0	0	0	0
Total Issuance	99 727	95 009	149 708	114 014
Issuance denominated in EURO (stated in mln EUR)	8 455	8 530	8 850	8 844
Issuance denominated in domestic currency (stated in mln EUR)	91 273	86 478	140 858	105 171
Issuance denominated in other currencies (stated in mln EUR)	0	0	0	0
Total issuance	99 727	95 008	149 708	114 015
Issuance fixed coupon	97 598	90 974	121 753	92 811
Issuance floating coupon	2 128	3 881	27 955	21 203
Issuance other	1	0	0	0
Total issuance	99 727	95 008	149 708	114 014
Maturity of bonds	12,0	9,5	14,1	11,4

6.1.3 GERMANY

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public Sector	797 492	760 264	734 713	720 835
Outstanding Covered Bonds backed by Mortgage	256 027	246 636	237 547	223 306
Outstanding Covered Bonds backed by Ships	3 172	3 212	3 670	4 669
Outstanding of Covered Bonds by Mixed Assets	0	0	0	0
Total Outstanding	1 056 691	1 010 112	975 930	948 810
Outstanding Jumbo	413 700	391 400	372 600	345 640
Outstanding non-Jumbo	642 991	618 712	603 330	603 170
Total Outstanding	1 056 691	1 010 112	975 930	948 810
Total Outstanding Public Placement	672 091	576 463	567 910	512 621
Total Outstanding Private Placement	384 600	433 649	408 020	436 189
Total Outstanding	1 056 691	1 010 112	975 930	948 810
Outstanding denominated in EURO	1 030 959	985 370	952 485	922 878
Outstanding denominated in domestic currency	4 551	7 652	5 056	1 248
Outstanding denominated in other currencies	21 181	17 090	18 389	24 684
Total Outstanding	1 056 691	1 010 112	975 930	948 810
Outstanding fixed coupon	901 004	838 345	845 386	823 130
Outstanding floating coupon	144 270	160 693	120 681	121 754
Outstanding other	11 417	11 075	9 863	3 926
Total Outstanding	1 056 691	1 010 112	975 930	948 810
Maturity of Bonds	4,6	4,8	5,0	5,4
Issuance (in mln euro)				
Total Covered Bonds Issuance				
New Issues of Covered Bonds backed by Public Sector	151 690	131 506	137 235	129 452
New Issues of Covered Bonds backed by Mortgage	57 621	40 773	33 722	35 336
New Issues of Covered Bonds backed by Ships	2 103	1 646	1 742	2 374
New Issues of Covered Bonds by Mixed Assets	0	0	0	0
Total Issuance	211 414	173 925	172 699	167 162
Issuance Jumbo	49 725	44 075	47 950	42 660
Issuance non-Jumbo	161 689	129 850	124 749	124 502
Total Issuance	211 414	173 925	172 699	167 162
Total Issuance Public Placement	138 958	109 423	106 895	76 935
Total Issuance Private Placement	72 456	64 502	65 804	90 227
Total Issuance	211 414	173 925	172 699	167 162
Issuance denominated in EURO	203 206	172 085	163 931	159 340
Issuance denominated in domestic currency	0	0	0	0
Issuance denominated in other currencies	8 208	1 840	8 768	7 822
Total issuance	211 414	173 925	172 699	167 162
Issuance fixed coupon	155 531	130 723	138 259	143 869
Issuance floating coupon	45 685	36 559	27 077	18 859
Issuance other	10 198	6 643	7 363	4 434
Total issuance	211 414	173 925	172 699	167 162
Maturity of bonds	6,4	6,3	7,1	7,4

6.1.4 SPAIN

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public Sector	4 900	7 200	9 640	11 590
Outstanding Covered Bonds backed by Mortgages	57 111	94 707	150 213	214 768
Outstanding Covered Bonds backed by Ships	0	0	0	0
Outstanding of Covered Bonds by Other Assets	0	0	0	0
Total Outstanding	62 011	101 907	159 853	226 358
Outstanding Jumbo	60 598	98 683	155 463	220 058
Outstanding non-Jumbo	1 413	3 224	4 390	6 300
Total Outstanding	62 011	101 907	159 853	226 358
Total Outstanding Public Placement	0	0	0	0
Total Outstanding Private Placement	0	0	0	0
Total Outstanding	0	0	0	0
Outstanding denominated in EURO	62 011	101 907	159 853	226 358
Outstanding denominated in domestic currency	0	0	0	0
Outstanding denominated in other currencies	0	0	0	0
Total Outstanding	62 011	101 907	159 853	226 358
Outstanding fixed bullet	61 921	100 417	153 588	212 878
Outstanding floating bullet	90	1 490	6 265	13 480
Outstanding others	0	0	0	0
Total Outstanding	62 011	101 907	159 853	226 358
Maturity of Bonds in years (Average at the end of each year)	7	8	8	8
Issuance (in mln euro)				
Total Covered Bonds Issuance				
New Issues of Covered Bonds backed by Public Sector	5 600	1 600	2 440	5 150
New Issues of Covered Bonds backed by Mortgages	28 502	37 835	57 780	69 890
New Issues of Covered Bonds backed by Ships	0	0	0	0
New Issues of Covered Bonds by Other Assets	0	0	0	0
Total Issuance	34 102	39 435	60 220	75 040
Issuance Jumbo	31 800	36 335	58 780	69 230
Issuance non-Jumbo	2 302	3 100	1 440	5 810
Total Issuance	34 102	39 435	60 220	75 040
Total Issuance Public Placement	0	0	0	0
Total Issuance Private Placement	0	0	0	0
Total Issuance	0	0	0	0
Issuance denominated in EURO	34 102	39 435	60 220	75 040
Issuance denominated in domestic currency	0	0	0	0
Issuance denominated in other currencies	0	0	0	0
Total issuance	34 102	39 435	60 220	75 040
Issuance fixed bullet	33 312	38 635	55 545	66 125
Issuance floating bullet	790	800	4 675	8 915
Issuance others	0	0	0	0
Total issuance	34 102	39 435	60 220	75 040
Maturity of bonds in years (Average at the issue date)	5	7	10	10

6.1.5 FRANCE

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding	86 949	105 766	124 773	154 602
Outstanding Covered Bonds backed by Public Sector	31 340	37 600	42 600	49 660
Outstanding Covered Bonds backed by Mortgage	21 079	26 816	32 133	43 012
Outstanding Covered Bonds backed by Ships	n/a	n/a	n/a	n/a
Outstanding of Covered Bonds by Mixed Assets	34 530	41 350	50 040	61 930
Total Outstanding	86 949	105 766	124 773	154 602
Outstanding Jumbo	64 757	75 307	80 132	102 577
Outstanding non-Jumbo	22192	30 459	44 641	52 025
Total Outstanding	86 949	105 766	124 773	154 602
Total Outstanding Public Placement	n/a	n/a	n/a	n/a
Total Outstanding Private Placement	n/a	n/a	n/a	n/a
Total Outstanding	86 949	105 766	124 773	154 602
Outstanding denominated in EURO (stated in mln EUR)	n/a	n/a	n/a	n/a
Outstanding denominated in other currencies (stated in mln EUR)	n/a	n/a	n/a	n/a
Total Outstanding	86 949	105 766	124 773	154 602
Outstanding fixed coupon	n/a	n/a	n/a	n/a
Outstanding floating coupon	n/a	n/a	n/a	n/a
Outstanding other	n/a	n/a	n/a	n/a
Total Outstanding	86 949	105 766	124 773	154 602
Maturity of Bonds	5,69	5,95	6,35	6,40
Issuance (in mln euro)				
Total Covered Bonds Issuance	22 281	25 487	28 617	42 034
New Issues of Covered Bonds backed by Public Sector	6 500	8 600	9 070	12 134
New Issues of Covered Bonds backed by Mortgage	6 181	5 737	6 397	12 637
New Issues of Covered Bonds backed by Ships	n/a	n/a	n/a	n/a
New Issues of Covered Bonds by Mixed Assets	9 600	11 150	13 150	17 263
Total Issuance	22 281	25 487	28 617	42 034
Issuance Jumbo	15 512	13 780	12 250	29 471
Issuance non-Jumbo	6 769	11 707	16 367	12 563
Total Issuance	22 281	25 487	28 617	42 034
Total Issuance Public Placement	17 492	16 611	16 963	32 437
Total Issuance Private Placement	4 660	8 877	11 654	9 597
Total Issuance	22 152	25 487	28 617	42 034
Issuance denominated in EURO (stated in mln EUR)	19 774	21 369	20 637	34 172
	n/a	n/a	n/a	n/a
Issuance denominated in other currencies (stated in mln EUR)	2 507	4 119	7 980	7 862
Total issuance	22 281	25 487	28 617	42 034
Issuance fixed coupon	n/a	n/a	n/a	n/a
Issuance floating coupon	n/a	n/a	n/a	n/a
Issuance other	n/a	n/a	n/a	n/a
Total issuance	22 281	25 487	28 617	42 034
Maturity of bonds	7,654078363	8,887989956	9,205437327	8,81

6.1.6 IRELAND

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public Sector	12 362	27 204	40 965	49 914
Outstanding Covered Bonds backed by Mortgage	0	2 000	4 000	11 900
Outstanding Covered Bonds backed by Ships	0	0	0	0
Outstanding of Covered Bonds by Mixed Assets	0	0	0	0
Total Outstanding	12 362	29 204	44 965	61 814
Outstanding Jumbo	11 490	25 418	32 467	39 417
Outstanding non-Jumbo	872	3 787	12 499	22 397
Total Outstanding	12 362	29 204	44 965	61 814
Total Outstanding Public Placement	11 999	27 278	35 050	43 557
Total Outstanding Private Placement	363	1 926	9 916	18 257
Total Outstanding	12 362	29 204	44 965	61 814
Outstanding denominated in EURO (stated in mln EUR)	10 881	26 696	37 312	52 800
Outstanding denominated in domestic currency (stated in mln EUR)	0	0	0	0
Outstanding denominated in other currencies (stated in mln EUR)	1 481	2 508	7 654	9 014
Total Outstanding	12 362	29 204	44 965	61 814
Outstanding fixed coupon	12 027	28 460	40 717	56 225
Outstanding floating coupon	335	631	1 955	2 635
Outstanding other	0	114	2 294	2 954
Total Outstanding	12 362	29 204	44 965	61 814
Simple Average Maturity of Bonds (years)	6	6	7	6
Issuance (in mln euro)				
Total Covered Bonds Issuance				
New Issues of Covered Bonds backed by Public Sector	12 362	15 047	13 576	9 722
New Issues of Covered Bonds backed by Mortgage	0	2 000	2 000	7 900
New Issues of Covered Bonds backed by Ships	0	0	0	0
New Issues of Covered Bonds by Mixed Assets	0	0	0	0
Total Issuance	12 362	17 047	15 576	17 622
Issuance Jumbo	11 490	14 000	6 907	12 259
Issuance non-Jumbo	872	3 047	8 669	5 363
Total Issuance	12 362	17 047	15 576	17 622
Total Issuance Public Placement	11 999	15 285	8 667	12 508
Total Issuance Private Placement	363	1 761	6 910	5 114
Total Issuance	12 362	17 047	15 576	17 622
Issuance denominated in EURO (stated in mln EUR)	10 881	15 816	10 593	15 182
Issuance denominated in domestic currency (stated in mln EUR)	0	0	0	0
Issuance denominated in other currencies (stated in mln EUR)	1 481	1 231	4 984	2 440
Total issuance	12 362	17 047	15 576	17 622
Issuance fixed coupon	12 027	16 467	12 103	15 937
Issuance floating coupon	335	466	1 305	848
Issuance other	0	114	2 167	837
Total issuance	12 362	17 047	15 576	17 622
Simple Average Maturity of bonds (years)	6	7	11	8

6.1.7 ITALY CDP

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public Sector	0	0	4 000	10 000
Outstanding Covered Bonds backed by Mortgage	0	0	0	0
Outstanding Covered Bonds backed by Ships	0	0	0	0
Outstanding of Covered Bonds by Mixed Assets	0	0	0	0
Total Outstanding	0	0	4 000	10 000
Outstanding Jumbo	0	0	4 000	9 500
Outstanding non-Jumbo	0	0	0	0
Total Outstanding	0	0	4 000	9 500
Total Outstanding Public Placement	0	0	4 000	9 500
Total Outstanding Private Placement	0	0	0	500
Total Outstanding	0	0	4 000	10 000
Outstanding denominated in EURO (stated in mln EUR)	0	0	4 000	10 000
Outstanding denominated in domestic currency	0	0	0	0
Outstanding denominated in other currencies (stated in mln EUR)	0	0	0	0
Total Outstanding	0	0	4 000	10 000
Outstanding fixed coupon	0	0	4 000	9 500
Outstanding floating coupon	0	0	0	0
Outstanding other	0	0	0	500
Total Outstanding	0	0	4 000	10 000
Maturity of Bonds	0	0	6	5
Issuance (in mln euro)				
Total Covered Bonds Issuance	0	0	4 000	6 000
New Issues of Covered Bonds backed by Public Sector	0	0	0	0
New Issues of Covered Bonds backed by Mortgage	0	0	0	0
New Issues of Covered Bonds backed by Ships	0	0	0	0
New Issues of Covered Bonds by Mixed Assets	0	0	0	0
Total Issuance	0	0	4 000	6 000
Issuance Jumbo	0	0	4 000	5 500
Issuance non-Jumbo	0	0	0	500
Total Issuance	0	0	4 000	6 000
Total Issuance Public Placement	0	0	4 000	5 500
Total Issuance Private Placement	0	0	0	500
Total Issuance	0	0	4 000	6 000
Issuance denominated in EURO (stated in mln EUR)	0	0	4 000	6 000
Issuance denominated in domestic currency	0	0	0	0
Issuance denominated in other currencies (stated in mln EUR)	0	0	0	0
Total issuance	0	0	4 000	6 000
Issuance fixed coupon	0	0	4 000	5 500
Issuance floating coupon	0	0	0	0
Issuance other	0	0	0	500
Total issuance	0	0	4 000	6 000
Maturity of bonds	0	0	6	7

6.1.8 LATVIA

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public Sector	0	0	0	0
Outstanding Covered Bonds backed by Mortgage	35	54	60	63
Outstanding Covered Bonds backed by Ships	0	0	0	0
Outstanding of Covered Bonds by Mixed Assets	0	0	0	0
Total Outstanding	35	54	60	63
Outstanding Jumbo	0	0	0	0
Outstanding non-Jumbo	0	0	0	0
Total Outstanding	0	0	0	0
Total Outstanding Public Placement	0	0	0	0
Total Outstanding Private Placement	0	0	0	0
Total Outstanding	0	0	0	0
Outstanding denominated in EURO (stated in mln EUR)	0	0	0	20
Outstanding denominated in domestic currency (stated in mln EUR)	35	36	38	34
Outstanding denominated in other currencies (stated in mln EUR)	0	18	21	8
Total Outstanding	35	54	60	63
Outstanding fixed coupon	26	27	26	21
Outstanding floating coupon	9	27	34	41
Outstanding other	0	0	0	0
Total Outstanding	35	54	60	63
Maturity of Bonds	5	5	4	3
Issuance (in mln euro)				
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 by Mixed Assets	0	0	0	0
Total Issuance	11	22	4	20
Issuance Jumbo	0	0	0	0
Issuance non-Jumbo	0	0	0	0
Total Issuance	0	0	0	0
Total Issuance Public Placement	0	0	0	0
Total Issuance Private Placement	0	0	0	0
Total Issuance	0	0	0	0
Issuance denominated in EURO (stated in mln EUR)	0	0	0	20
Issuance denominated in domestic currency (stated in mln EUR)	11	3	4	0
Issuance denominated in other currencies (stated in mln EUR)	0	18	0	0
Total issuance	11	22	4	20
Issuance fixed coupon	9	3	0	0
Issuance floating coupon	2	18	4	20
Issuance other	0	0	0	0
Total issuance	11	22	4	20
Maturity of bonds	6	8	5	5

6.1.9 LUXEMBOURG

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public Sector	16 870	19 627	24 968	28 360
Outstanding Covered Bonds backed by Mortgage	0	0	0	150
Outstanding Covered Bonds backed by Ships	0	0	0	0
Outstanding of Covered Bonds by Mixed Assets	0	0	0	0
Total Outstanding	16 870	19 627	24 968	28 510
Outstanding Jumbo	5 000	4 000	2 000	2 000
Outstanding non-Jumbo	11 870	15 627	22 968	26 510
Total Outstanding	16 870	19 627	24 968	28 510
Total Outstanding Public Placement	10 594	10 200	13 720	18 833
Total Outstanding Private Placement	2 696	5 112	5 534	9 677
Total Outstanding	13 290	15 312	19 254	28 510
Outstanding denominated in EURO (stated in mln EUR)	9 473	11 032	10 909	11 819
Outstanding denominated in domestic currency (stated in mln EUR)	0	0	0	0
Outstanding denominated in other currencies (stated in mln EUR)	7 397	8 595	14 059	16 191
Total Outstanding	16 870	19 627	24 968	28 510
Outstanding fixed coupon	9 231	9 221	15 427	19 077
Outstanding floating coupon	3 365	4 289	7 376	7 217
Outstanding other	694	1 802	7 879	2 216
Total Outstanding	13 290	15 312	30 682	28 510
Maturity of Bonds	4	8	11	n/a
Issuance (in mln euro)				
Total Covered Bonds Issuance				
New Issues of Covered Bonds backed by Public Sector	4 528	5 516	9 611	9 730
New Issues of Covered Bonds backed by Mortgage	0	0	0	150
New Issues of Covered Bonds backed by Ships	0	0	0	0
New Issues of Covered Bonds by Mixed Assets	0	0	0	0
Total Issuance	4 528	5 516	9 611	9 880
Issuance Jumbo	750	0	0	0
Issuance non-Jumbo	3 778	5 516	9 611	9 880
Total Issuance	4 528	5 516	9 611	9 880
Total Issuance Public Placement	3 197	1 670	6 749	6 798
Total Issuance Private Placement	1 331	2 646	783	3 082
Total Issuance	4 528	4 316	7 532	9 880
Issuance denominated in EURO (stated in mln EUR)	2 131	3 589	2 468	3 628
Issuance denominated in domestic currency (stated in mln EUR)	522	0	0	954
Issuance denominated in other currencies (stated in mln EUR)	1 875	1 927	7 143	5 298
Total issuance	4 528	5 516	9 611	9 880
Issuance fixed coupon	203	264	267	8 092
Issuance floating coupon	924	1 410	132	1 601
Issuance other	12	346	343	187
Total issuance	1 139	2 020	742	9 880
Maturity of bonds	4	13	21	n/a

6.1.10 HUNGARY

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public Sector	0	0	0	0
Outstanding Covered Bonds backed by Mortgage	3 622	4 962	5 072	5 924
Outstanding Covered Bonds backed by Ships	0	0	0	0
Outstanding of Covered Bonds by Mixed Assets	0	0	0	0
Total Outstanding	3 622	4 962	5 072	5 924
Outstanding Jumbo	0	0	0	0
Outstanding non-Jumbo	3 622	4 962	5 072	5 924
Total Outstanding	3 622	4 962	5 072	5 924
Total Outstanding Public Placement	2 178	3 192	3 382	4 188
Total Outstanding Private Placement	1 444	1 770	1 690	1 736
Total Outstanding	3 622	4 962	5 072	5 924
Outstanding denominated in EURO (stated in mln EUR)	0	350	540	1 547
Outstanding denominated in domestic currency (stated in mln EUR)	3 622	4 612	4 532	4 377
Outstanding denominated in other currencies (stated in mln EUR)	0	0	0	0
Total Outstanding	3 622	4 962	5 072	5 924
Outstanding fixed coupon	2 683	4 560	4 594	5 214
Outstanding floating coupon	297	316	397	635
Outstanding other	642	86	81	75
Total Outstanding	3 622	4 962	5 072	5 924
Maturity of Bonds	5	5	4	4
Issuance (in mln euro)				
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	2 924	2 388	808	1 418
New Issues of Covered Bonds backed by Ships	0	0	0	0
New Issues of Covered Bonds by Mixed Assets	0	0	0	0
Total Issuance	2 924	2 388	808	1 418
Issuance Jumbo	0	0	0	0
Issuance non-Jumbo	2 924	2 388	808	1 418
Total Issuance	2 924	2 388	808	1 418
Total Issuance Public Placement	2 113	2 016	618	1 412
Total Issuance Private Placement	811	372	190	6
Total Issuance	2 924	2 388	808	1 418
Issuance denominated in EURO (stated in mln EUR)	0	350	190	1 007
Issuance denominated in domestic currency (stated in mln EUR)	2 924	2 038	618	411
Issuance denominated in other currencies (stated in mln EUR)	0	0	0	0
Total issuance	2 924	2 388	808	1 418
Issuance fixed coupon	1 823	2 055	718	1 168
Issuance floating coupon	178	0	90	250
Issuance other	923	333	0	0
Total issuance	2 924	2 388	808	1 418
Maturity of bonds	5	5	4	3

6.1.11 THE NETHERLANDS

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public sector	0	0	0	0
Outstanding Covered Bonds backed by mortgage	0	0	2 000	7 500
Outstanding Covered Bonds backed by Ships	0	0	0	0
Outstanding of covered bonds by other assets	0	0	0	0
Total Outstanding	0	0	2 000	7 500
Outstanding Jumbo	0	0	2 000	5 500
Outstanding non-Jumbo	0	0	0	2 000
Total outstanding	0	0	2 000	7 500
Total outstanding Public placement	0	0	2 000	5 500
Total Outstanding Private placement	0	0	0	2 000
Total Outstanding	0	0	2 000	7 500
Outstanding denominated in EURO	0	0	2 000	6 400
Outstanding denominated in domestic currency	0	0	0	0
Outstanding denominated in other currencies	0	0	0	1 100
Total Outstanding	0	0	2 000	7 500
Outstanding fixed coupon	0	0	2 000	7 200
Outstanding floating coupon	0	0	0	0
Outstanding others	0	0	0	300
Total Outstanding	0	0	2 000	7 500
Maturity of bonds	0	0	0	0
Issuance (in mln euro)				
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	0	0	2 000	5 500
New Issues of Covered Bonds backed by Ships	0	0	0	0
New Issues of covered bonds by other assets	0	0	0	0
Total Issuance	0	0	2 000	5 500
Issuance Jumbo	0	0	2 000	3 500
Issuance non-Jumbo	0	0	0	2 000
Total Issuance	0	0	2 000	5 500
Total Issuance Public placement	0	0	2 000	3 500
Total Issuance Private placement	0	0	0	2 000
Total issuance	0	0	2 000	5 500
Issuance denominated in EURO	0	0	2 000	4 400
Issuance denominated in domestic currency	0	0	0	0
Issuance denominated in other currencies	0	0	0	1 100
Total issuance	0	0	2 000	5 500
Issuance fixed coupon	0	0	2 000	5 200
Issuance floating coupon	0	0	0	0
Issuance others	0	0	0	300
Total issuance	0	0	2 000	5 500
Maturity of bonds	0	0	0	0

6.1.12 AUSTRIA

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public Sector	6 750	n/a	12 720	13 680
Outstanding Covered Bonds backed by Mortgage	4 000	n/a	3 560	3 420
Outstanding Covered Bonds backed by Ships	n/a	n/a	n/a	n/a
Outstanding of Covered Bonds by Mixed Assets	n/a	n/a	n/a	n/a
Total Outstanding	10 750	n/a	16 280	17 100
Outstanding Jumbo	n/a	n/a	n/a	n/a
Outstanding non-Jumbo	n/a	n/a	n/a	n/a
Total Outstanding	n/a	n/a	n/a	n/a
Total Outstanding Public Placement	n/a	n/a	n/a	n/a
Total Outstanding Private Placement	n/a	n/a	n/a	n/a
Total Outstanding	n/a	n/a	n/a	n/a
Outstanding denominated in EURO (stated in mln EUR)	n/a	n/a	n/a	n/a
Outstanding denominated in domestic currency (stated in mln EUR)	n/a	n/a	n/a	n/a
Outstanding denominated in other currencies (stated in mln EUR)	n/a	n/a	n/a	n/a
Total Outstanding	n/a	n/a	n/a	n/a
Outstanding fixed coupon	n/a	n/a	n/a	n/a
Outstanding floating coupon	n/a	n/a	n/a	n/a
Outstanding other	n/a	n/a	n/a	n/a
Total Outstanding	n/a	n/a	n/a	n/a
Maturity of Bonds	n/a	n/a	n/a	n/a
Issuance (in mln euro)				
Total Covered Bonds Issuance				
New Issues of Covered Bonds backed by Public Sector	1 802	n/a	3 591	3 591
New Issues of Covered Bonds backed by Mortgage	1 029	n/a	214	n/a
New Issues of Covered Bonds backed by Ships	n/a	n/a	n/a	n/a
New Issues of Covered Bonds by Mixed Assets	n/a	n/a	n/a	n/a
Total Issuance	2 831	n/a	3 805	3 591
Issuance Jumbo	n/a	n/a	n/a	n/a
Issuance non-Jumbo	n/a	n/a	n/a	n/a
Total Issuance	n/a	n/a	n/a	n/a
Total Issuance Public Placement	n/a	n/a	n/a	n/a
Total Issuance Private Placement	n/a	n/a	n/a	n/a
Total Issuance	n/a	n/a	n/a	n/a
Issuance denominated in EURO (stated in mln EUR)	n/a	n/a	n/a	n/a
Issuance denominated in domestic currency (stated in mln EUR)	n/a	n/a	n/a	n/a
Issuance denominated in other currencies (stated in mln EUR)	n/a	n/a	n/a	n/a
Total issuance	n/a	n/a	n/a	n/a
Issuance fixed coupon	n/a	n/a	n/a	n/a
Issuance floating coupon	n/a	n/a	n/a	n/a
Issuance other	n/a	n/a	n/a	n/a
Total issuance	n/a	n/a	n/a	n/a
Maturity of bonds	n/a	n/a	n/a	n/a

Note: In Austria, the figures are tentative.

6.1.13 POLAND

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public Sector	0	0	0	0
Outstanding Covered Bonds backed by Mortgage	160	220	558	453
Outstanding Covered Bonds backed by Ships	0	0	0	0
Outstanding of Covered Bonds by Mixed Assets	0	0	0	0
Total Outstanding	160	220	558	453
Outstanding Jumbo	0	0	0	0
Outstanding non-Jumbo	160	220	558	453
Total Outstanding	160	220	558	453
Total Outstanding Public Placement	91	91	265	339
Total Outstanding Private Placement	69	129	293	114
Total Outstanding	160	220	558	453
Outstanding denominated in EURO (stated in mln EUR)	37	62	62	62
Outstanding denominated in domestic currency (stated in mln EUR)	111	115	440	357
Outstanding denominated in other currencies (stated in mln EUR)	11	43	56	34
Total Outstanding	160	220	558	453
Outstanding fixed coupon	4	4	4	4
Outstanding floating coupon	156	216	554	450
Outstanding other	0	0	0	0
Total Outstanding	160	220	558	453
Maturity of Bonds	6	5	5	5
Issuance (in mln euro)				
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	123	63	224	52
New Issues of Covered Bonds backed by Ships	0	0	0	0
New Issues of Covered Bonds by Mixed Assets	0	0	0	0
Total Issuance	123	63	224	52
Issuance Jumbo	0	0	0	0
Issuance non-Jumbo	123	63	224	52
Total Issuance	123	63	224	52
Total Issuance Public Placement	91	0	174	52
Total Issuance Private Placement	32	63	50	0
Total Issuance	123	63	224	52
Issuance denominated in EURO (stated in mln EUR)	23	25	0	0
Issuance denominated in domestic currency (stated in mln EUR)	100	7	211	52
Issuance denominated in other currencies (stated in mln EUR)	0	31	12	0
Total issuance	123	63	223	52
Issuance fixed coupon	0	0	0	0
Issuance floating coupon	123	63	224	52
Issuance other	0	0	0	0
Total issuance	123	63	224	52
Maturity of bonds	5	5	5	5

6.1.14 PORTUGAL

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public Sector				
Outstanding Covered Bonds backed by Mortgage				2 000
Outstanding Covered Bonds backed by Ships				
Outstanding of Covered Bonds by Mixed Assets				
Total Outstanding				2 000
Outstanding Jumbo				2 000
Outstanding non-Jumbo				
Total Outstanding				2 000
Total Outstanding Public Placement				2 000
Total Outstanding Private Placement				
Total Outstanding				2 000
Outstanding denominated in EURO (stated in mln EUR)				2 000
Outstanding denominated in domestic currency (stated in mln EUR)				
Outstanding denominated in other currencies (stated in mln EUR)				
Total Outstanding				2 000
Outstanding fixed coupon				2 000
Outstanding floating coupon				
Outstanding other				
Total Outstanding				2 000
Maturity of Bonds				10
Issuance (in mln euro)				
Total Covered Bonds Issuance				
New Issues of Covered Bonds backed by Public Sector				
New Issues of Covered Bonds backed by Mortgage				2 000
New Issues of Covered Bonds backed by Ships				
New Issues of Covered Bonds by Mixed Assets				
Total Issuance				2 000
Issuance Jumbo				2 000
Issuance non-Jumbo				
Total Issuance				2 000
Total Issuance Public Placement				2 000
Total Issuance Private Placement				
Total Issuance				2 000
Issuance denominated in EURO (stated in mln EUR)				2 000
Issuance denominated in domestic currency (stated in mln EUR)				
Issuance denominated in other currencies (stated in mln EUR)				
Total issuance				2 000
Issuance fixed coupon				2 000
Issuance floating coupon				
Issuance other				
Total issuance				2 000
Maturity of bonds				10

6.1.15 SLOVAK REPUBLIC

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public Sector	0	0	0	0
Outstanding Covered Bonds backed by Mortgage	370	792	1 235	1 861
Outstanding Covered Bonds backed by Ships	0	0	0	0
Outstanding of Covered Bonds by Mixed Assets	0	0	0	0
Total Outstanding (	370	792	1 235	1 861
Outstanding Jumbo	0	0	0	0
Outstanding non-Jumbo	370	792	1 235	1 861
Total Outstanding	370	792	1 235	1 861
Total Outstanding Public Placement	n/a	n/a	n/a	n/a
Total Outstanding Private Placement	n/a	n/a	n/a	n/a
Total Outstanding	370	792	1 235	1 861
Outstanding denominated in EURO (stated in mln EUR)+	0	0	0	310
Outstanding denominated in domestic currency (stated in mln EUR)	370	792	1 235	1 551
Outstanding denominated in other currencies (stated in mln EUR)	0	0	0	0
Total Outstanding	370	792	1 235	1 861
Outstanding fixed coupon	370	32	1 224	1 860
Outstanding floating coupon	0	0	11	1
Outstanding other	0	0	0	0
Total Outstanding	370	792	1 235	1 861
Maturity of Bonds	7.29	4.80	5.70	4.06
Issuance (in mln 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	258	414	455	617
New Issues of Covered Bonds backed by Ships	0	0	0	0
New Issues of Covered Bonds by Mixed Assets	0	0	0	0
Total Issuance	258	414	455	617
Issuance Jumbo	0	0	0	0
Issuance non-Jumbo	258	414	455	617
Total Issuance	258	414	455	595
Total Issuance Public Placement	n/a	n/a	n/a	n/a
Total Issuance Private Placement	n/a	n/a	n/a	n/a
Total Issuance	258	414	455	617
Issuance denominated in EUR (stated in mln EUR)	0	0	0	310
Issuance denominated in domestic currency (stated in mln EUR)	258	414	455	307
Issuance denominated in other currencies (stated in mln EUR)	0	0	0	0
Total issuance	258	414	455	617
Issuance fixed coupon	258	414	444	597
Issuance floating coupon	0	0	11	20
Issuance other	0	0	0	0
Total issuance	258	0	11	20
Maturity of bonds	n/a	n/a	n/a	n/a

6.1.16 FINLAND

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public sector	0	0	0	0
Outstanding Covered Bonds backed by mortgage	0	250	1 500	3 000
Outstanding Covered Bonds backed by Ships	0	0	0	0
Outstanding of covered bonds by other assets	0	0	0	0
Total Outstanding	0	250	1 500	3 000
Outstanding Jumbo	0	0	1 000	2 000
Outstanding non-Jumbo	0	250	500	1 000
Total outstanding	0	250	1 500	3 000
Total outstanding Public placement	0	0	1 000	2 000
Total Outstanding Private placement	0	250	500	1 000
Total Outstanding	0	250	1 500	3 000
Outstanding denominated in EURO	0	250	1 500	3 000
Outstanding denominated in domestic currency	0	0	0	0
Outstanding denominated in other currencies	0	0	0	0
Total Outstanding	0	250	1 500	3 000
Outstanding fixed coupon	0	0	1 000	2 250
Outstanding floating coupon	0	250	500	750
Outstanding others	0	0	0	0
Total Outstanding	0	250	1 500	3 000
Maturity of bonds	0	0	0	0
Issuance (in mln euro)				
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	0	250	1 250	1 500
New Issues of Covered Bonds backed by Ships	0	0	0	0
New Issues of covered bonds by other assets	0	0	0	0
Total Issuance	0	250	1 250	1 500
Issuance Jumbo	0	0	1 000	1 000
Issuance non-Jumbo	0	250	250	500
Total Issuance	0	250	1 250	1 500
Total Issuance Public placement	0	0	1 000	1 000
Total Issuance Private placement	0	250	250	500
Total issuance	0	250	1 250	1 500
Issuance denominated in EURO	0	250	1 250	1 500
Issuance denominated in domestic currency	0	0	0	0
Issuance denominated in other currencies	0	0	0	0
Total issuance	0	250	1 250	1 500
Issuance fixed coupon	0	0	1 000	1 250
Issuance floating coupon	0	250	250	250
Issuance others	0	0	0	0
Total issuance	0	250	1 250	1 500
Maturity of bonds	0	0	0	0

6.1.17 SWEDEN

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public Sector	0	0	0	0
Outstanding Covered Bonds backed by Mortgage	0	0	0	55 208
Outstanding Covered Bonds backed by Ships	0	0	0	0
Outstanding of Covered Bonds by Mixed Assets	0	0	0	0
Total Outstanding	0	0	0	55 208
Outstanding Jumbo	0	0	0	5 277
Outstanding non-Jumbo	0	0	0	49 931
Total Outstanding	0	0	0	55 208
Total Outstanding Public Placement	0	0	0	54 723
Total Outstanding Private Placement	0	0	0	486
Total Outstanding	0	0	0	55 208
Outstanding denominated in EURO (stated in mln EUR)	0	0	0	5 277
Outstanding denominated in domestic currency (stated in mln EUR)	0	0	0	49 421
Outstanding denominated in other currencies (stated in mln EUR)	0	0	0	510
Total Outstanding	0	0	0	55 208
Outstanding fixed coupon	0	0	0	54 970
Outstanding floating coupon	0	0	0	21
Outstanding other	0	0	0	217
Total Outstanding	0	0	0	55 208
Maturity of Bonds	0	0	0	2,8
Issuance (in mln euro)				
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	0	0	0	17 550
New Issues of Covered Bonds backed by Ships	0	0	0	0
New Issues of Covered Bonds by Mixed Assets	0	0	0	0
Total Issuance	0	0	0	17 550
Issuance Jumbo	0	0	0	5 277
Issuance non-Jumbo	0	0	0	12 273
Total Issuance	0	0	0	17 550
Total Issuance Public Placement	0	0	0	17 463
Total Issuance Private Placement	0	0	0	87
Total Issuance	0	0	0	17 550
Issuance denominated in EURO (stated in mln EUR)	0	0	0	5 277
Issuance denominated in domestic currency (stated in mln EUR)	0	0	0	11 781
Issuance denominated in other currencies (stated in mln EUR)	0	0	0	491
Total issuance	0	0	0	17 550
Issuance fixed coupon	0	0	0	17 541
Issuance floating coupon	0	0	0	2
Issuance other	0	0	0	7
Total issuance	0	0	0	17 550
Maturity of bonds	0	0	0	4,1

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 (outstanding volume at the end of 2005: 92,8 bn Euro) 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 have also been converted into covered bonds in 2006. The figures include both the converted bonds and the new bonds issued during the year.

6.1.18 U.K.

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public sector	0	0	0	0
Outstanding Covered Bonds backed by mortgage	5 000	14 987	26 776	50 594
Outstanding Covered Bonds backed by Ships	0	0	0	0
Outstanding of covered bonds by other assets	0	0	0	0
Total Outstanding	5 000	14 987	26 776	50 594
Outstanding Jumbo	5 000	14 250	23 250	43 750
Outstanding non-Jumbo		737	3 526	6 844
Total outstanding	5 000	14 987	26 776	50 594
Total outstanding Public placement	5 000	14 250	23 250	43 750
Total Outstanding Private placement		737	3 526	6 844
Total Outstanding	5 000	14 987	26 776	50 594
Outstanding denominated in EURO	5 000	14 250	24 380	44 880
Outstanding denominated in domestic currency	0	737	2 340	3 080
Outstanding denominated in other currencies	0	0	56	2 634
Total Outstanding	5 000	14 987	26 776	50 594
Outstanding fixed coupon	5 000	14 250	23 250	43 750
Outstanding floating coupon	0	0	3 526	6 844
Outstanding other	0	0	0	0
Total Outstanding	5 000	14 250	26 776	50 594
Maturity of bonds	n/a	n/a	n/a	n/a
Issuance (in mln euro)				
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	5 000	9 987	11 795	23 812
New Issues of Covered Bonds backed by Ships	0	0	0	0
New Issues of covered bonds by other assets				
Total Issuance	5 000	9 987	11 795	23 812
Issuance Jumbo	5 000	9 250	9 000	22 093
Issuance non-Jumbo	0	737	2 795	1 719
Total Issuance	5 000	9 987	11 795	23 812
Total Issuance Public placement	5 000	9 250	9 000	20 500
Total Issuance Private placement		737	2 795	3 312
Total issuance	5 000	9 987	11 795	23 812
Issuance denominated in EURO	5 000	9 250	10 130	20 500
Issuance denominated in domestic currency	0	737	1 609	733
Issuance denominated in other currencies	0	0	56	2 579
Total issuance	5 000	9 987	11 795	23 812
Issuance fixed coupon	5 000	9 987	9 297	22 219
Issuance floating coupon	0	0	2 498	1 593
Issuance others	0	0	0	0
Total issuance	5 000	9 987	11 795	23 812
Maturity of bonds	n/a	n/a	n/a	n/a

6.1.19 SWITZERLAND

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public Sector	0	0	0	0
Outstanding Covered Bonds backed by Mortgage	20 735	20 606	21 670	23 096
Outstanding Covered Bonds backed by Ships	0	0	0	0
Outstanding of Covered Bonds by Mixed Assets	0	0	0	0
Total Outstanding	20 735	20 606	21 670	23 096
Outstanding Jumbo	0	0	0	0
Outstanding non-Jumbo	20 735	20 606	21 670	23 096
Total Outstanding	20 735	20 606	21 670	23 096
Total Outstanding Public Placement	20 735	20 606	21 670	23 096
Total Outstanding Private Placement	0	0	0	0
Total Outstanding	20 735	20 606	21 670	23 096
Outstanding denominated in EURO (stated in mln EUR)				
Outstanding denominated in domestic currency (stated in mln EUR)	Only denominated in Swiss Francs			
Outstanding denominated in other currencies (stated in mln EUR)				
Total Outstanding				
Outstanding fixed coupon	20 735	20 606	21 670	23 096
Outstanding floating coupon	0	0	0	0
Outstanding other	0	0	0	0
Total Outstanding	20 735	20 606	21 670	23 096
Maturity of Bonds	n/a	n/a	n/a	n/a
Issuance (in mln euro)				
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	3 661	3 061	3 212	4 093
New Issues of Covered Bonds backed by Ships	0	0	0	0
New Issues of Covered Bonds by Mixed Assets	0	0	0	0
Total Issuance	3 661	3 061	3 212	4 093
Issuance Jumbo	0	0	0	0
Issuance non-Jumbo	3 661	3 061	3 212	4 093
Total Issuance	3 661	3 061	3 212	4 093
Total Issuance Public Placement	3 661	3 061	3 212	4 093
Total Issuance Private Placement	0	0	0	0
Total Issuance	3 661	3 061	3 212	4 093
Issuance denominated in EURO (stated in mln EUR)				
Issuance denominated in domestic currency (stated in mln EUR)	only denominated in Swiss Francs			
Issuance denominated in other currencies (stated in mln EUR)				
Total issuance				
Issuance fixed coupon	3 661	3 061	3 212	4 093
Issuance floating coupon	0	0	0	0
Issuance other	0	0	0	0
Total issuance	3 661	3 061	3 212	4 093
Maturity of bonds	n/a	n/a	n/a	n/a

6.1.20 USA

Outstanding (in mln EUR)	2003	2004	2005	2006
Total Covered Bonds Outstanding				
Outstanding Covered Bonds backed by Public Sector	0	0	0	0
Outstanding Covered Bonds backed by Mortgage	0	0	0	4 000
Outstanding Covered Bonds backed by Ships	0	0	0	0
Outstanding of Covered Bonds by Mixed Assets	0	0	0	0
Total Outstanding	0	0	0	4 000
Outstanding Jumbo	0	0	0	4 000
Outstanding non-Jumbo	0	0	0	0
Total Outstanding	0	0	0	4 000
Total Outstanding Public Placement	0	0	0	4 000
Total Outstanding Private Placement	0	0	0	0
Total Outstanding	0	0	0	4 000
Outstanding denominated in EURO (stated in mln EUR)	0	0	0	4 000
Outstanding denominated domestic currency	0	0	0	0
Outstanding denominated in other currencies (stated in mln EUR)	0	0	0	0
Total Outstanding	0	0	0	4 000
Outstanding fixed coupon	0	0	0	0
Outstanding floating coupon	0	0	0	0
Outstanding other	0	0	0	0
Total Outstanding	0	0	0	0
Maturity of Bonds	0	0	0	n/a
Issuance (in mln euro)				
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	0	0	0	4 000
New Issues of Covered Bonds backed by Ships	0	0	0	0
New Issues of Covered Bonds by Mixed Assets	0	0	0	0
Total Issuance	0	0	0	4 000
Issuance Jumbo	0	0	0	4 000
Issuance non-Jumbo	0	0	0	0
Total Issuance	0	0	0	4 000
Total Issuance Public Placement	0	0	0	0
Total Issuance Private Placement	0	0	0	0
Total Issuance	0	0	0	4 000
Issuance denominated in EURO (stated in mln EUR)	0	0	0	4 000
Issuance denominated in domestic currency	0	0	0	0
Issuance denominated in other currencies (stated in mln EUR)	0	0	0	0
Total issuance	0	0	0	4 000
Issuance fixed coupon	0	0	0	0
Issuance floating coupon	0	0	0	0
Issuance other	0	0	0	0
Total issuance	0	0	0	0
Maturity of bonds	0	0	0	n/a

			Denmark		Germany			France		Ireland		Italy		Latvia	Luxembourg	
Questions:	Reference in original questionnaire	Instrument	Realkredit-obligationer	Ship Cove-red Bonds	Offentliche Pfandbriefe	Hypotheken -Pfandbriefe	Schiffs-Pfandbriefe	Caisse de Refinan-cement de l'Habitat	Obligations Foncières	Public Asset Covered Securities	Mortgage Asset Covered Securities	Cassa Depositi e Prestiti	General framework (Law 130/99)	Covered Bonds	Lettres de Gage publiques	Lettres de Gage hypoth.
I. STRUCTURE OF THE ISSUER																
I.1.	I.1	Who is the issuer?														
		Universal credit institution											X	X		
		Universal credit institution with a special license			X	X	X									
		Specialized credit institution	X	X				X	X	X	X				X	X
		Specialized financial institution										X				
		Other														
I.2	rephrasing of 1.3a and I.3b	Where are the cover assets located? (accounting treatment)														
		directly on B/S of the issuer	X	X	X	X	X		X	X	X	X		X	X	X
		in subsidiary, consolidated with B/S of the issuer														
		off-B/S						X					X			
II. FRAMEWORK																
II.1.	Rephrasing of II.1	What governs covered bond issuance?														
		Specific covered bond legislation	X	X	X	X	X	X	X	X	X		X	X		
		Contractual arrangements										X				
II.2	Rephrasing of II.1	What is the legal framework for bankruptcy of the issuer for covered bonds?														
		General insolvency law												X		
		Specific legal framework superseding the general insolvency law	X	X	X	X	X	X	X	X	X	X	X		X	X
III. COVER ASSETS																
III.1	III.1	What types of assets may be included in the cover pool (tick one or more boxes) ?														
		Exposures to public sector entities	X		X				X	X		X	X	X	X	
		Exposures to credit institutions	X		X					X	X			X	X	X
		Mortgage loans	X			X		X	X		X		X	X		X
		Senior MBS issued by securitisation entities							X		X		X			
		Ship loans		X			X									
III.2	III.2a	What is the geographical scope for public sector assets (tick one or more boxes)?														
		Domestic	X		X					X				X	X	
		Multilateral development banks			X				X	X					X	
		EEA	X		X				X	X		X	X		X	
		CH, USA, Canada, Japan	X		X					X NZ, AUS					X	
		OECD	X												X	
		Worldwide														
III.3	III.2a	What is the geographical scope for mortgage assets (tick one or more boxes)?														
		Domestic	X			X		X			X			X		X
		EEA	X			X		X	X		X		X	X		X
		CH, USA, Canada, Japan	(X)			X			X		X NZ, AUS					X
		OECD	(X)													X
		Worldwide	(X)	X			X									X
III.4	III.3a	Is the use of derivatives permitted in the cover pool?														
		Yes	X	X	X	X	X		X	X	X	X	X	X	X	X
		No														
III.5	III.6 (slightly rephrased)	Are there regular covered bond specific disclosure requirements to the public?														
		Yes, by law			X	X	X	X	X	X	X		X	X	X	X
		Yes, by contract										X				
		Yes, by voluntary disclosure	X	X						X	X	X				
		No														
IV. VALUATION OF THE MORTGAGE COVER POOL & LTV CRITERIA																
IV.1	IV.1a	Are there legal provisions for property valuation?														
		Yes	X	X		X	X	X	X		X		X	X		X
		No														
IV.2	IV1b	What is the basis for property valuation?														
		mortgage lending value	X			X	X		X							X
		market value		X							X			X		
		other											X			

Hungary	Netherlands	Austria				Poland		Portugal		Finland		Sweden	United Kingdom	Ukraine	Switzerland	Romania	United States
Mortgage Bonds («Jelzáloglevél»)	ABN AMRO Covered Bonds	Public Pfandbriefe	Mortgage Pfandbriefe	Public sector backed secured bank bonds (Fundierte)	Mortgage backed secured bank bonds (Fundierte)	publiczne listy zastawne (public covered bonds)	hipoteczne listy zastawne (mortgage covered bonds)	Obrigações sobre o sector público	Obrigações hipotecárias	Public covered bonds	Mortgage covered bonds	Covered Bonds	UK Covered Bonds	Covered Bonds	Pfandbriefe (Mortgage only)	Covered Bonds	Covered Bonds
	X	X	X	X	X			X	X				X	X		X	
												X					
X						X	X	X	X	X	X				X	X	
													X	X			X
X	X	X	X	X	X	X	X	X	X	X	X	X		X		X	X
								X	X				X				
															X		
X		X	X	X	X	X	X	X	X	X	X	X		X	X	X	
	X												X				X
	X												X				X
X		X	X	X	X	X	X	X	X	X	X	X		X	X	X	
	X	X		X		X		X	X	X	X	X					
	X	X	X	X	X			X	X	X	X	X	X				X
X	X		X		X		X	X	X		X	X	X	X	X	X	X
	X				(X)								X				X
										X		X			X		
		X		X				X	X	X							
		CH		CH													
						X						X					
	X						X				X	X	X	X	X		
X			X		X			X	X		X	X					
			CH		CH												
																X	
	X																
X	X	X	X	X	X	X	X	X	X	X	X	X	X	X			X
															X		
X						X	X							X	X	X	
	X							X	X	X	X	X	X				X
		X	X	X	X												
X		X	X	X	X		X	X	X		X	X		X	X	X	
	X												X				X
v		X	X	X	X		X								X		
								X	X		X	X	X	X			X
	X																

Questions:	Reference in original questionnaire	Instrument	Denmark		Germany			France		Ireland		Italy		Latvia	Luxembourg	
			Realkredit-obligationer	Ship Cove-red Bonds	Öffentliche Pfandbriefe	Hypotheken -Pfandbriefe	Schiffs-Pfandbriefe	Caisse de Refinan-cement de l'Habitat	Obligations Foncières	Public Asset Covered Securities	Mortgage Asset Covered Securities	Cassa Depositi e Prestiti	General framework (Law 130/99)	Covered Bonds	Lettres de Gage publiques	Lettres de Gage hypoth.
IV.3.	IV.3	What are the LTV limits (single asset based)?														
		Residential	80%			60%		80%	80%		75%		80%	75%	n/a	60%
		Commercial	60%			60%			60%		60%		60%	60%	n/a	60%
		Agricultural	70%			60%								60%	n/a	60%
		Ships		70%			60%							60%	n/a	n/a
IV.4	extension of IV.3	Is there any additional LTV limit on a portfolio basis?														
		yes						X			X				n/a	X
		no	X	X		X	X		X				X	X	n/a	
IV.5	extension of IV.3	Are loans in excess of LTV limits eligible for inclusion in the cover pool?														
		yes		X		X	X	X	X		X				n/a	X
		no	X											X	n/a	
V. ASSET-LIABILITY GUIDELINES																
V.1	V.1-3	Are there risk mitigating provisions for:														
		a) Interest rate risk(s):														
		By legislation/regulation	X	X	X	X	X	X	X	X	X		X		X	X
		By contractual obligation										X				
		By published voluntary commitments												X		
		Other														
		No														
		b) Foreign exchange risk(s):														
		By legislation/regulation	X	X	X	X	X		X	X	X			X	X	X
		By contractual obligation										X				
		By published voluntary commitments														
		Other														
		No											X			
		c) Maturity mismatch risk(s):														
		By legislation/regulation	X	X				X	X	X	X		X	X		
		By contractual obligation										X				
		By published voluntary commitments														
		Other														
		No			X	X	X								X	X
V.2	V.5a	Is mandatory overcollateralisation required?														
		By legislation/regulation	X	X	X	X	X	X	X	X	X		X	X		
		By contractual obligation								X	X	X				
		By published voluntary commitments													X	X
		Other														
VI. COVER POOL MONITOR & BANKING SUPERVISION																
VI.1.	VI.1	Is there a cover pool monitor independent from the issuer?														
		Yes, individual appointed/approved by the regulator			X	X	X		X	X	X				X	X
		Yes, by regulatory authority												X		
		other						X				X	X			
		No	X	X												
VI.2	VI.5b	Is there a special banking supervision according to UCITS 22(4)?														
		Yes	X	X	X	X	X	X	X	X	X			X	X	X
		No										X	X			
VII. SEGREGATION OF ASSETS & BANKRUPTCY REMOTENESS																
VII.1	Summary of ques-tions VII.1a to VII.1c	What is the cover pool?														
		All the B/S assets							X							
		Qualifying assets											X			
		assets registered in the cover register	X	X	X	X	X	X		X	X	X		X	X	X
VII.2	VIII.3a	Do covered bonds accelerate, when the issuer goes insolvent?														
		yes, automatically by law														
		no	X	X	X	X	X	X	X	X	X	X	X	X	X	X

Hungary	Netherlands	Austria				Poland		Portugal		Finland		Sweden	United Kingdom	Ukraine	Switzerland	Romania	United States
Mortgage Bonds («Jelzáloglevél»)	ABN AMRO Covered Bonds	Public Pfandbriefe	Mortgage Pfandbriefe	Public sector backed secured bank bonds (Fundierte)	Mortgage backed secured bank bonds (Fundierte)	publiczne listy zastawne (public covered bonds)	hipoteczne listy zastawne (mortgage covered bonds)	Obrigações sobre o sector público	Obrigações hipotecárias	Public covered bonds	Mortgage covered bonds	Covered Bonds	UK Covered Bonds	Covered Bonds	Pfandbriefe (Mortgage only)	Covered Bonds	Covered Bonds
70%	125% (LTFV)		60%				60%	N.A.	80%		60%	75	60%-75%	75%	X	80%	75%
60%			60%				60%	N.A.	60%		60%	60		60%	X	70%	
60%			60%				60%					70		60%	X		
												N/A					
X							X										
	X		X		X			X	X		X	X	X	X	X	X	X
	X		X		X		X						X				X (but LTV haircut in ACT)
X								X	X		X	X		X	X	X	
X		X	X			X	X	X	X		X	X					
	X										X		X	X			X
				X	X												
															X	X	
X		X	X			X	X	X	X		X	X					
	X			X									X	X			X
															X	X	
X		X	X			X	X	X	X	X	X	X		X			
				X						X	X		X			X	X
	X																
															X		
		X	X				X		X			X		X (10%)		X	
											X		X		X		X
X																	
X		X	X	X	X	X	X	X	X			X				X	
										X	X				X		
	X							X	X				X	X			X
X		X	X	X	X	X	X	X	X	X	X	X		X		X	
	X												X (2007)		X		X
	X	X	X	X	X								X				X
X						X	X	X	X	X	X	X		X	X	X	
																X	
X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X		X

Questions:	Reference in original questionnaire	Instrument	Denmark		Germany			France		Ireland		Italy		Latvia	Luxembourg	
			Realkredit-obligationer	Ship Cove-red Bonds	Offentliche Pfandbriefe	Hypotheken -Pfandbriefe	Schiffs-Pfandbriefe	Caisse de Refinan-cement de l'Habitat	Obligations Foncières	Public Asset Covered Securities	Mortgage Asset Covered Securities	Cassa Depositi e Prestiti	General framework (Law 130/99)	Covered Bonds	Lettres de Gage publiques	Lettres de Gage hypoth.
VII.3	Summary of ques-tions under VII.2	How are the covered bondholders protected against claims from the other creditors in case of insolvency of the issuer?														
		Segregation from the general insolvency estate by law	X	X	X	X	X			X	X	X	X	X	X	X
		Segregation from the general insolvency estate by contract														
		Preferential claim within the general insolvency procedure						X	X							
		Specific cover pool administration			X	X	X					X		X	X	X
		(countries can tick one or more boxes)														
VII.4	VII.3c	Is there recourse to the issuer's insolvency estate upon a cover pool default?														
		yes, senior to unsecured creditors	X	X				X								
		yes, pari passu with unsecured creditors			X	X	X			X	X		X	X	X	X
		no recourse										X				
		not relevant							X							
VII.5	VII.3b	Are there provisions that require derivatives to continue in case of insolvency of the issuer?														
		Yes			X	X	X		X	X	X	X		X	X	X
		No	X	X									X			
VII.6	VII.3b	If derivatives are permitted in the cover pool, what is their ranking?														
		pari passu to coveredbond holders		X	X	X	X		X	X	X		X	X	X	X
		subordinated to coveredbond holders	X									X				
		Not applicable														
VIII. RISK WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION																
VIII.1	VIII.2	Does the cover bond fulfill the criteria of UCITS 22(4)?														
		Yes	X	X	X	X	X	X	X	X	X		X	X	X	X
		No										X				
		Not applicable														
VIII.2	VIII.3	Does the covered bond legislation completely fall within the criteria of Annex VI, Part 1, Paragraph 68 (a) to (f) of the Capital Requirements Direc-tive (CRD) 2006/48/EC ?														
		Yes			X	X	X	X		X	X		X	X	X	X
		No														
		No, but there are currently proposals to amend the legislation	X	X					X							
		Not applicable										X				
VIII.3	VIII.4	Are listed covered bonds eligible in repo transac-tions with the national central bank?														
		Yes	X	X	X	X	X	X	X	X	X	X	X	X	X	X
		No														
VIII.4	VIII.5	Are there any special investment regulations regarding covered bonds?														
		Yes	X	X	X	X	X	X	X					X	X	X
		No								X	X	X	X			

Hungary	Netherlands	Austria				Poland		Portugal		Finland		Sweden	United Kingdom	Ukraine	Switzerland	Romania	United States
Mor-tgage Bonds («Jelzáloglevél»)	ABN AMRO Covered Bonds	Public Pfandbriefe	Mortgage Pfandbriefe	Public sector backed secured bank bonds (Fundierte)	Mortgage backed secured bank bonds (Fundierte)	publiczne listy zastawne (public covered bonds)	hipoteczne listy zastawne (mortgage covered bonds)	Obrigações sobre o sector público	Obrigações hipotecárias	Public covered bonds	Mortgage covered bonds	Covered Bonds	UK Covered Bonds	Covered Bonds	Pfandbriefe (Mortgage only)	Covered Bonds	Covered Bonds
X		X	X	X	X	X	X	X	X	X	X	X		X	X	X	
	X												X				X
												X					
						X	X			X	X			X		X	
X	X	X	X	X	X	X	X	X	X	X	X	X	X	X		X	X
															X		
X								X	X	X	X	X	X				X
	X	X	X	X	X	X	X							X	X	X	
X		X	X	X	X			X	X			X					
										X	X		X	X			X
															X	X	
															Switzerland is not a EU member		
X		X	X	X	X	X	X	X	X	X	X	X				X	
	X												X (2007)				
														X	X		X
															Switzerland is not a EU member		
X		X	X	X	X	X	X	X	X	X	X	X					
	X												X (2007)			X	
														X	X		X
X	X	X	X	X	X			X	X	X	X	X			X		
						X	X						X	X		X	X (but €-denom. CBs are eligible for repo with the ECB)
	X	X	X	X	X	X	X	X	X	X	X	X				X	
X													X	X	X		X